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# Texts Submitted for the International Symposium on Fiscal Imbalance

Report

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## GENERAL INTRODUCTION

### 1. INTRODUCTION

The Commission on Fiscal Imbalance, set up by the Québec government, planned to hold an international symposium on September 13 and 14, 2001 at which a number of experts were to describe intergovernmental fiscal arrangements in various countries, namely four established federations (United States, Germany, Switzerland and Australia), one recent federation (Belgium), one country whose institutions are similar to those of a federal country (Spain) and three non-federal countries that nonetheless have a multilevel government structure<sup>1</sup> (France, the United Kingdom and Italy). This selection of countries provides a fairly complete portrait of the existing situation in developed countries with federal systems<sup>2</sup> and in a few non-federal countries with societies similar to ours. Mr. Robert Ebel of the World Bank Institute was to provide an overview of the situation around the world, more particularly in developing countries and countries in transition to a market economy.

Unfortunately, the tragic events of September 11 in New York forced the cancellation of the symposium. Almost all the speakers had sent a text they intended to use for their presentation during the symposium.<sup>3</sup> In addition, the Commission had already conducted a study of the fiscal arrangements in six countries that were to be analyzed at the event. This work is summarized in a document entitled *Intergovernmental Fiscal Arrangements: Germany, Australia, Belgium, Spain, United States, Switzerland*.

This general introduction summarizes the speakers' papers, an exercise that involves definite limits and difficulties. First of all, the symposium was not held. Next, federations are complex entities whose specific features cannot easily be isolated for comparison purposes. A specific degree of fiscal decentralization<sup>4</sup> may prove excessive in a federation whose people have very similar preferences, while it may prove insufficient for a federation with sharp regional differences. Lastly, a summary seeking to bring elements present in all the texts would be doomed to failure. An observation mentioned in many texts may not be in some, and the situation in some countries may differ from that of most countries of the sample. The following summary will, accordingly, try to present the ideas and observations found in many of the texts, with nuances where necessary.

#### *The Analytical Framework*

The following summary is based on a number of general principles of fiscal federalism, principles that implicitly or explicitly inspire most of the texts submitted. Fiscal federalism studies the assignment of fields of jurisdiction among various orders of government in terms of spending (defence, health and education) and taxation (personal income tax, corporate tax and consumption tax). It also deals with intergovernmental fiscal relations.

There is a broadly accepted presumption among fiscal federalism experts to the effect that jurisdiction over the delivery of public services should be allocated to the order of government closest to the citizen, unless responsibility for such delivery can be more effectively taken on by a government that is further. This principle is known as either the decentralization principle<sup>5</sup> or the subsidiarity principle.<sup>6</sup> But decentralization of responsibilities without an allocation of sufficient financial resources (or access to sufficient financial resources) would not allow the full realization of the benefits of decentralization. There must be a matching between spending and revenue. This can be obtained in two fundamentally different ways, i.e. through own-source revenue (in which case the federated states are said to have *fiscal autonomy*) and through transfer revenue from the federal government (in which case they enjoy *financial autonomy* if the transfers are unconditional).

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<sup>1</sup> The expression "levels of government" is appropriate in the context of non-federal countries. The terms "central", "regional" and "local" in this case designate the three major levels. In the case of a federation, we speak of "orders of government". Each order is sovereign in its fields of jurisdiction and accordingly is not subordinate, in these areas, to any other. In Canada, the terms "federal order", "provincial order" and "local level" are used since the municipal level is subordinate, constitutionally, to the provincial order.

<sup>2</sup> There are currently 23 federations in the world. Ronald Watts (1999) adds Spain to this list.

<sup>3</sup> Only professor Albert Solé, of the University of Barcelona, was unable to send us a text. He had agreed, at the last minute, to replace a speaker who was unable to attend and planned to use manuscript notes for his presentation.

<sup>4</sup> A distinction should be made between federalism and territorial administrative decentralization, in which the division of jurisdictions or of tasks between the central and territorial authorities is not constitutionalized and may, consequently, be amended at the discretion of the central authorities. The term "decentralization" in the present document refers to the notion of federalism unless it is clear, from the context, that the other meaning is intended.

<sup>5</sup> Robert Ebel notes (see p. 145 of the present document) the classic formulation of this principle, attributable to Wallace Oates, author of the major work *Fiscal Federalism* in 1972: "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision".

<sup>6</sup> The texts give many definitions of this principle. We will return to this later.

From the outset, some terminological clarification is needed. The framework of analysis for fiscal federalism used here refers to two separate situations, depending on whether the country in question has a non-federal system of government with many levels or a federal structure. In terms of analysis, there is an essential difference between non-federated countries and federations. In the former case, regional and local administrations are agents of the central power. By contrast, a federal structure implies the presence of orders of government that are, in a sense, “side by side”, autonomous in their respective fields of jurisdiction. The principles of federalism, such as the principles of autonomy, participation and separation, have to be taken into account. In fact, in federal countries, these principles have in practice precedence over the more analytical concepts of decentralisation and subsidiarity since they follow from explicit political agreements and are constitutionalized<sup>7</sup>.

In what follows, we begin by sketching out a general picture of certain broad principles raised by the authors before describing their presentation of the current situation in their country concerning the financing of the federated states’ competencies and the intergovernmental fiscal arrangements. This is followed by a general conclusion.

## 2. GENERAL PRINCIPLES

### 2.1. *Subsidiarity and Efficiency in the Delivery of Public Services*

According to Bernard Dafflon, the subsidiarity principle (or decentralization principle) “recommends that competencies in the provision of public services should be vested to the lowest possible level in the fiscal hierarchy” (see p. 63 of the present document). David Collins uses a virtually identical definition: under the subsidiarity principle, “public activities should be carried out at the lowest government level consistent with efficiency considerations” (p. 134).

Many of the authors give various reasons in favour of decentralization of jurisdictions over spending: preferences regarding public services differ from one community to another; proximity between citizens and elected officials encourages the expression of preferences and accountability; the variety of suppliers of public services offers more choice to citizens, promotes more efficient management of public finances and encourages innovation in the public sector. Bill Fox, for instance, makes this case strongly:

*Some have expressed concern that greater decentralization will result in less uniformity across the U.S. [...]. It is true that greater diversity in service delivery is a likely outcome of decentralization, but this is the intent. Decentralization is not only expected to allow advantages in terms of administering programs at the sub-national level, but to allow sub-national control over the types of services offered and to permit experimentation on the best ways to deliver services. These advantages can only be realized if the potential for diversity across states is permitted, and indeed, expected (p. 24).*

In the same vein, Robert Ebel suggests:

*The key element underlying the interest in fiscal decentralization is to achieve these objectives<sup>8</sup> by increasing efficiency, transparency, and accountability in the public sector. In a fiscally decentralized system, the policies of subnational branches of governments are permitted to differ in order to reflect the preferences of their residents. Furthermore, fiscal decentralization brings government closer to the people and a representative government works best when it is closer to the people (p. 145).*

It is also worth quoting extensively from David Collins’ paper in this regard. In his view, it is important to respect the constitutional jurisdictions of the federated order of government to ensure that the economic and social gains inherent in decentralization are realized:

*The basis for the belief in federalism is the existence of different preferences, for types and levels of public services and taxes, in different areas of the nation. [...] A unitary nation, with a single central government (which has local government directly under its constitutional control) will be largely constrained to provide common levels of service at common tax levels. The implementation of uniform*

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<sup>7</sup> See Richard Bird (1993a, 1993b), quoted by Guy Gilbert (p. 227) for a discussion of the differences between the *economic* framework of analysis that assumes (implicitly or explicitly) that regional and local administrations are agents of the central power and the so-called *federal finance* framework of analysis that recognizes that, in a true federation, “altering jurisdictional boundaries or assignments is seldom an easily accessible policy instrument; rather it is a constraint that can be altered only with considerable cost and difficulty” and that the negotiations therein take place between equal partners (Bird 1993b, p. 294). In practice, here, we will be concerned with the federal finance framework of analysis, which is more appropriate for the study of federations, unless the context suggests otherwise.

<sup>8</sup> Robert Ebel refers to the objectives of economic stability, sustainable growth, and provision of basic public services equitably across people and jurisdictions.

*policies across areas of disparate preferences will [...] have substantial efficiency implications. This arises from the fact that the provision of a common level of services funded by common taxes will lead to underprovision of services in some areas compared with what those communities would prefer, and overprovision in others. [...] In a federal system, on the other hand, the individual states can provide service levels according to that community's preferences. Some states will choose to have high expenditure/high tax policies. Others will choose policy mixes of low expenditures and low taxes. [...] There are various reasons why provision of some types of public service by sub-national jurisdictions will better match consumer preferences than provision by the national government: With a multilevel system of government, politicians may have a better knowledge of voters' preferences; decentralisation of government may lead to better control of public officials, because the ratio of elected representatives to public officials is higher; electors in sub-national jurisdictions are more likely to be aware of the costs of the provision of public services and so are more likely to make rational decisions about appropriate levels of public service provision. These decisions are not obscured by cross-subsidies to or from other jurisdictions. This analysis is embodied in the concept of subsidiarity<sup>9</sup> (pp. 133-134).*

According to these authors, the principle of decentralization or subsidiarity is a fundamental principle in the allocation of fields of jurisdiction among a country's orders of government. In the case of Switzerland, Bernard Dafflon goes so far as to say that the principle has doubtless been more scrupulously observed than elsewhere and that, as a result, "the power to decide and finance the provision of public services has remained largely (and jealously) in decentralised hands, in the cantons or in the communes" (p. 63). Sonja Wälti confirms this:

*As for the division of jurisdictions, the Swiss federal Constitution stipulates a strict concept of subsidiarity, i.e. unless the Constitution attributes a jurisdiction explicitly to the Confederation, it is within the competence of the cantons (p. 104). [OUR TRANSLATION]*

Paul Bernd Spahn points out that:

*the concept of subsidiarity – cherished in the Maastricht-Treaty as protecting the sovereignty of nation states and lower tiers of government against supranational interference – has become an attractive guiding principle for reorganizing the relationship between the German federation and its states (p. 182).*

Under the subsidiarity principle, centralized delivery of services is desirable only when it is more efficient. In a federal context, there necessarily exists a tension between efficiency criteria that favour a degree of centralization in some fields and the principles of separation, autonomy and participation, principles that are key to the operation of a federation. In this regard, there is no ready-made solution. However, as Bernard Dafflon points out, one principle remains: the federal government may not impose its concept of "efficiency" on the other order of government. Thus, the principles of federalism prevail in a federation, not the subsidiarity principle.

These efficiency criteria that may be raised are, according to the authors, the presence of significant economies of scale and the existence of substantial externalities.<sup>10</sup> According to these criteria, it is efficient to assign exclusive jurisdiction regarding national defence to the federal order, for instance.

While Bernard Dafflon suggests that centralized delivery may enable better coordination of policies given the presence of externalities, he also recognizes that cooperation among governments of federated entities provides an efficient instrument in such cases. Paul Bernd Spahn also mentions that and cites the case of the conferences of ministers of the *Länder* in Germany, which act in a coordinated way to adopt common principles in various matters. Bernard Dafflon describes the extent, in Switzerland, of so-called "horizontal" cooperation among the cantons. There are many cooperative mechanisms going to the extent of horizontal transfers through which the cantons reciprocally compensate each other for benefits generated by the public policy of a single canton that profit the residents of other cantons (financial agreements for university education, for instance). Federations like Switzerland and Germany sometimes give preference to horizontal cooperative mechanisms that do not depend on centralized involvement.

These intergovernmental cooperative structures between federated entities also bolster their collective negotiating power with the federal government. For instance, in Switzerland, according to Bernard Dafflon:

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<sup>9</sup> Following this analysis, David Collins concludes that the increase in vertical fiscal imbalance following the 2000 reform of the fiscal arrangements will have harmful effects on the efficiency of resource allocation in Australia.

<sup>10</sup> We speak of "externalities" when the decentralized delivery of a public service generates benefits outside the borders of the territorial communities that provide them.

*[...] fiscal matter cannot be decided at the federal level without previous consultation of the CCMF [Conference of the Cantonal Ministers of Finance]. It is a powerful pressure group, regularly consulted by the federal Finance Administration. It has been successful in negotiating global financial packages in which the point of view of the cantons differs from that of the federal government. It has played an important role in shaping federal finance, the federal tax system and tax harmonisation, which was to remain 'formal', and has a dominant position in federal equalisation policies (p. 65).*

## **2.2. Matching Revenue and Spending: Fiscal Autonomy and Transfers**

The benefits of decentralized delivery cannot be fully achieved unless supported by financial resources, without which decentralization would be devoid of meaning. Accordingly, it is necessary to match responsibilities for spending and sources of revenue as closely as possible. That is why all the texts deal with the crucial issue of funding of regional or federal political entities, as the case may be. Each country studied in the texts received has its own way of dealing with this issue.

In practical terms, this matching takes various forms, each one corresponding to a greater or lesser degree of autonomy of the federated entities. The first is to ensure that these entities have access to their own sources of revenue, and that such access is constitutionally protected. The second is to provide them with federal cash transfers, consisting of grants from the federal budget, i.e. a share of tax proceeds of which at least some parameters are set by the federal government.

### **2.2.1. Fiscal Autonomy**

Fiscal autonomy assumes that the federated states have access to tax fields over which they exercise control. Such control may be total (definition of the tax base, establishment of the applicable rates and collection); this refers to "own taxes". However, the control may be limited to control over setting rates applicable to a tax base defined by the federal government; this refers to "joint taxes".<sup>11</sup>

There are advantages to matching revenue and spending between orders of government in this way. Ideally, the government making an expenditure should be the one that funds it, since this encourages a greater sense of responsibility in the management of public funds. Access to autonomous tax fields also satisfies the constitutional autonomy of federated political entities and provides them with the tools they need to express their tax policy preferences. According to Paul Bernd Spahn:

*An autonomous tax policy – at least 'at the margin' – is an essential and constituent element of state<sup>12</sup> sovereignty. It strengthens the accountability of politicians and bureaucrats vis-à-vis their citizens, and thus contributes to render state budget policies more responsive, effective and efficient (p. 51).*

Otto Beierl maintains that "centralization of national fiscal policy leads to a reduction in the states' fiscal responsibility" (p. 55) and he goes on to suggest that the German federated states (Länder) should have more fiscal autonomy. Bernard Dafflon notes that the Swiss cantons enjoy broad fiscal autonomy and that as a result,

*[...] the tax burden can differ substantially from one jurisdiction to another according to their view about the tax system, the combination of the ability-to-pay and the benefit principles, and the progressiveness of the rate schedules. Additional reasons are that the cantons provide varying levels of consumption of public services and have significant differences in the unit cost of providing public services at comparable minimum standards (p. 81).*

However, full fiscal autonomy of federated entities can raise certain problems. Tax base mobility and the tax competition that may result between federated states can prompt federated states with an independent fiscal policy to impose an insufficient tax burden. This *harmful tax competition* (OECD 1998) is evoked by Bernard Dafflon and Magali Verdonck. However, the migrations induced by different taxation practices are, in some cases, relatively minor, as is the case in Switzerland, according to the authors quoted by Bernard Dafflon. In addition, some point out that, far from eroding the tax base of federated states, tax competition actually encourages the adoption of efficient taxation practices. This, as some of the conference speakers point out, is one of the advantages of tax competition.

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<sup>11</sup> In this regard, Robert Ebel notes the definition of "own revenue" proposed by Richard Bird of the University of Toronto: "Bird (2000) defines own revenues as taxes (i) that are assessed by subnational governments, (ii) for which subnational governments set the rate, and (iii) the revenues accrue to the local government. A revenue may be 'own source' even if the tax base is centrally defined and the proceeds are centrally collected" (p. 148). The various categories of taxes and the degrees of autonomy that attach thereto are described in Box 3 of Robert Ebel's paper.

<sup>12</sup> He is referring to the *Länder*, i.e. the federated states, and not to the federal state.



The problem of tax base mobility is acute for many federated states, in particular the Bruxelles-Capitale Region, which is both a city and a federated state, for urban cantons and the city-states of Germany (Bremen, Berlin and Hamburg) where many workers enjoy services without paying for them. Otto Beierl suggests dealing with this problem through non-centralized, bilateral mechanisms. According to Magali Verdonck, the tax rates governments apply often take into account the relative mobility of tax bases. For instance, the property tax base has little mobility and is local in the countries studied. Some suggest that it would be useful to apply the criterion of relative mobility of tax bases in the allocation of tax fields, but this criterion has its limits in a federal context. One of the conditions of fiscal sovereignty of federated states is, as Bernard Dafflon notes, access to a large number of tax fields.

Some authors also mention that full fiscal autonomy of federated entities can hamper a country's macroeconomic stability, though, according to Robert Ebel:

*Recent studies on the relationship between fiscal federalism and macroeconomic governance find that 'decentralized fiscal systems offer a greater potential for improved macroeconomic governance than centralized fiscal systems'. In fact, highly decentralized federal countries, such as Switzerland, Germany, Austria, and USA, have very stable macroeconomic performance and low rates of inflation (p. 152).*

Lastly, if the only fiscal resources of federated states are those generated within their territory, significant disparities in taxation and delivery of public services can result. The yield of the main taxes typically differs among regions of a federation. In other words, there are disparities in fiscal capacity among federated states that can be reduced through an equalization mechanism. Many authors described how each federation deals with the issue of balancing fiscal autonomy with interregional fiscal solidarity and how each federation proposes to resolve this problem.

### 2.2.2. Intergovernmental Transfers and Shared Taxes

Revenue and spending can also be linked through intergovernmental transfers or by sharing the proceeds of federal taxes. These transfers are generally made by the federal government to the federated states, though there are some cases where the transfers are made in the other direction. For instance, in Switzerland, the cantons pay a contribution to the federal government to fund social security, which lies within federal legislative jurisdiction. In Spain, Navarre and the Basque Country collect almost all taxes within their territory and then pay a share (the cupo) to the central state depending on the services the latter provides.

Intergovernmental transfers result in particular from the discordance, between the two orders of government, between own-source revenue and spending. In the case of federations, this disparity stems from the constitutional division of jurisdictions and tax fields. David Collins refers to this when he talks about vertical fiscal imbalance:

*The term vertical fiscal imbalance (VFI) relates to a mismatch for an individual level of government (federal, state or local) between its revenue-raising powers and expenditure responsibilities (p. 130).*

Similarly, Robert Ebel mentions:

*A vertical imbalance occurs when the expenditure responsibilities of sub-national governments do not match with their revenue raising power (p. 166).*

Intergovernmental transfers, as indicated in the authors' texts, assume a variety of forms from one federation to another. However, beyond the description of intergovernmental financial relations as such, the authors consider the issue of the financial autonomy federated states retain, in each case, as far as how the transferred funds are used.

The financial autonomy of federated states remains complete when the transfer is unconditional. Among sources of revenue that are not own-source, unconditional transfers provide the best guarantee that the autonomy of federated entities will be respected and they minimize the distortions in decision-making regarding the delivery of public services and goods. They have no impact on how the government distributes its spending among various types of public services. Equalization, for instance, normally consists of unconditional transfers.

Conditional transfers, on the other hand, which are sometimes called for, from an economic standpoint, to correct inefficiencies tied to the presence of externalities, may pose a number of problems. They influence the choices of governments that receive them, sometimes creating distortions, and they especially favour governments that already have a high fiscal capacity. Shared-cost programs, for instance, by reducing the cost of certain public services for recipient governments, encourage them to spend more than they otherwise would. Accordingly, it is not surprising that

the growth in spending on Medicaid – a major shared-cost health program for the needy – in the United States accounts for a significant proportion of the increase in the states' share of total government spending in the United States. Sonja Wälti provides examples of how conditional transfers create distortions in the choices made by cantons, pointing out that:

*[...] research is unanimous in showing that the financially strongest cantons also benefit from the biggest conditional transfers simply because they have the means to raise sufficient revenues in order to obtain a big share (p. 106). [OUR TRANSLATION]*

### 3. THE SITUATION OF THE COUNTRIES STUDIED

The authors describe the intergovernmental financial relations within their country and the constitutional and political context in which these relations unfold. Over the years, each of the countries studied has adopted a particular solution to the problem of funding federated states or regional and local administrations, as the case may be. As we shall see, these solutions are not frozen in time. Based on the contributions of the authors and on the Commission's document<sup>13</sup> when necessary, we begin with an overview of each country. We then broadly describe the expenditure and revenue jurisdictions of the federated states. Lastly, we consider recent and ongoing processes for reforming intergovernmental fiscal arrangements in these countries, after which we briefly describe certain key components of existing transfer programs.

#### 3.1. Overview

Germany has an inter-linked intergovernmental system in which the Länder governments are an integral part of the federal decision-making process because of their presence in the Bundesrat, the second chamber of the federal Parliament. The members of the Bundesrat are members of the Länder governments. All federal laws affecting the Länder, including all decisions regarding intergovernmental finances, require the approval of the Bundesrat. It comes as no surprise that the term cooperative federalism is often used to describe intergovernmental relations, which are remarkably transparent, in Germany. Fiscal balance is achieved and maintained within this framework thanks to a mechanism (see Otto Beierl) that adjusts the revenue of the two orders of government to place them in a similar budget situation. The need to ensure fiscal balance between the federal government (Bund) and the states (Länder), enshrined in the Constitution (Basic Law or Grundgesetz),<sup>14</sup> is therefore central to German institutional mechanisms. Paul Bernd Spahn mentions: "According to the objectives of the constitution, there is no 'vertical fiscal imbalance' in Germany as exists in other federations with exclusive tax assignments (such as Australia)" (p. 41).

In Australia, intergovernmental financial relations were radically changed by the reform implemented in 2000, which David Collins describe in detail. The states lost some fiscal autonomy by abandoning taxes (A\$3.5 billion or close to 10% of their tax revenue). In return, they obtained a veto over any change to the new goods and services tax (GST) that is paid in full to the states and, overall, obtained a fiscal base that is more robust and that provides a better growth potential to fund their programs, the fields of jurisdiction in which the States spend the most being education and health. There is a substantial volume of transfers. This year, transfers from the Commonwealth to the states and local administrations are estimated at about A\$51 billion of which close to 60% (\$30 billion) is unconditional and paid according to an equalization formula. This amount exceeds the tax revenue of the states and local administrations.

Belgium became a federation only recently, in 1993. Decentralization of jurisdictions to the Communities and Regions, two co-existent types of orders of government, is accordingly relatively recent, and the question of their funding is a pressing issue. The Regions have only a relatively low proportion of own-source revenue compared to their federal transfer revenue. Negotiations in this regard are frequent.

In the United States, the states enjoy substantial fiscal autonomy. The states' share of income tax is growing and the federal government does not apply a general consumption tax. All transfers from the federal government to the states are conditional. According to Bill Fox, they account for about 40% of direct spending by the states and, according to data provided by Bruce Wallin, 31% of spending by states and local communities. The federal government maintains significant control over these transfers.

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<sup>13</sup> COMMISSION ON FISCAL IMBALANCE (2001), *Intergovernmental Fiscal Arrangements : Germany, Australia, Belgium, Spain, United States, Switzerland*, Background Paper for the International Symposium on Fiscal Imbalance, 13 and 14 September, Québec.

<sup>14</sup> Article 106-3.

In Switzerland, the two orders of government have access to varied sources of taxation and the cantons enjoy considerable fiscal autonomy. According to Sonja Wälti, unconditional transfers from the federal government account for 6.4% of the cantons' revenue while conditional transfers make up 20% (17% according to Bernard Dafflon). A major reform of the equalization system is under study in this country.

In countries like Italy, the United Kingdom and Spain, responsibilities have begun and continue to be transferred to regional political entities. In Spain, the transfer initiated with the adoption of the 1978 Constitution is substantial. The Constitution stipulates that "the autonomous communities shall enjoy financial autonomy for the development and exercise of their competencies" (article 156-1). Autonomous resources to fund new responsibilities are increasing, as Pere Galí points out in the case of Catalonia. But since responsibilities have increased more rapidly than autonomous resources in recent years and decades, the issue of the fiscal autonomy of the autonomous communities is central to political negotiations in Spain.

According to Guy Gilbert, "the de jure and de facto exercise of public financial power in France is [...] much more decentralized than in many other unitary countries, including in the European Union," (p. 227) [OUR TRANSLATION] largely because of the 1982 to 1986 legislation on decentralization and jurisdictions. However, in his view, the country has reached a crossroads, as a desire to recentralize has emerged.

### **3.2. *Extent of Jurisdictions of Federated States and Regions***

#### **3.2.1. *Revenue Decentralization***

Taxation is already highly decentralized in the two oldest modern federations, the United States (1789) and Switzerland (1848). Their federated entities, states and cantons, have access to a large number of sources of revenue over which they have considerable control. American states and Swiss cantons make ample use of this fiscal autonomy, resulting in significant differences in fiscal policy. In the U.S., states and local administrations account for a growing share of government revenue since World War 2, attributable to the growth of their revenue in relation to GDP, while the federal government's share of revenue in relation to GDP remained relatively stable. Bill Fox believes that federal control over everything affecting inter-state commerce in the United States imposes a constraint on their taxation power. In Switzerland, the proportions have been fairly stable for 30 years for the Confederation, the cantons and the communes. The cantons' share of total revenue rose after World War 2 and has remained stable since. A fiscal harmonization law has slightly reduced the autonomy of the cantons, though Bernard Dafflon notes that the cantons successfully pressured the Confederation to ensure that the scope of such harmonization remains limited. Far from leading to convergence of rates, such harmonization is essentially limited to setting the framework in which the cantons must define their direct taxes and standardize filing forms.

In Germany, the federation has only limited exclusive authority over taxation (customs duties and tax monopolies). As for other taxes, the *Länder* parliaments have jurisdiction as long as the federal Parliament does not exercise its jurisdiction. In practical terms, tax legislation is mainly federal, and tax administration is decentralized: the *Länder* in particular are charged with collecting shared taxes (personal income tax, corporate income tax, value-added tax or VAT). Such decentralized tax collection also exists in Spain, in the case of the two *foral regime* autonomous communities, Navarre and the Basque Country. They collect almost all taxes within their territory and pay the *cupo*, i.e. their share for services provided, to the central government.

In many countries, various measures have been (or are currently being) implemented to increase the autonomous fiscal resources of federated entities' and regional governments. According to Robert Ebel, many countries in transition and developing countries have undertaken some degree of tax decentralization. In Spain, the funding agreements of autonomous communities provide them with growing autonomous fiscal resources. In Belgium, the Regions' fiscal autonomy is low, but rising. Greater fiscal autonomy for the Regions, constantly demanded by Flanders, increased in 2001. In Italy, greater fiscal powers were granted to the regions in the 1990s. In the United Kingdom, the Scottish Parliament now has the power to vary by 3% the basic rate of the income tax by (the *tartan tax*).

In our sample, Australia has gone its own way regarding decentralization of taxation. The states exercise their fiscal autonomy within fairly limited fields. They are absent from the major sources of taxation. The federal monopoly in the personal and corporate income tax field stems from the perpetuation of a "temporary" acquisition during World War 2 of exclusive legislative power, while its monopoly over general consumption taxes results from a narrow interpretation of the Constitution by the High Court. Accordingly, the states' fiscal autonomy is fairly low, bearing in mind that Australia is a relatively old federation (1901). The recent reform even reduced it somewhat, as we have seen. The shares of government revenue of the Commonwealth, on the one hand, and the states and local administrations, on the other, remained stable during the 1990s (73% and 27% respectively), but they have changed since the 2000 reform took

effect, according to David Collins. In fact, the Commonwealth's share has risen 5% because the new GST, that replaced certain taxes that states gave up and is paid in full to the states, is considered a federal tax.

### 3.2.2. *Spending Decentralization*<sup>15</sup>

In many countries, responsibilities for spending programs, and even legislative authority in some cases, are highly decentralized or are heading in that direction.

In the case of the three oldest federations (United States, Switzerland and Australia), the federated states' share of total public spending and the distribution of jurisdiction over spending are fairly stable overall, with the possible exception of the United States where the share of the states and local administrations in public spending as a whole has been on an upswing since World War 2.

From the standpoint of the jurisdictions and responsibilities of the American states, the few notable changes concern the greater flexibility they have received in the administration of social assistance programs (for which they receive federal funding), within the limits and conditions set by the federal government, and the adoption of a law limiting the capacity of the federal government to impose unfunded mandates on states. However, as Bill Fox and Bruce Wallin point out, these changes are somewhat limited in scope.

In Switzerland, the shares have been fairly stable for 30 years for the three categories of government: 31-33% for the Confederation, 39-40% for the cantons and 27-29% for the communes. The distribution of jurisdictions is strongly influenced by the application of the subsidiarity principle and has not fundamentally changed in 30 years. The cantons and communes account for two thirds of public spending and they predominate in the education, health, public order, culture and environmental sectors. However, in the social affairs sector, as a general rule, Bernard Dafflon notes a slight trend towards centralization (federal legislative control rising slightly with a concomitant increase in the execution role of the cantons).

Lastly, in Australia, the proportions were also stable during the 1990s, the Commonwealth being responsible for 56-58% of spending and the other governments accounting for 42-44%. David Collins points out that the 2000 reform did not alter the distribution of jurisdictions.

In the case of Belgium, the decentralization process that started a number of decades ago and marked among other things by the 1993 federalization continues today. The latest institutional agreements, in particular the so-called "Saint-Polycarpe" Agreement in 2001, again increased the jurisdictions of the Regions. The federated entities (Communities and Regions) account for a growing share of overall spending, though federal predominance is still substantial, attributable to a large extent to the fact that social security remains within federal jurisdiction.<sup>16</sup> The largest spending items of the Regions and Communities are, respectively, economic affairs and education.

In Spain, the autonomous communities' share of public spending has risen sharply over the last 20 years. Whereas autonomous communities did not exist just over 20 years ago they now account for about one third of public spending and their share is growing. All the autonomous communities now have jurisdiction in a large number of fields (including education) and will all soon have jurisdiction over health.

In Italy, between 1990 and 1997, the share of public spending attributable to the regions rose from 23% to 26% while that of local governments held steady at 20% and this trend has doubtless been accentuated in recent years, according to Laura Raimondo. However, the regions' share remained stable in relation to GDP. Italy is currently undergoing an extensive decentralization process (the 1997 Bassanini I law and its sequels), strongly influenced by the subsidiarity principle. In a referendum in October 1991, 64% of voters approved the regionalization of jurisdiction over education and health, in particular.

In 1997, the United Kingdom, a unitary country, initiated a process of devolution of jurisdictions to the Parliament of Scotland and to the Assemblies of Northern Ireland and Wales. In France, whose administrative decentralization legislation of the 1980s produced a relatively "decentralized" unitary country among the countries of the European Union, current trends point to a possible recentralization, according to Guy Gilbert.

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<sup>15</sup> This section does not deal with Germany since the texts contain little discussion of this question.

<sup>16</sup> Flanders, however, is demanding that this sector be decentralized.

### 3.3. Reforms of Intergovernmental Fiscal Arrangements

In their texts, the authors describe the recent history of intergovernmental fiscal arrangements and the efforts currently being made in these countries to change these arrangements. Beyond the specific situation of each country, some general observations emerge regarding these past and present reforms. They are often responses to demands or pressure from federated states; they seek to adapt the financial arrangements to changes that make them necessary; they are generally the culmination of a public negotiation process that unfolds within an institutional framework that stipulates the active and formal participation of the federated entities; as a general rule, they are political agreements from which the federated governments do not expect to emerge with a loss and, lastly, these reforms are most often not implemented unilaterally by the federal government.

In Germany, the system of financial arrangements has shown its great flexibility by successfully adapting to the major shock of the entry of the much less affluent eastern *Länder* into the equalization system. In addition, the reform of intergovernmental fiscal relations passed in 2001, which will become effective in 2005, is the result of pressure brought to bear by three *Länder* (Bavaria, Baden-Wurtemberg and Hesse) and the decision of the Constitutional Court that, in 1999, essentially ruled in their favour. Since such a reform of the equalization system must be passed by the two houses of the federal Parliament, including the *Bundesrat*, it must obtain broad consensus among the governments of the *Länder* and the federal government. In fact, it was passed unanimously. According to the current estimates, the reform should increase the financial resources of all the *Länder*.

Switzerland is also studying an extensive reform of equalization which currently does little to narrow the disparities in financial capacity among cantons. Equalization among cantons works largely through conditional transfers with the federal funding rate being higher for cantons with a lower financial capacity. However, the more affluent cantons nonetheless obtain the lion's share of these transfers because of their greater ability to pay. In addition, financial relations among governments are, from the point of view of many observers, entangled, impeding the autonomy of the cantons. Accordingly, pressure for reform is in the direction of greater fiscal responsibility of the cantons, streamlined tasks and stronger equalization (of revenue instead of spending) so that it plays its role more effectively. In Switzerland, the role of the cantons is such that a reform cannot be adopted without their support. This power of the cantons substantially reduced the scope of the fiscal harmonization law that became effective in 2001. The reform of equalization is being negotiated with the active participation of the canton governments. The myriad inter-canton bodies have studied and ratified the proposal throughout the process. In any event, a canton government can hold a referendum to block or slow the implementation of such a reform if it can convince seven other cantons to support it or if it gathers enough signatures within the canton. It is worth noting that since November 2000, the proposal stipulates compensation for cantons that would be worse off financially because of the reform.

In the United States, the 1996 reform of social assistance, in particular the Temporary Assistance to Needy Families (TANF) program, has substantially changed inter-governmental funding of income support programs. This was in response to the failures of the earlier system, a growing anti-Washington sentiment, problems with federal public finances and the demands of state governors for more flexibility in the administration of programs. This reform moved from a shared-cost funding model in this field to block funding in which the amounts paid depend on the amounts granted under the programs replaced by the reform. The reform was developed in close cooperation with the National Governors Association. The legislation on unfunded mandates was passed in 1995 in a similar context.

One of the reasons for the reform in Australia was the desire for more stable and growing funding for health and education, in particular. The reform replaced a system of unconditional equalization transfers (Financial Assistance Grants) with access to the general consumption tax field (creation of Australia's GST all of whose proceeds are paid to the states in the form of unconditional transfers distributed according to an equalization formula). It accordingly links funding of state programs more closely to the yield of the GST than to federal budget decisions. As such, an intelligent accommodation has been achieved, using a federal law, to decisions by the High Court that deprive the states and territories of access to various major tax fields such as consumption of goods and services and the sale of specific goods (gasoline, tobacco and alcohol). The reform was supported unanimously by the states and territories. The new intergovernmental fiscal arrangements guarantee that states receive transfer revenue at least equal to what they would have obtained without the reform and that no change will be made to the GST without the unanimous agreement of the states and the Commonwealth.

More stable funding for health and education is also a core demand of the autonomous communities (ACs) in Spain seeking greater fiscal autonomy. The ACs will soon have complete responsibility for health. The expected growth in costs in this field is adding to the pressure for AC funding agreements that would secure greater financial autonomy for

them. The unanimous agreement the 15 ACs under the *common regime*<sup>17</sup> and the central state reached in July 2001 to define a new funding system for the ACs for 2002-2006 goes in this direction.

In Belgium, the problems of education funding in the French Community and Flanders' desire for fiscal autonomy were key elements to the political negotiations that led to the Saint-Polycarpe Agreement in 2001. This agreement stipulates a refinancing of the Communities, extension of the fiscal jurisdictions of the Regions and the transfer of jurisdictions to the Communities and the Regions. All decisions and reforms concerning intergovernmental financial relations in this country require a broad consensus, since special funding laws are required to pass them. These special laws require the approval of two thirds of the members of each house of the federal Parliament and of a simple majority within each linguistic group (French-speaking and Dutch-speaking), in each house. Through the institutional changes passed in recent decades, political players are seeking among other things to give the federated entities more autonomy and achieve a new balance between the main linguistic groups within a Belgium united around a bilingual capital, Brussels.

Lastly, in the United Kingdom, the devolution of powers to the Parliament of Scotland and the Assemblies of Northern Ireland and Wales is in particular a response to autonomy sentiment, especially in Scotland. In Italy, the decentralization process, which was approved in a referendum in October 2001, is in response to expectations from the northern regions demanding major reforms.

### 3.4. *Asymmetries*

In many of the countries studied, significant asymmetries are present in institutions and in the mechanisms governing how they operate.

In Spain, two communities operate under the *foral regime*, giving them considerable autonomy and virtually total control over tax collection. The 15 other ACs operate under the *common regime* but, within the *common regime*, the ACs have various degrees of autonomy. They all converge towards the same model in this regard, but at different speeds, adapted to each one's situation.

The merger of the Flemish executive and legislative bodies (Region and Community) gives, as Marcel Gérard points out, an asymmetric cast to Belgium's federal system. There is a single Flemish government but there are two French-speaking governments, that of the French Community in Brussels and that of the Walloon Region in Namur.

In the United Kingdom, the devolution process has advanced further for the Parliament of Scotland than for the Assemblies of Northern Ireland and Wales. "Asymmetric devolution is, in part, a response to the inherent asymmetry of the United Kingdom," as is pointed out by David Heald (p. 266). In Italy, *special regions* (islands and alpine minorities) are distinguished from *ordinary regions*, with the former being more autonomous in setting their spending. Lastly, in France, Corsica receives special funding (the *dotation-Corse*).

### 3.5. *Operating Terms of Intergovernmental Transfer and Revenue Sharing Programs*

As we have seen, federations generally stipulate formal mechanisms for the participation of federated states in deciding intergovernmental fiscal arrangements. Looking beyond the institutional mechanisms, how are the transfer amounts set, how are they distributed among federated states and how can their growth be forecast?

In the federations studied, the authors' remarks lead to the following general observation: intergovernmental transfer amounts are generally set using objective mechanisms that contribute to reduce the federal government's scope for arbitrariness in their determination. The overall envelope provided under a transfer program is either set by a formula, determined according to needs, based on an amount provided in the past and subsequently indexed or depends on the yield of a tax. The transfer amounts are then distributed according to criteria that reflect needs or seek to achieve redistribution objectives. Lastly, funding agreements apply over a relatively long period, affording a measure of funding predictability.<sup>18</sup>

In Germany, the operating terms of transfer programs feature a high degree of transparency in financial relations among governments. The rules of the vertical sharing of the proceeds of shared taxes are written into the Constitution (personal and corporate income tax) and in federal legislation that requires the approval of the governments of the *Länder*, ensured through their presence in the *Bundesrat* (for the VAT). The federal transfer envelopes are then passed by the

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<sup>17</sup> Excluding the two *foral regime* ACs that collect essentially all the tax revenue generated within their territory.

<sup>18</sup> In this regard, Robert Ebel draws certain different conclusions, but his analysis mainly looks at the situation prevailing in developing countries and countries in transition to a market economy.

federal bodies that need, given the role of the *Bundesrat*, prior agreement from the various governments. The flows of funds resulting from the equalization calculations are computed using data provided by the *Länder*, which are responsible for collecting taxes. Transfers among the *Länder* – equalization – are distributed following complex calculations using known formulas and readily accessible statistics.<sup>19</sup> The equalization formula must satisfy the requirements of the Constitution (uniformity of living conditions for Germans throughout the federation) and of a so-called equalization “general standards” law (*Maßstäbengesetz*) passed in July 2001, in response to a decision of the Constitutional Court. Lastly, the new agreement reached in 2001 governs financial relations for a period of 15 years (2005-2019).

In Australia, the amount of the unconditional transfer envelope is automatically determined by the proceeds of the GST, which applies at a rate of 10% to a broad base. In addition, during a transition phase, a revenue guarantee system applies, ensuring that no state is financially worse off following the reform.<sup>20</sup> The operating rules of this tax, whose proceeds are paid entirely to the states, can only be changed if there is unanimous agreement of the two houses of the federal Parliament, the federal government and the state Parliaments. Their distribution stems from the calculation of “relativities”, which is a highly complex process, but the integrity and transparency of the process of applying the formula are guaranteed by an independent body, the Commonwealth Grants Commission (CGC). The appointments and consultations of this body, often public, actively involve the governments of the states and territories and its recommendations, rarely questioned, are the subject of open intergovernmental discussions.

In Belgium, the rules for adopting transfer programs to the Regions and Communities are those that apply for special laws, i.e. a two-thirds majority in both houses and a majority in each linguistic group of the two federal houses. Transfer amounts and the sharing rules for shared taxes were initially set on historical bases. For instance, under the VAT and personal income tax vertical sharing rules, the amounts initially transferred to fund new jurisdictions of federated entities were equivalent to the amounts allocated to these items in the federal budget. Indexation of the total amounts and changes in the distribution among the Regions and Communities were defined for a period of ten years. The new funding agreements, based on education needs in the case of the Communities, also stipulate indexation and distribution mechanisms. In the case of Regions, personal income tax is shared initially on a territorial basis, amounts being returned to where they were collected, and then redistributed among the Regions according to a very simple equalization formula, to reduce the resulting resources disparities. The new funding agreements for 2001 also provide a funding framework for the federated states for the next ten years.

In Spain, the autonomous communities are funded on the basis of the laws of the central Parliament that implement, at the legislative level, the multilateral and bilateral agreements between governments. The one for July 2001, which stems from a unanimous agreement of the autonomous communities and the central government, sets out the funding system of the *common regime* ACs for a five-year period (2002-2006). These agreements increase the autonomous fiscal resources of the ACs, stipulate transfers whose amounts depend on the scope of the jurisdictions of the communities concerned, indexation of the amounts and revenue guarantee mechanisms. The closest thing to equalization in Spain is the Inter-regional Compensation Fund. Its funds are subject to conditions and are distributed according to criteria that reflect needs.

In the United States, the legislative budget process of Congress governs the determination of transfers. Various lobbies also have input into the process. Many federal transfer programs are based on formula grants that, in virtually every case, take account of an indicator of need or of financial capacity to generate revenue. Per capita income is often one of these indicators, as in the case of the Medicaid program. In fact, federal assistance is not provided solely according to needs. Amounts actually paid under certain specific shared-cost transfer programs also depend on the state's ability to pay. Transfer funding often depends on a multi-year budgetary authorization. For instance, in the case of the TANF, funding is based on an authorization lasting five years.

Lastly, in Switzerland, the rules regarding recourse to a referendum to contest federal laws limit the leeway of the Confederation and increase the influence of the cantons. Transfer flows are calculated using a number of distribution formulas for specific transfers and shared taxes (ten formulas in all). The formulas, or certain specific components of the formulas, have changed over time: they have undergone no less than 68 changes since 1959 to satisfy, in view of the Swiss political process, the demands and pressures of the cantons.

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<sup>19</sup> These calculations are available on the Internet.

<sup>20</sup> If a state receives, as its share of GST receipts, a smaller amount than what it would have received had the reform not been implemented, the federal government pays it an amount to make up the difference. According to David Collins, the proceeds of the GST should increase such that, in 2006-2007, each state's share of the GST will exceed the revenue it would have obtained without the reform.

#### 4. CONCLUSION

In spite of the risks inherent in a comparison of federations, some conclusions can be drawn from reading the texts submitted for the symposium. First, many indicators suggest that federated states or regional administrations, as the case may be, currently play a stable or growing role in the countries of our sample. Some countries are undergoing significant territorial decentralization (Italy, the United Kingdom and Spain), and even proceeding with a formal decentralization of jurisdictions (Belgium). This is indicative of stable or growing public needs in the fields of jurisdiction of the federated states and a willingness to bring public bodies and citizens closer together. Robert Ebel sums it up well:

*In the last two decades there has been a worldwide interest in decentralization of government in all parts of the world. The pursuit of decentralization is widespread, as both developed and developing countries attempt to challenge central governments' monopoly of decision-making power (p. 145).*

Another interesting fact is that federated states are playing an active and formal role in intergovernmental fiscal relations in many of these federations. The participation of federated states in the definition, review and operation of these relations is so important that reforms of intergovernmental fiscal arrangements are made unanimously or under special majority rules that require the support of the various partners of the federation. In addition, in almost every case, it is stipulated that the reforms adopted (Australia, Germany and Belgium) or under study (Switzerland) will have positive financial consequences for all the federated states.

Also, in the federations studied, the revision and operating details of transfer programs are, in general, governed by a set of rules that contribute to reduce the scope for arbitrary action by the central government in the determination of envelopes. The operating rules that govern these programs also encourage, in some cases, improved predictability of funding, in particular through indexation rules or by tying funding to certain variables (the yield of a tax, for instance) whose growth can be forecast.

Lastly, we are convinced, from reading these texts, that there is wide diversity in how the federations considered deal with the issue of intergovernmental fiscal relations. These countries have developed fiscal arrangements that meet their specific needs and they adopt reforms to adapt them to new conditions. Reforms of fiscal arrangements in these countries are the culmination of political negotiations that are certainly difficult, but ratified by all in the end. This is not surprising. Intergovernmental fiscal arrangements are the "expression of the federal principle" (Otto Beierl, p. 55), i.e. they must result from negotiations between orders of government on an equal footing and always aim at achieving a better sharing of the financial resources within the federation.



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# DECENTRALIZATION IN THE UNITED STATES: WHERE HAS THE COUNTRY HEADED?

By William F. Fox

## 1. INTRODUCTION

The United States, like many countries, has engaged in an ongoing debate about the appropriate size of government and the best assignment of expenditures and revenues across levels of government. Answers to these questions surely vary over time. Early U.S. history was characterized by very decentralized government, and the era during and immediately following World War II showed evidence of centralization. The issue at hand is whether the centralization pattern has been reversed. A strong case can be made that government in the U.S. has decentralized in recent years, but the evidence is certainly mixed.<sup>1</sup>

Decentralization of the U.S. government structure is apparent over the past 50 years in the increasing shares of expenditures and revenues that are housed at the state/local level. But, the federal revenue share has fallen because of an increase in the share of GDP paid in state/local taxes, not because of a significant reduction in federal taxes as a share of GDP or by an obvious shift of authority from the federal to state and local government. Much of state expenditure growth is in response to federal matching programs over which states have limited control. Also, federal control over state revenue authority is effectively growing, meaning the decentralization may be more apparent than real.

## 2. NUMBER OF GOVERNMENT UNITS

The U.S. is composed of one federal, fifty state and many sub-state governments. The number of states has not changed since 1959, when Alaska and Hawaii became states, but there have been many changes in the number of sub-state governments. The role that different types of sub-state governments play varies by state, but there are similarities by region across the U.S.

The number of sub-state governments declined from 116,807 in 1952 to 87,504, but the entire decline had taken place by 1982 when the total bottomed out at 78,269 (Table 1). The pattern differs dramatically both within types of general-purpose governments (cities, counties, and townships) and between general purpose and special purpose districts. The number of general-purpose governments has stayed relatively constant, particularly for counties, a level of government covering the geographic area of the U.S., and townships (which are primarily important in New England). The number of municipalities has increased by about 15.3 percent since 1952.

**TABLE 1**

NUMBER OF GOVERNMENTS								
	Federal, State and Local	Federal	State	Local Governments				
				County	Municipal	Town or Townships	School District Governments	Special District Governments
1952	116,807	1	50	3,052	16,807	17,202	67,355	12,340
1967	81,299	1	50	3,049	18,048	17,105	21,782	21,264
1987	83,237	1	50	3,042	19,200	16,691	14,721	29,532
1992	85,006	1	50	3,043	19,279	16,656	14,422	31,555
1997	87,504	1	50	3,043	19,372	16,629	13,726	34,683

Opposite trends have occurred for school districts and other special (usually single) purpose districts. The number of school districts fell from 67,335 in 1952 to 13,726 in 1997, with consolidation occurring at both the district and school level. Other special purpose districts, for water, sewer and other services, rose rapidly from 12,340 in 1952 to 34,683 in 1997. Thus, changes in the total number of governments are explained by the degree to which school district declines offset the increase in other districts. School district declines dominated for the first 20 years of the study period, and growth in other special districts dominated in subsequent years.

<sup>1</sup> Much has been written in recent years about concepts of decentralization, devolution, and other means of categorizing shifts from national to sub-national governments. This paper is using these concepts interchangeably to focus on the extent to which substantive shifts are taking place between levels of government in the U.S.

### 3. REVENUE DECENTRALIZATION

Decentralization of revenues has occurred throughout the post World War II era. Tax revenue in the U.S. has grown slowly but continuously as a share of GDP for many years (see Table 2). Federal revenue increased significantly during World War II and has remained at nearly the same level as a share of GDP since. Local and state revenue, on the other hand, has risen steadily as a share of GDP since World War II. As a result, state and local governments consistently generated a greater share of revenues than the federal government until World War II and have provided a lower share thereafter (See Table 3). The greatest increase since the war has been at the state level, where revenues are about one-half larger as a share of GDP.

TABLE 2

NUMBER OF GOVERNMENTS				
	Total	Federal	State	Local
1934	16.2	5.9	3.6	6.8
1940	16.6	6.9	4.7	5.0
1946	26.8	20.9	3.1	2.8
1952	27.1	20.0	3.7	3.3
1957	27.1	18.9	4.3	4.0
1962	27.7	18.1	4.9	4.7
1967	29.5	19.3	5.4	4.7
1972	30.1	18.0	6.6	5.4
1977	31.5	18.8	7.5	5.2
1982	34.1	21.0	7.9	5.2
1987	34.4	20.0	8.6	5.7
1992	34.9	19.9	9.0	6.0
1994	34.6	19.8	8.9	5.9
1995	35.1	20.0	9.2	5.9
1996	33.9	18.5	9.5	6.0
1997	34.5	19.0	9.6	5.9
1998	35.2	19.5	9.7	6.0

TABLE 3

DISTRIBUTION OF GOVERNMENT REVENUES				
	Total	Federal	State	Local
1902	100.0	40.0	11.1	48.9
1913	100.0	33.6	12.6	53.8
1922	100.0	47.1	13.6	39.3
1927	100.0	38.2	17.0	45.5
1934	100.0	36.3	22.1	41.7
1940	100.0	41.7	28.2	30.2
1946	100.0	78.0	11.6	10.4
1952	100.0	73.9	13.8	12.3
1957	100.0	69.6	15.7	14.6
1962	100.0	65.4	17.8	16.8
1967	100.0	65.7	18.5	15.9
1972	100.0	59.9	22.1	18.0
1977	100.0	59.7	23.9	16.4
1982	100.0	61.7	23.1	15.2
1987	100.0	58.3	25.1	16.6
1992	100.0	57.0	25.7	17.3
1994	100.0	57.2	25.8	17.0
1995	100.0	57.0	26.3	16.7
1996	100.0	54.6	27.8	17.5
1997	100.0	55.0	27.9	17.1
1998	100.0	55.3	27.6	17.1

### **3.1. Constitutional Limitations over State Revenue Collections**

The federal and state governments generally have considerable independence in their ability to raise revenues. The U.S. constitution prohibits state taxation in two ways: states cannot tax interstate or international commerce. The limitation on states' ability to tax interstate commerce is an increasingly important issue as multi-state production and distribution and cross state sales are all growing very rapidly. The U.S. constitution specifically places control over interstate commerce, and in this context taxation, in the hands of Congress. Thus, Congress can define what constitutes interstate commerce and the extent to which states can tax it. The corporate income, sales and individual income taxes are all increasingly affected by interstate activities. To-date, Congress has been hesitant to provide states with a reasonable structure in which to tax firms that exploit state economies, through mail order, electronic commerce, and other types of cross border sales. Congress has been content to allow a Supreme Court ruling that says firms are only required to collect sales taxes on behalf of a state if the firm has physical presence in the state. Further, Congress imposed a moratorium that precludes taxes on access to the Internet. The moratorium is set to expire in October 2001. Congress is currently considering whether to extend the moratorium<sup>2</sup> and whether the nexus standard should be broadened. The current expectation is that Congress is likely to extend the moratorium but is unlikely to expand the nexus standard during the next several years. The States are very concerned about their ability to collect taxes, and 42 governors recently sent a letter to Congress asking for action. The importance of Congress' control over interstate commerce and therefore state revenue means an increasingly centralized level of authority, even as states raise more of the revenues.

The problem for state governments is exacerbated by the tax competition that exists between states. The competitive forces make it difficult for states to impose production-based taxes on business. Recent changes forced by competitive pressures include exemption of manufacturing equipment from the sales tax, reductions in taxes on telecommunications, and adjustments in the formula used to determine the share of a multi-state firm's profits that are taxed in a state<sup>3</sup>. Thus, states need to rely more on consumption-based taxation, but Congress has not enabled states to collect the taxes effectively.

Each states' constitution may impose additional limitations on state revenue authority. Specific state constitutions and statutes generally determine local government revenue authority as well. Thus, the role of state versus local government in raising revenue differs dramatically across states. The national constitution only limits local governments in the same sense that states are controlled.

### **3.2. Revenue Sources by Level of Government**

Historically, the different levels of government have tended to specialize in the primary revenue source they employ. The federal government has relied on personal income taxes (Table 4), states on sales taxes (Table 5), and local governments on property taxes (Table 6). Several significant changes in this pattern have been taking place. First, the income elasticity of income taxes is greater than for sales taxes, causing the personal income tax to supplant the sales tax as the largest state tax source<sup>4</sup>.

Nonetheless, the federal share of total income tax collections is only slightly lower than in 1977, and has been stable since 1987. States generate 43 percent of their revenues through personal or corporate income taxes. Personal income taxes generally have very high income elasticities (see Dye and McGuire, 1991), resulting in rapid revenue growth<sup>5</sup>.

Rapidly rising revenues because of income tax structures have allowed many states to lower their maximum personal income tax rate and still experience good growth. Corporate income taxes have evidenced lower income elasticities during the 1990s, most likely because business tax planning has become more effective during the past decade.

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<sup>2</sup> The moratorium has indeed been extended until November 1, 2003.

<sup>3</sup> Most states use a formula that taxes on the basis of property, payroll, and sales. The trend has been towards increasing the weight on sales, which lowers the production-oriented nature of the tax.

<sup>4</sup> The comparison is of the general sales tax, which provided the largest share of state revenue from 1970 until 1998 and the personal income tax. The combination of general and selective sales taxes continues to generate significantly more revenues than the personal income and corporate income taxes combined.

<sup>5</sup> Forty-one states have a broad-based personal income tax. Those states without a broad-based income tax have been more likely to experience significant fiscal pressure from a structural imbalance.

**TABLE 4****DISTRIBUTION OF INDIVIDUAL INCOME TAX COLLECTIONS**

	<b>Federal</b>	<b>State</b>	<b>Local</b>
1902	—	—	—
1913	—	—	—
1922	—	100.0	—
1927	92.6	7.4	—
1934	83.5	16.5	—
1940	81.1	17.4	1.5
1946	97.5	2.3	0.2
1952	96.5	3.2	0.3
1957	95.3	4.2	0.5
1962	93.8	5.6	0.6
1967	91.4	7.3	1.4
1972	86.2	11.8	2.0
1977	84.3	13.7	2.0
1982	85.5	13.1	1.5
1987	82.4	16.0	1.6
1992	80.5	17.7	1.8
1994	80.8	17.4	1.7
1995	81.1	17.3	1.7
1996	81.7	16.6	1.7
1997	82.3	16.2	1.6
1998	82.5	15.9	1.5

**TABLE 5****DISTRIBUTION OF GROSS RECEIPTS AND CUSTOMS TAX COLLECTIONS**

	<b>Federal</b>	<b>State</b>	<b>Local</b>
1902	94.6	5.4	—
1913	91.3	8.2	0.4
1922	88.2	10.3	1.5
1927	69.8	28.6	1.6
1934	65.1	33.9	1.0
1940	51.8	45.1	3.2
1946	70.0	28.2	1.8
1952	59.5	36.5	4.0
1957	54.0	41.0	5.0
1962	49.9	44.7	5.4
1967	43.5	51.1	5.4
1972	34.9	57.7	7.4
1977	27.7	62.5	9.9
1982	32.8	56.6	10.6
1987	23.9	63.1	13.0
1992	24.5	62.6	12.8
1994	25.0	62.3	12.7
1995	24.5	62.7	12.9
1996	22.6	64.1	13.3
1997	22.5	64.1	13.4
1998	21.5	64.7	13.8

Despite the rapid growth in state income tax revenues, state governments continue to collect most of the general and selective sales taxes (see Table 5). States raise about one-third of their revenues with general sales taxes, which have lower elasticities than income taxes. The higher elasticity of income taxes would be true even if the sales tax had a broad base, but three factors have combined to make sales tax elasticities particularly small during the past several decades. First, though sales tax bases vary widely by state, the general pattern is for most services to be exempt. Rapid

growth in service consumption has resulted in a decline in the sales tax base relative to total consumption. Second, states have legislated new exemptions for some large items in an attempt to enhance equity (such as food and clothing) and other items to enhance economic development (such as manufacturing equipment).

The exemptions shrink the tax base, regardless of whether they represent good tax policy. Third, the growing trend towards remote sales has reduced the ability to collect revenues that are due. All states impose a compensating use tax with their sales tax, which requires that the tax be paid if an item is either purchased or used in a state. The tax is due from the consumer if it is not collected from the vendor. States have tended to offset the poor revenue performance of sales taxes by raising rates. The median sales tax rate has risen from 3.25 percent to 5 percent during the past several decades. The sales tax has fallen relative to the income tax, and been approximately able to maintain its revenue share, only because of these rate increases.

**TABLE 6**

DISTRIBUTION OF PROPERTY TAX COLLECTIONS			
	Federal	State	Local
1902	—	11.6	88.4
1913	—	10.5	89.5
1922	—	10.5	89.5
1927	—	7.8	92.2
1934	—	6.7	93.3
1940	—	5.9	94.1
1946	—	5.0	95.0
1952	—	4.3	95.7
1957	—	3.7	96.3
1962	—	3.4	96.6
1967	—	3.3	96.7
1972	—	2.9	97.1
1977	—	3.6	96.4
1982	—	3.8	96.2
1987	—	3.8	96.2
1992	—	4.1	95.9
1994	—	4.3	95.7
1995	—	4.7	95.3
1996	—	4.8	95.2
1997	—	4.7	95.3
1998	—	4.6	95.4

Second, there has been a slight increase in the share of local revenues raised from sales and income taxes. Thirty-four states allow local governments to impose sales taxes. Most local governments are granted some control over the rate (and in a few cases the base) though a few states impose a rate on behalf of local governments. Local governments are also using income taxes more, with 15 states permitting local governments to levy such taxes. The income tax base is often limited to wages. Use of sales and income taxes provides some revenue diversification for local governments, but the property tax continues to be a very dominant revenue source, generating 72.9 percent of local tax revenues. Local governments own nearly all property tax revenues as this source provides a little revenue for a small set of states and represents about 5 percent of total property tax revenues (Table 6).

### 3.3. Revenue Conclusion

The relative increase in state/local revenues suggests devolution is occurring. This conclusion must be tempered for several reasons. First, no shift from federal revenue to state revenue has occurred. Instead, government revenue has risen as a share of the economy, and the increase has been at the state/local level. Second, much of the pressure on states to raise additional revenues has come from the need to match intergovernmental transfers from the federal government, as is described more below. States have found it necessary to match rapidly rising federal programs, such as Medicaid (health care for the low-income population). Third, federal control over state/local revenue sources is growing. Simply, the justifications for decentralization are almost entirely on the expenditure side of government, and most revenues are more easily collected at the national level. The federal government could assist sub-national governments in collection of revenues but has been hesitant to do so far. Indeed, the general direction has been towards federal limitations on state actions. Examples include the Internet Tax Freedom Act that placed a moratorium on the ability to impose sales taxes on access to the internet, federal preemption of local taxes on direct broadcast services, and federal limitation on state taxes on interstate travel. Benefits in operation of the U.S. economy may merit such

limitations, but these do represent strong controls over state revenues. Congressional responses of these types are not surprising since the federal government takes the political heat for any expansions in state revenue capacity and administrative practices, but does not receive any of the revenue.

#### 4. EXPENDITURE DECENTRALIZATION

Decentralization of government expenditures is also strongly underway. The expenditure pattern is similar to the revenue pattern. The state/local share has risen relative to the total government expenditures since World War II (Table 7). Though both state and local governments have experienced rapid increases, the largest relative increase has been at the state level. Expenditure data before 1994 are difficult to compare with those after 1994 because the U.S. Bureau of the Census no longer collects and disseminates data on the national government spending and revenue. Thus, the data are best interpreted by seeing a decline in the federal share of expenditures until 1994 and a continued set of declines after 1994. The declining role of defense spending has been a key reason for the smaller federal role in recent years.

TABLE 7

DISTRIBUTION OF GOVERNMENT EXPENDITURES				
	Total	Federal	State	Local
1902	100.0	34.1	8.1	57.8
1913	100.0	29.8	9.2	61.0
1922	100.0	39.4	11.2	49.5
1927	100.0	30.4	12.4	57.2
1934	100.0	38.9	15.9	45.2
1940	100.0	46.1	14.1	39.8
1946	100.0	84.1	4.1	11.8
1952	100.0	69.4	9.2	21.4
1957	100.0	61.0	12.0	27.0
1962	100.0	57.6	13.2	29.2
1967	100.0	55.1	15.3	29.6
1972	100.0	47.8	19.2	33.0
1977	100.0	48.1	19.4	32.5
1982	100.0	52.6	18.6	28.8
1987	100.0	52.4	19.1	28.5
1992	100.0	47.6	22.0	30.5
1994	100.0	45.3	23.3	31.4
1995	100.0	57.7	18.2	24.1
1996	100.0	54.3	19.4	26.4
1997	100.0	52.1	20.1	27.8
1998	100.0	51.5	20.2	28.2

Shifts from federal to state delivery of welfare programs (though still with considerable federal finance) have been another important factor in the federal decline. The need to fund matching grants for federal welfare programs has been a very important component of growth in state expenditures. The federal Medicaid program has been the source of much of the increase. Medicaid costs have grown very rapidly with increases in overall health care costs in the U.S. Spending grew 5.9 percent annually in the 1980s and 9.8 percent annually in the 1990s. Transfers in the form of welfare (formerly called Aid to Families with Dependent Children, and now called Temporary Assistance to Needy Families) and the food stamp program have also been added to state budgets, though they are primarily financed by federal dollars. Overall, state welfare programs have grown from 22.9 percent of state expenditures in 1978 to 31.4 percent in 1998. State spending on corrections has been another source of pressure on state expenditures.

State versus local expenditure responsibility is primarily determined by state governments and their constitutions and differs widely across the states. On average, states raise 56.1 percent of the combined revenues and spend 41.7 percent of the combined expenditures (see Table 8). The variation is wide, with state government raising 81.5 percent of revenues in Alaska, but only 44.5 percent in Rhode Island. Similarly, the state government expends only 33.1 percent of the total in California, but 77.6 percent in Hawaii.



TABLE 8

## STATE SHARE OF STATE &amp; LOCAL REVENUES AND EXPENDITURES, 1998

	General revenue from own sources	Direct general expenditure		General revenue from own sources	Direct general expenditure
United States Total	56.1	41.7	Montana	62.1	54.4
Alabama	60.5	48.7	Nebraska	53.8	44.2
Alaska	81.9	62.8	Nevada	52.7	32.4
Arizona	55.9	37.8	New Hampshire	46.9	50.8
Arkansas	67.0	54.1	New Jersey	54.2	42.2
California	56.5	33.1	New Mexico	73.1	54.2
Colorado	49.4	37.6	New York	44.5	36.3
Connecticut	65.4	54.9	North Carolina	59.9	43.6
Delaware	81.0	64.4	North Dakota	64.6	54.7
Florida	48.7	36.3	Ohio	54.4	41.0
Georgia	51.7	42.0	Oklahoma	62.0	46.3
Hawaii	78.6	77.6	Oregon	57.9	42.7
Idaho	62.0	43.8	Pennsylvania	58.5	44.6
Illinois	52.1	39.7	Rhode Island	64.0	58.3
Indiana	57.2	42.3	South Carolina	58.4	51.0
Iowa	58.4	45.1	South Dakota	55.8	51.9
Kansas	56.4	40.0	Tennessee	52.4	44.3
Kentucky	69.1	55.9	Texas	49.6	39.8
Louisiana	59.1	50.2	Utah	63.5	52.8
Maine	60.0	54.2	Vermont	61.3	59.8
Maryland	56.7	45.9	Virginia	58.8	44.5
Massachusetts	67.5	55.8	Washington	59.0	44.2
Michigan	65.2	38.4	West Virginia	69.0	58.5
Minnesota	59.3	39.4	Wisconsin	63.2	36.3
Mississippi	61.1	47.5	Wyoming	56.6	41.4
Missouri	57.4	45.7			

A significant shift in education finance has occurred, though kindergarten through twelfth grade education is primarily a locally provided service across the U.S. Overall, states have gone from financing one-third of public elementary and secondary education expenditures at the end of World War II to financing about one-half of spending today (these expenditures are treated as local in Table 7).<sup>6</sup> These expenditures are categorized as local spending, but have placed additional revenue pressure on the states. A series of court rulings regarding states' constitutional responsibility for education is one reason for the increasing state role. The constitutional requirements differ across states, but court challenges have been raised in at least 43 states (see Evans, Murray, and Schwab, 1997).

The challenges normally examine whether the constitution makes education a fundamental right, and if so, are differentials in service levels between school districts permissible given the degree of constitutional responsibility held by the state. The courts have ruled in at least 16 states that the existing provision of education is not constitutionally acceptable. The remedy has normally been greater state finance, but with local governments still responsible for the expenditures. A controversial issue is whether greater state funding has increased or decreased total education spending. The early research, based mostly on California, concluded that centralization of education finance reduced spending. However, the more recent work suggests that total education spending is rising with centralization (Evans, Murray, and Schwab, 1997). The notion is that per pupil spending is increased for the lowest spending school districts, but without any decrease in spending by the higher spending districts.

Dissatisfaction with the property tax has been another important reason for the relative shift from local to state education finance. Surveys of attitudes about taxation have generally found that the property tax is the least preferred tax source, likely because the tax is normally remitted all at once.

<sup>6</sup> There has been no increase in the share of state revenues that go to local education.

#### 4.1. Expenditure Conclusion

Shifts in the share of spending at the state/local level also suggest greater decentralization. Both state and local governments have seen significant increases in the post-war period. But, whether this means greater devolution depends on whether any functions have shifted to the state/local level. Much of the pattern is attributable to a change in priorities that have reduced defense, which is federally funded, relative to other programs. This can hardly be seen as a significant increase in devolution. Thus, the case for greater devolution must be based on the greater role played by states in the income maintenance program. During the past 25 years, state spending has increased because of shifting responsibilities for food stamps, TANF and in particular Medicaid. Some state control over Medicaid (such as the waiver given to Tennessee for the TennCare program) and for the block grants for TANF allow some decentralized decision-making as well suggesting real devolution. Still, federal control over these matching programs means there is much less national to state decentralization than appears to exist.

### 5. INTERGOVERNMENTAL TRANSFERS

As in essentially every country, intergovernmental assistance is an important source of sub-national government finance in the U.S. In a general sense federal to state/local transfers have become less important as a revenue source. Federal grant programs were very large in the 1970s and were significantly cut beginning at the end of the Carter administration and then during the Reagan administration of the 1980s (see Table 9). Federal grants have been growing again in relative importance since the late 1990 but this is almost exclusively attributable to the rapidly rising Medicaid program and not to general growth in federal assistance. Federal transfers to local governments have not rebounded to nearly the extent that has occurred for state governments. It should be noted that state transfers are overstated and local transfers understated because the federal government transfers funds to states that are intended for local governments.

**TABLE 9**

**TOTAL INTERGOVERNMENTAL REVENUE FROM THE FEDERAL  
GOVERNMENT AS A PERCENT OF DIRECT GENERAL EXPENDITURE**

	State	Local
1977	44.4	9.8
1978	44.6	10.6
1979	43.8	10.2
1980	43.1	9.5
1981	42.3	9.1
1982	38.7	8.0
1983	37.5	7.5
1984	37.8	6.9
1985	37.8	6.6
1986	37.9	5.7
1987	36.4	5.0
1988	35.8	4.1
1989	35.6	3.9
1990	35.5	3.7
1991	36.6	3.6
1992	38.8	3.6
1993	41.0	3.6
1994	41.8	3.9
1995	41.1	4.0
1996	41.3	3.9
1997	41.2	4.0
1998	40.9	4.0

Further evidence of the magnitude of intergovernmental assistance in the U.S. is that federal and state governments are each responsible for a larger share of total revenues than of total expenditures (compare Tables 3 and 7). Only local governments are responsible for more expenditures than revenues. Expenditures (Table 7) are categorized according to the level of government where the service is delivered and not where the revenues are raised. Thus, intergovernmental finance is a revenue of the granting government and an expenditure of the receiving government.

Almost all transfers from the national to state and local governments are given in the form of specific grants, many of which are for income maintenance purposes. Federal transfers amounted to 26.0 percent of state general revenues in

1998 and 3.9 percent of local government general revenues. No form of revenue sharing exists, having been eliminated a decade ago. Major programs, such as Medicaid, food stamps, and TANF, are all part of the income maintenance program that is now provided by the states. Medicaid, the largest of these programs, is financed with matching grants, with each state's share determined by the per capita personal income. The federal share varies from 50.0 to 76.8 percent of the cost. The federal government fully finances food stamps. Following many years of shared finance, the federal share of TANF is financed by a block grant to states. Highway aid, particularly for interstate highways, is another major federal program that is often financed with matching grants.

**TABLE 10**

**INTERGOVERNMENTAL REVENUE FROM STATE GOVERNMENT AS A  
SHARE OF TOTAL LOCAL GOVERNMENT DIRECT GENERAL EXPENDITURE**

	Percent		Percent
United States Total	36.0	Missouri	32.5
Alabama	37.4	Montana	35.0
Alaska	35.1	Nebraska	27.4
Arizona	41.5	Nevada	35.3
Arkansas	43.1	New Hampshire	14.2
California	46.3	New Jersey	31.4
Colorado	26.2	New Mexico	51.6
Connecticut	29.0	New York	33.1
Delaware	47.5	North Carolina	40.6
District of Columbia	-	North Dakota	34.6
Florida	28.9	Ohio	35.7
Georgia	32.2	Oklahoma	37.1
Hawaii	10.9	Oregon	38.5
Idaho	40.3	Pennsylvania	36.1
Illinois	30.1	Rhode Island	29.9
Indiana	35.8	South Carolina	33.8
Iowa	36.4	South Dakota	26.5
Kansas	35.5	Tennessee	29.7
Kentucky	37.5	Texas	28.5
Louisiana	34.4	Utah	37.7
Maine	28.6	Vermont	28.1
Maryland	29.0	Virginia	30.4
Massachusetts	39.9	Washington	36.6
Michigan	48.8	West Virginia	46.9
Minnesota	37.6	Wisconsin	44.0
Mississippi	38.6	Wyoming	39.2

Generalizations about state to local intergovernmental aid programs are difficult to make, given the independence that states have in financing services (Table 10). States provide both specific grants and shared tax revenues, with local governments having received 36.0 percent of their direct general expenditures from state transfers in 1998, but with wide variation by state. Hawaii is at the low end, with transfers equal to 10.9 percent and New Mexico is at the high end with 51.6 percent transfers.

The largest specific state grant is for education (see Evans, Murray, and Schwab, 1997). Almost all states use some type of an equalization grant for education, often determined through a foundation formula. Foundation formulas are positively related with need for expenditures and negatively related with local capacity to raise revenues (usually measured by the property tax base). One state, Hawaii, finances all of local education spending, and one state, North Carolina, provides a flat per pupil grant amount. States provide specific grants for many other purposes, including roads, police and fire protection and so forth.

Both situs of collection and formula based revenue sharing are common across the states. For example, Tennessee shares its sales, corporate income, and narrowly defined personal income taxes on a situs basis. The motor fuel, gross receipts, and alcohol taxes are shared based on simple formulas. Revenue sharing from these taxes equaled 8.6 percent of state tax revenues in Tennessee during 2000.

## **6. CONCLUSION**

There is no single answer to whether the U.S. is becoming more or less decentralized. The extent of devolution depends on the metric used. A true increase in devolution would suggest that certain services were shifted from federal to state and local governments for delivery, state and local governments had greater independence in delivering certain services, or state and local governments had greater authority to raise revenues.

The federal government is responsible for a greater share of expenditures and revenues now than in the pre-World War II era suggesting greater centralization. But the pattern in the post war period has been a rising role for state and local government in terms of both expenditures and revenues suggesting decentralization. But the extent of devolution is much more difficult to determine since state/local control over both their revenues and expenditures can be much less significant than it appears. There has been no significant outright transfer of responsibilities to state and local governments with the possible exception of states taking over administration of some income maintenance programs. By and large, these governments continue to deliver the services for which they have traditionally had responsibility. At the same time, state and local governments' ability to generate revenues has been curtailed by federal control over interstate commerce.

Much of the political rhetoric in recent years has centered on the importance of decentralizing government. Perhaps the single most important reason was that the Republican Party, many of whose members are very interested in restraining the federal government's size, gained control over Congress during the mid-1990s. There is discussion that President Bush will issue an executive order establishing a federal watchdog intended to ensure that the federal government will not undertake any function that state and local governments can perform (Washington Post). Of course, movement towards decentralization is not so simplistic and there are many other causes as well (see Kincaid, 1997). Development of block grants for welfare (the TANF program), with considerable independence for state governments to operate the program, was widely touted as evidence of the decentralization. However, the program represented a very small component of both federal and state budgets. In total, Kincaid noted that only 15 of 618 federal categorical grant programs in 1995 were block grants, and even these included significant controls over state and local behavior.

Some have expressed concern that greater decentralization will result in less uniformity across the U.S. (for example, Kincaid, 1997). It is true that greater diversity in service delivery is a likely outcome of decentralization, but this is the intent. Decentralization is not only expected to allow advantages in terms of administering programs at the sub-national level, but to allow sub-national control over the types of services offered and to permit experimentation on the best ways to deliver services. These advantages can only be realized if the potential for diversity across states is permitted, and indeed, expected.

## FORCES BEHIND CENTRALIZATION AND DECENTRALIZATION IN THE UNITED STATES

By Bruce A. Wallin

Over its more than two hundred years of history, the relationship between the national and state governments in the United States has been on the one hand stable, mostly due to Constitutional specifications, but at the same time fluid, the result of political and institutional dynamics. In the earliest years state and local governments were primary in the federation. Then national government power grew in spurts in the nineteenth century, and rose fairly consistently and dramatically as the twentieth century progressed. Toward the end of that era, the pendulum began to swing back toward the states, and in some ways continues to do so today.

The purpose of this paper is to discuss this ebb and flow of intergovernmental relations in the United States. It will begin by discussing the nation's founding and the eventual growth of national government power, much of it facilitated by use of intergovernmental aid. A review of the system that emerged by the 1960s and 1970s will be followed by a discussion of the criticism that a more centralized system provoked, and the subsequent movement, both explicit and implicit, toward decentralization. I will argue that while decentralization of decision-making from the federal government to state and local governments has garnered increased attention, explicit federal government policy shifts have not matched the rhetoric. The state and local government role has increased, however, due to their willingness to increase own source revenues.

The paper will conclude with brief observations on the treatment of fiscal imbalance in the US federal system, and on the mechanisms available for mediating differences of opinion between national and state governments.

### 1. THE FOUNDING AND SUBSEQUENT GROWTH OF NATIONAL POWER

The United States fought its revolutionary war in response to domination by a government deemed too far removed and out of touch with the needs of its citizens – a charge leveled at Washington itself in more recent times. The Declaration of Independence pledged the thirteen colonies and their citizens' lives, fortunes, and sacred honor "to each other," not to any grander government.<sup>1</sup> Following victory in the Revolutionary War and governance under the flawed Articles of Confederation, the biggest debate at the constitutional convention in Philadelphia was the question of whether or not there was a need for a national government at all.

Internal and external policing matters reluctantly turned the framers in favor of a national government, although its powers were thought were to be very limited by a clear delineation in Article I, Section 8, the so-called "enumerated powers clause."<sup>2</sup> Still, concerns over the potential power of this new national government lead to the adoption of the first ten amendments to the Constitution, the "Bill of Rights." Most importantly for any discussion of federalism is the tenth amendment: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States, respectively, or to the people."<sup>3</sup> Most thought that this provision provided a firm guarantee that the power of the national government would be constrained.

History would prove otherwise. The earliest blow to a restrained national government came from the US Supreme Court in the 1819 case of *McCulloch v. Maryland*.<sup>4</sup> In its decision the Court ruled that the US Congress had "implied" powers that allowed it to legislate well beyond the specific charges found in the Constitution. And it also announced the principle of national government supremacy – that when a conflict between federal and state law occurred, the federal law was supreme.<sup>5</sup>

The US's great and unfortunate Civil War in the mid-nineteenth century affirmed national government power in a less subtle way. By winning the war the North's view that the Union was a nation of people, not a compact of states, was fortified. No state could secede from the Union of its own accord.

In the first half of the twentieth century, crises, both home and abroad, were to give a boost to centralization of government power. The domestic crisis was the Great Depression. When many states were unable to respond to the economic dislocation that was occurring, the federal government, under the leadership of President Franklin Delano

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<sup>1</sup> US Declaration of Independence.

<sup>2</sup> US Constitution.

<sup>3</sup> Amendment X, US Constitution.

<sup>4</sup> *McCulloch v. Maryland*, 4 Wheat. 316 (1819)

<sup>5</sup> *Ibid.*

Roosevelt, intervened. Programs such as social security and minimum wage laws greatly broadened the reach and responsibility of the national government. Why did the states and the people accept these actions? Because there seemed to be no alternative.<sup>6</sup>

The crises of World Wars I and II greatly ratcheted up the revenue raising ability of the national government. In preparation for World War I, the 16<sup>th</sup> Amendment to the Constitution gave the federal government the power to levy a tax on income, a power previously held only by states.<sup>7</sup> As the war unfolded, rates climbed from 1-6% to 6-65% and coverage was broadened. When the war was over, rates fell, but never back to previous levels.<sup>8</sup> In response to World War II coverage was again broadened, and rates raised. Perhaps as important the federal government began the practice of withholding income taxes from wages, which greatly reduces taxpayer opposition to tax burdens.<sup>9</sup> The impact of these changes was dramatic. In 1927 federal government revenues were approximately 58% of state and local government own source revenues; by 1952 they were 170%.<sup>10</sup>

It was in the second half of the twentieth century that intergovernmental fiscal assistance was to take center stage in the evolution toward more federal government power. The return of US soldiers from World War II and a desire to fuel a domestic economy lead in the 1950s to federal government grant programs aimed at, among other things, building homes and the highways to connect them. Then in the 1960s civil unrest and concern over poverty lead to President Johnson's Great Society programs. Included were important intergovernmental programs aimed at medical care for the poor (Medicaid), and others designed to help state and local governments fight crime, rebuild inner cities, improve public transit, and help in job training.<sup>11</sup> Federal grants-in-aid grew from 4.7% of total federal outlays in 1955 to a historic high of 17% in 1973, and went from providing 10.2% of state and local revenues to 24%, or nearly one in every four dollars.<sup>12</sup> Intergovernmental aid increased national government power without increasing national government presence, thus obscuring for many citizens the shift in government authority.

What is apparent from a brief review of this history is that the increase in national government power did not occur according to any well-reasoned grand design. It grew greatly as a pragmatic response to crises, both at home and abroad. None of this history argues that the national government was more knowledgeable, or had better values, than did its state and local counterparts. What it did have was Constitutional authority for defense, and fiscal superiority.

## 2. THE US INTERGOVERNMENTAL FISCAL SYSTEM

By 1975 the number of federal grant programs had grown to 442 from 132 programs in 1960 (TABLE ONE). The federal government's intergovernmental grant system had become large, complex, and increasingly under attack. While in the broad sense many grants were a response to trends and dislocations in the social and economic environment, there were also institutional factors at work. A study on the growth on federal intergovernmental aid conducted by the US Advisory Commission on Intergovernmental Relations (ACIR) found grant generation to be primarily a governmental insider's game, with members of Congress the most responsible.<sup>13</sup> The ACIR also noted the important dynamic of interest group support for programs, more often evidenced in protecting programs than initiating them. There were sporadic instances of presidential initiation of grant programs, such as Johnson's Great Society, and bureaucratic momentum to sustain programs in place. But Congress was clearly the major player, with interest groups and bureaucracies integral parts of the "iron triangle."

The grant system that existed in the early 1970s involved for the most part categorical grants for designated purposes, and included requirements for strict supervision by the federal government. Categorical grants are grants that "require that federal funds be expended for specified purposes only and have quite specific planning, record-keeping, and reporting requirements as well."<sup>14</sup> The following provisions are typical of categorical grants:

- ◆ statements of permitted uses of funds (such as specifying by law how the funds are to be used or requiring the grantee to submit detailed plans of how the funds are to be used);
- ◆ expenditure constraints (such as that the money 'supplement, not supplant' local funds);

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<sup>6</sup> See US Advisory Commission on Intergovernmental Relations, *The Federal Role in the Federal System: The Dynamics of Growth, Volume II* (Washington, DC: ACIR, 1981), chapter four.

<sup>7</sup> Ibid., chapter three.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

<sup>10</sup> Calculated from Table 18, US Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism 1994* (Washington, DC: US Advisory Commission on Intergovernmental Relations, 1994).

<sup>11</sup> *The Federal Role in the Federal System*, chapter three.

<sup>12</sup> *Significant Features of Fiscal Federalism 1994*, Table 10.

<sup>13</sup> US Advisory Commission on Intergovernmental Relations, *The Federal Role in the Federal System*, Vol.X.

<sup>14</sup> Richard D. Bingham, Brett W. Hawkins, and F. Ted Herbert, *The Politics of Raising State and Local Revenue* (New York: Praeger, 1978), p. 56.

- ◆ requirements that the grantee match the federal contribution with own-source funds;
- ◆ record-keeping and reporting requirements (for example, that grantees maintain accounting records of how they spent federal money);
- ◆ and requirements that non-accounting data be supplied (such as reports on planned and actual resource use).

Most categorical grant programs also require the preparation of state or local plans as a condition of receiving aid, and most also require reports of program activities and accomplishments.<sup>15</sup> Clearly, while providing state and local governments with new revenue, categorical grants did not come free.

The preference of Congress for categorical grants was the result of many forces. Congress likes the categorical approach chiefly because it allows members to take direct credit for the programs. Members love being able to appear at ribbon cutting ceremonies opening, for example, a new park financed by federal funds. The connection is direct, and is one that the member hopes his or her constituents will recall at re-election time. Further, internal Congressional norms suggest that the more dollars and programs a committee or subcommittee supervises, the more important that committee is. Thus the "specialization" of the grant system neatly matches the specialization of Congress. Categorical grants also allow the targeting of federal money to specific groups who are deemed "deserving" by Congress, or perhaps to reward associations who have contributed to campaigns. Finally, tight controls on the use of federal money act to mollify the concerns of fiscal conservatives who fear misuse of the funds at the state and local level. It is not surprising, therefore, that before 1966 nearly all federal grant programs were categorical in nature, and that they have consistently accounted for more than three-quarters of all federal grant-in-aid money (TABLE TWO).<sup>16</sup> The "golden rule" of grants was "he who has the gold makes the rule."

Criticisms of categorical grants first appeared in the late 1960s. Critics, particularly recipient governments, saw categorical grant programs administratively burdensome and too restrictive in that they did not allow enough flexibility to allow for tailoring and adaptation to city or state specific conditions. Further, there was duplication and overlap among some grant programs, while a proliferation of grants at work in a similar geographic area, yet administered by different federal agencies, making coordination difficult. Block grants, the second major type of aid to emerge in the US intergovernmental system, first appeared in 1966 and were a response to these concerns.

The characteristics of block grants are as follows:

- ◆ recipient jurisdictions have fairly wide discretion within the designated program or functional area;
- ◆ administration, reporting, planning, and other program features are intended to keep grantor supervision and control at a minimum;
- ◆ formula-based allocation provisions are intended to limit grantor discretion and decrease fiscal uncertainty for the grantees;
- ◆ eligibility provisions are fairly precise, tending to favor general as opposed to special district governments, retaining grantor administrative discretion, and favoring state and local generalist officials over program specialists;
- ◆ funding provisions tend toward specifying low matching requirements for recipient jurisdictions.<sup>17</sup>

Block grants, then, designate broad goals and leave the means to these ends to local discretion to a much greater extent than do categorical grants. The first block grant program was 1966's Partnership for Health Act, followed closely by the Safe Streets Act of 1968.

President Nixon launched the broadest attack on the federal government's grant system in his 1971 State of the Union message. He called for a program of general revenue sharing, or unrestricted aid to state and local governments, along with six new block grants that he termed "special revenue sharing."<sup>18</sup> His pronouncements in support of these programs were heavily anti-categorical, and hence anti-Washington. His goal was to reinvigorate state and local governments by putting decision making closer to the people, and to reduce administrative costs that came with the existing grant system. Enacted by Congress and signed into law by Nixon in 1972, the general revenue sharing program provided roughly \$6 billion a year for state and local governments from 1972-1976. It was re-authorized in 1976 for four years. In 1980 states were dropped from the program, and only local governments benefited from the program before it passed

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<sup>15</sup> Ibid., p. 58.

<sup>16</sup> David B. Walker, *The Rebirth of Federalism*, 2<sup>nd</sup> ed., (New York: Chatham House Publishers, 2000), p. 10.

<sup>17</sup> Deil Wright, *Understanding Intergovernmental Relations* (North Scituate, MA: Duxbury Press, 1978), p. 130.

<sup>18</sup> See Richard P. Nathan, *The Plot that Failed: Nixon and the Administrative Presidency* (New York: Wiley, 1975).

from the intergovernmental scene in 1986.<sup>19</sup> Nixon had termed his revenue sharing program part of a “new American Revolution.”

### 3. DECENTRALIZATION

President Nixon’s anti-Washington rhetoric caught on, and became a consistent theme for the successful presidential candidates who were to follow him. Jimmy Carter, the self-proclaimed “little old peanut farmer from Georgia,” continued the anti-Washington theme. He was defeated in 1980 by Ronald Reagan, who took the pro-states/anti-Washington rhetoric to a new level. The seeming digression from this trend, George Bush’s election in 1988, was due more to the failures of the Dukakis campaign than to any reaffirmation of Washington. The election of Bill Clinton and George W. Bush continued the importance of an “outsider” campaign.

During this period state and local government officials increased their criticism of the federal government’s pattern of intergovernmental relations. New complaints were added to the existing list that most prominently included the high administrative costs, lack of flexibility, and uncertainty. Cross-cutting requirements to the receipt of grants in particular increased in the 1970s and 1980s. These conditions of receiving federal grants often imposed policies on state and local governments, in seeming violation of the 10<sup>th</sup> Amendment. Initially involving mostly administrative and procedural issues, Congress began to add goals in areas such as nondiscrimination, health and safety, and environmental protection, without explicitly funding them.

Examples of these requirements include a mandating of a 21-year-old drinking age for states, a 55-mph speed limit on interstate highways, and accessibility of government buildings for the handicapped. The US Supreme Court affirmed these arrangements when they were challenged. They concluded that entering into a grant was a voluntary decision by the sub-national governments, and that therefore they had the option to decline the funds if they did not want to be subject to the conditions attached.<sup>20</sup> While this view may have been technically true, the loss of federal funds made rejection on principle politically unwise.

The increased use of direct orders, many in the 1980s and often without funding, further raised the ire of state and local officials. Examples here included the Americans with Disabilities Act, Safe Drinking Water Act Amendments, the Water Quality Act, and the Brady Bill. Estimates of the financial impact of these unfunded mandates continued to rise.

#### 3.1. Explicit Decentralization

Several presidents, with varying success, tried to respond to these concerns. President Reagan was somewhat successful in reducing the number of rules and regulations relating to grants, although it proved to be a modest success. President George Bush proposed a sweeping program of federal government program “turnbacks” in an attempt to re-rationalize the federal grant system, but was unsuccessful. President Clinton’s administration increased the use of “waivers” in programs like welfare to allow the states to experiment. But it was the election of a Republican majority to Congress in 1994 that was to produce the two trophies of recent decentralization.

Republicans who ran for the House of Representatives in 1994 put together a list of policy goals called “the Contract with America.” The first item on the list to be passed was 1995’s Unfunded Mandates Reform Act (UMRA), seemingly responding to the vociferous objections of state and local officials. The law allowed any member of Congress to raise a point of order on the floor to stop any proposed legislation that involved an uncompensated state or local cost greater than \$50 million a year.<sup>21</sup>

While the bill received a lot of publicity and seemed to stem the tide of uncompensated federal government intrusion, it was not as significant as some thought. Most importantly it was made prospective, thereby removing none of the onerous orders already in place. Further, a simple majority can override the point of order. There are exemptions, including those regulations relating to discrimination, grant conditions, preemptions, or provision of services not having state or local fiscal implications. Paul Posner has found that the law’s enactment slowed the number of new mandates, but still allowed Congress to enact intrusive grant conditions and preemptions in the years following.<sup>22</sup> Posner has noted that Congress in some instances merely reduced the estimate of the mandate’s cost to bring it under the \$50 million threshold, and in other cases has produced a consensus that the point of order should be overruled, such as under Megan’s Law on the registration of sexual offenders.

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<sup>19</sup> See Bruce A. Wallin, *From Revenue Sharing to Deficit Sharing: General Revenue Sharing and Cities* (Washington, DC: Georgetown University Press, 1998).

<sup>20</sup> See National League of Cities vs. Usery (1976).

<sup>21</sup> See Paul Posner, *The Politics of Unfunded Mandates* (Washington, DC: Georgetown University Press, 1998).

<sup>22</sup> Ibid.



The most noteworthy Congressional enactment involving decentralization has been welfare reform, or passage of the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) of 1996. While a long overdue reform of a program criticized by liberals and conservatives alike, the ease of its passage was still rather remarkable. State government officials, particularly governors, had long been seeking waivers from the stringent requirements of existing welfare rules, especially those of the Aid to Families with Dependent Children (AFDC) entitlement. During his campaign, President Clinton had promised to “end welfare as we know it,” and in 1996 he found a willing partner in the Republican-led Congress.

Most importantly PRWORA’s Title I repealed the AFDC entitlement, replacing it with the Temporary Assistance for Needy Families act (TANF).<sup>23</sup> No longer would individuals automatically qualify for a fixed payment set by the national government. TANF is a block grant to state governments, a set amount of fiscal resources that states can allocate as they wish, with some restrictions. States now have considerable discretion in determining eligibility and levels of assistance. They can experiment with ways of reducing dependency through job training and placement, childcare, etc.

This increase in discretion made sense from a variety of perspectives. Clearly the existing system was not working. Further, state populations vary greatly in terms of needs, and diverse state economies call for differing approaches to facilitating employment. The fact that the amount of the block grant is fixed provides an incentive for states to be efficient and effective.

But it is also important to note that as opposed to most previous block grants, this one still imposed many rules and conditions. These include a provision that to continue to receive full funding parents must find some work after receiving twenty-four months of benefits, and face a five-year lifetime limit on the receipt of benefits. Other federal government rules require recipient parents under the age of eighteen to live under adult supervision and a high school degree or enrollment in a similar program. There are many more. David Walker concludes “Clearly this 502-page multifaceted omnibus measure is neither a heavily devolutionary nor a continuously centralizing package of programs, but combines elements of both.”<sup>24</sup>

It is also important to note that the five-year PRWORA also was projected to produce roughly \$50 billion in budgetary savings over the five years for the federal government, with many of the reductions coming from lower spending in Medicaid, Supplemental Security Insurance, and food stamps. Deficit reduction was an extremely important concern of the Congress and the President in the mid-1990s, and at least one member of Congress has suggested that his committee “was given a number and told to achieve it.”

Welfare reform in the US has to date been viewed as a great success. Its first year witnessed a 25 percent decline in the number on welfare, progress that more than doubled in its second year. Some of this success can be attributed to innovative state strategies, and some to the booming economy that has surrounded the reform’s implementation. Yet there are two problems in evaluating the program’s success. The first is determining how much is due to state innovations, and how much is due to the expanding economy. Only now, when the economy slows, may the answer become clearer. The other difficulty is knowing just exactly what has happened to those who have left the welfare rolls. There is broad skepticism that all or even most have actually found gainful employment. What has happened to the others?

The main point that needs to be re-emphasized regarding these two trophies of devolution, relief from unfunded mandates and welfare reform, is that neither of these two legislative enactments offers unequivocal evidence of a true devolution of federal government power. The Unfunded Mandates Relief Act is prospective, thus leaving in place many huge fiscal burdens for state and local governments, and further contains enough loopholes to suggest that it may be more symbolic than significant. Welfare reform involves a major shift in programmatic direction, but may have been driven by deficit reduction concerns as much as by any sentiment that state governments know best how to run the program, a view supported by the fact that it has so many rules that it hardly qualifies as pure return of decision-making to the state level.

It is also important to note that several other devolutionary initiatives that were considered by the national government in the second half of the decade never did gain passage, including proposed block grants for Medicaid and public housing. A major regulatory reform measure relating to the federal government’s ability to issue rules on health, safety, and the environment also failed to win approval. Meanwhile Congress, according to Walker, “enacted a maze of mandates and preemptions,” some conservative, some liberal.<sup>25</sup>

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<sup>23</sup> See Walker, *op. cit.*

<sup>24</sup> *Ibid.*, p. 165.

<sup>25</sup> *Ibid.*, p. 166.

Perhaps most telling has been the movement of federal government influence into the two program areas most traditionally left in the state and local sphere, law enforcement and education. President Clinton and Congress agreed on funding to local governments for additional police officers, and imposed many restrictions on its receipt. President George W. Bush and the Congress are now considered likely to pass increased aid to states for elementary and secondary education, with rules that might include nationwide testing of students, and with repercussions for poor results.

Meanwhile, state governments have seen their revenue raising ability greatly constrained by a national government moratorium on state taxation of internet commerce. The great majority of governors have requested that Washington lift this ban, allowing them to tap the potential of this integral element of the "new economy," and in particular to recapture sales tax revenues lost due to the shift from brick and mortar businesses to those conducted in cyberspace.

In sum, there has been a renewed emphasis placed on decentralization in the United States. But the reality of federal government devolutionary action has not matched the rhetoric.

### ***3.2. Implicit (Incremental) Decentralization***

Perhaps more important than the explicit devolutionary policy moves made by the federal government has been a reduction in aid to local governments, a shift from federal grant programs aimed at state and local governments to those directly aiding individuals, and an increase in the share of all US government revenues raised by state and local governments.

From 1978 to 1990 federal aid declined from 17% of federal outlays to 10.8%, as a military buildup and entitlement pressures claimed a greater share of resources. As a proportion of state and local outlays federal aid declined from 47% to 26.9% during this period (TABLE THREE). Local governments were the hardest hit. Federal aid to local governments fell from 10.6% of direct local general expenditure in 1978 to 3.7% in 1990. The reasons are many, and include the deficit pressures on the national government that grew greatly in the 1980s and a general feeling that states should bear the major responsibility of their local units of government.

Federal aid to state governments in particular grew in the 1990s, but most of this increase is due to the rapidly rising cost of the Medicaid program (health care to the poor). Medicaid costs soared in the early 1990s in response to inflation in the medical care field, as well as increased longevity. This is the key element of the aforementioned shift in federal funding from places to people (from programs aimed at governments to payments to individuals). In 1978 more than two-thirds (68%) of federal aid was aimed at state and local government programs; by 1998 nearly two-thirds (62.5%) involved payments to individuals (TABLE THREE). Since 1980 federal government grant priorities have shifted from education, training and employment, transportation, community and regional development, and general government, to income security, and most dramatically, health care (TABLE FOUR).

Perhaps the most important devolutionary story to be told is the increasing share of total US government financing done by state and local governments. Between 1987 and 1997 federal government revenue fell from 20% to 19% of GDP, while state government revenue grew a percentage point from 8.6% to 9.6%, and local government receipts grew from 5.7% to 5.9%. State and local governments have thus been more willing to raise revenues than has their federal counterpart.

It is important to remember that the US Constitution has always guaranteed concurrent tax and spending powers for the national and state governments, and states have historically allowed their local units of government great discretion over property tax revenues. Until the Great Depression local governments in the US raised by far the greatest share of governmental revenue in the US fiscal system. Then, from 1946 to 1996, state government revenues nearly tripled as a percent of GDP, compared to a 23% increase for the federal government.

The more recent increases in state revenue raising are due to several factors. States first had to pick up some of the slack from the slowdown in federal aid growth in the 1980s. Then the recession of 1990-92 forced many states to raise taxes to cover expenditure needs, tax increases that generated more revenue when the economy rebounded. The inflation in health care costs hit states hard, both in terms of health care costs for their employees and in terms of their matching share for the federal Medicaid program. Finally, most states have had to respond to legal challenges to their systems of elementary and secondary school finance. The usual response to such court rulings has been increased state aid. During a period of relatively low inflation, state aid to their local units of government grew 25% from 1992-1996 (TABLE FIVE).

What is noteworthy is the fact that state and local elected officials have been willing to take the politically dangerous risk of increasing revenues in an era of Tax Revolt fears and one of increasing competition for businesses.

### 3.3. Summary

The shift of fiscal power from national to state governments is a result of many forces. State governments greatly modernized their political, administrative, and fiscal systems in the last half of the twentieth century, improving their overall capacity and trustworthiness. Criticism of centralization of power in Washington began with President Nixon, and perhaps peaked under President Reagan. An intellectual focus on rational choice theory swept academia in the 1980s, adding intellect to rhetoric. After an early recession, the cumulative state fiscal position grew stronger for the rest of the decade.

Politically the nation's representation had steadily been moving South and West, two areas generally more suspicious of Washington than others. The newly elected, both at the state and federal level, were often Republicans who generally hold a bias in favor of local government, and culminated in the Republican Revolution of 1994. Meanwhile state and local governmental officials were losing their power over Congress, due to the increasing presence of single interest groups able to help fund election campaigns and the subsequent centralization of political party activities.<sup>26</sup> These groups placed their own claims on federal resources, and in doing so helped increase federal deficits, which were to become a severe obstacle to any continuation of the increases in federal grants that had been occurring. Two prime examples of this loss of power are the termination of the federal general revenue sharing program, the most popular program ever among state and local officials, and the elimination of tax deductibility of state and local sales taxes under the 1986 tax reform. There is something counter-intuitive about these two actions in a period characterized as "pro-state." Decentralization US-style resulted in states getting more power, but reduced their power over Washington's budget. It is also important to note that in the last decade the US Supreme Court has increasingly come to rule in favor of state autonomy in cases involving federalism.<sup>27</sup>

All of these factors helped produce a pro-decentralization mood in the United States. Still, as noted above, the federal grant-in-aid system remains overwhelmingly dominated by categorical grants, and Congress continues to add burdensome requirements on the states.

## 4. FISCAL IMBALANCES

Any federal system is likely to contain horizontal fiscal imbalances, and the more decentralization, the more the imbalance. The US experience is no exception. At the revenue raising level, the ACIR has occasionally measured the tax-raising capacity of all fifty states, and their tax effort. Tax capacity, or tax bases available to states, produced a range from 68-146 (indexed to 100 for the average state) in 1991, the most recent year available. Thirteen states were below 90. Tax effort (the actual amount of revenue raised as a percentage of the base) ranged from 73 to 156 that same year.<sup>28</sup>

The decentralization, both explicit and implicit, that is occurring in the United States is likely to worsen this tendency, and widen, for example, educational and health care disparities between the states. An additional influence is the fact that revenue raising is more constrained in some states than others, most importantly by the existence of state constitutional and/or statutory limits on revenue raising.

Are we, as a nation, willing to accept these disparities? Probably, as we have historically been willing to tolerate them. Indeed, the national government has rarely been able to enact legislation with a redistributive focus. For example there were many attempts to make the revenue sharing program more needs based, but they were ultimately unsuccessful. This is partly due to the need of every member of Congress to protect his or her own district or state in the determination of any formula, and the inability of interest groups representing state and local governments to get support from their membership for redistribution. The primary means of redistribution in the federal grant system today is the sliding matching share for state Medicaid matching, which is lower the lower a state's per capita income. State aid to their local units of government, on the other hand, tends to be much more redistributive, often attempting to ameliorate disparities in local revenue-raising ability.

The only time vertical fiscal imbalance was seriously used as an argument for federal aid was during the debates over the general revenue sharing program. That argument, while still intellectually valid, lost political credence as the federal government's budget deficit grew. This is not to say that the national government's revenue raising superiority is not an inherent element in justifying federal aid, but it clearly is not the explicit reason, as evidenced by grant design and the termination of general revenue sharing.

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<sup>26</sup> See Wallin, op. cit., pp. 124-127.

<sup>27</sup> See John Kincaid, "The Devolution Tortoise and the Centralization Hare," *New England Economic Review*, May/June 1998.

<sup>28</sup> Significant Features of Fiscal Federalism 1994.

## 5. MECHANISMS FOR RESOLVING INTERGOVERNMENTAL DISPUTES

Prior to 1913's 17<sup>th</sup> Amendment to the Constitution, state governments had a somewhat direct linkage to national government policies as US Senators were elected by their respective state legislatures. Later the link between state and Congressional representatives was further weakened by the changes that occurred in electioneering in the United States – primarily the use of the media, with a resultant dramatic increase in cost of campaigns. Over the past thirty years this has given the special interest groups that are able to raise campaign funds more power than that derived from endorsements by state and local officials.

The primary interaction between state and local officials and the Congress in more recent times has been by means of the public interest groups that represent them – especially the National Governors Association, and the National League of Cities and US Conference of Mayors. The National Governors Association was very involved in the formulation of welfare reform, for example. Most states, and even some local governments, have full-time lobbyists in Washington.

It is also important to note that the analytical ability of the federal government with respect to intergovernmental relations has been greatly diminished. In 1987, both the US House and Senate subcommittees that focused on intergovernmental relations were consolidated into larger committees, with a resultant loss of focus. Intergovernmental units in both the federal Office of Management and Budget (OMB) and Congress's General Accounting Office were similarly decommissioned. The final blow came with the de-funding of the US Advisory Commission on Intergovernmental Relations, a "permanent" federal commission in existence since 1959. The Commissioners, appointed by the President, included elected and administrative officials from the federal, state, and local levels of government. The ACIR represented the only institution in the US where officials representing these varied perspectives would meet on a regular basis, and its staff consistently produced significant reports on federal-state-local issues.

What is left is the US Supreme Court as arbiter of disputes. Up until the mid-1980s the Court was seen as one of the facilitators of centralization of power in Washington, with its decision in the 1976 case of *National League of Cities v. Usery* representative. It was in that case that the Court affirmed the validity of all grant conditions as a "voluntary" agreement between the national government and states. By the mid-1980s the Court tried to pull back from serving as "intergovernmental umpire," but as the 1990s arrived it increasingly ruled in favor of states, in part reflecting the conservative ideology of those appointed under Reagan and Bush.

## 6. CONCLUSION

The story of decentralization in the United States is long and complex. But the emphasis on decentralization, while perhaps slightly increased, is certainly not new. We have a long history of state and local government autonomy, emanating from the US Constitution, and in particular from its approval of concurrent powers to tax and spend. Clearly the reality of decentralization in the US, while interesting, has not matched the rhetoric, and its potential problems may only emerge when exposed to a long-term economic slowdown.

## ANNEX: TABLES

TABLE 1

INTERGOVERNMENTAL RELATIONS (IGR) TRENDS, FISCAL YEARS 1960-98														
		Great Society		NEW FEDERALISM		New Partnership Federalism			Reagan Federalism		Bush Years		Clinton Era	
	1960 Total	1964	1969	1970	1977	1978	1981	1980 Total	1982	1989	1990	1993	1994	1998
Number of grant programs	132	397 ('67)		442 ('75)		492 ('78)		539	404	492	492	593	633 ('95)	660+ ('97)
Grant outlays in current dollars (billions)	\$7.0	\$10.2	\$20.2	\$24.1	\$68.4	\$77.9	\$94.8	\$91.4	\$88.1	\$122.0	\$135.4	\$193.6	\$210.6	\$250.9
Grant outlays in constant 1992 dollars (billions)	\$33.4	\$45.8	\$65.8	\$77.8	\$149.7	\$159.5	\$146.4	\$155.7	\$127.4	\$136.2	\$144.7	\$188.6	\$200.5	\$215.9
Federal aid as a percentage of state and local outlays (own source)	23.4%	25.2%	29.4%	30.9%	41.2%	47.0%	39.6%	43.0%	37.8%	26.6%	26.0%	31.5%	31.7%	31.2% ('97)
Federal aid (current dollars) as a percentage of total Federal aid	7.6%	8.6%	11.0%	12.3%	16.7%	17.0%	14.0%	15.5%	11.8%	10.7%	10.8%	13.7%	14.4%	14.6%
Grants for payments to individuals as a percentage of total Federal aid	35.7%	35.0%	35.9%	36.3%	33.2%	31.7%	39.9%	35.7%	44.0%	54.3%	55.9%		62.3%	62.5%
Forms of grants <sup>a</sup>	132C	2B,3T rest C		5B, G, 2T		426C ('75)	5B, G	492C	4B, G, 534C	12B, G, 396C	14B, 478C	15B, 633C ('95)		24B, 640C <sup>e</sup>
Percentage of aid bypassing the states	8	12		24 ('78)		29% ('78)		23.6%	24.2%	14.5% ('88)	11.2% ('92)		11.4% ('94)	11.56% ('97) <sup>e</sup>
Major IGR regulations	2	7 ('61-'68)		23 ('69-'76)		5 ('76-'80)		37 ('80)	21 ('81-'88)		6 ('89-'92)		11 ('94-'95)	6 ('96-'97) <sup>e</sup>
Federal preemptions	89 ('59)	47 ('60-'69)		108 ('70-'79)				344 ('80)	100 ('80-'89)		25 ('90-'91)		7 ('93-'96)	

From David B. Walker, THE REBIRTH OF FEDERALISM (New York: Chatham House, 2000) (Table Int-2)

Sources: Adapted from Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1985-86 edition, M-146, p. 19; 1989 M-163-II, pp. 18-24; David B. Walker, Towards a Functioning Federalism (1961), 100-131; U.S. Bureau of the Census, Government Finances, 1988-90 editions; ACIR, Characteristics of Federal Grants-in-Aid Programs to State and Local Government, M-188 (January 1994), p. 1; ACIR, Federal Statutory Preemption of State and Local Authority. A 121 (Washington, D.C., Government Printing Office, September 1992): 7, 9; 1992 data from OMB, Budget Baselines Historical Data and Alternatives for the Future, January 1993. ACIR, Characteristics of Federal Grants-in-Aid Programs to State and Local Governments: Grants Funded in FY 1995, M-195 (June 1995), 3; G. Ross Stephens, University of Missouri-Kansas City, private communication, 8 July 1998; Historical Tables, Budget of the U.S. Government, FY 1999, on-line via GPO Access; General Accounting Office, Grant Programs, Design Features – Shape Flexibility, Accountability, and Performance Information (GAO/GGD-98-137) (Washington D.C., June 1998), 7ff

a. Forms of Grant Codes: B = block; C = categorical; G = general revenue sharing; T = target

e. Estimated

TABLE 2

**OUTLAYS FOR GENERAL-PURPOSE, BROAD-BASED, AND OTHER GRANTS,  
SELECTED FISCAL YEARS, 1975-97**

*(Dollar Amounts in Billions)*

	1975	1978	1981	1984	1987	1989	1991	1993	1997
<b>Current Dollars</b>									
General-purpose	7.0	9.6	6.8	6.8	2.1	2.3	2.2	2.4	2.3
Broad-based (mostly block)	4.6	11.5	10.0	13.0	13.1	12.7	16.4	21.8	41.04 <sup>a</sup>
Other (categoricals)	38.2	56.8	77.9	77.8	93.2	106.9	133.4	182.2	190.86
<b>Total</b>	<b>49.8</b>	<b>77.9</b>	<b>94.7</b>	<b>97.6</b>	<b>108.4</b>	<b>121.9</b>	<b>152.0</b>	<b>206.4</b>	<b>234.2</b>
<b>Percentage of Total</b>									
General-purpose	14.1	12.3	7.2	7.0	1.9	1.9	1.4	1.1	0.1
Broad-based (mostly block)	9.2	14.7	10.6	13.3	12.1	10.4	10.8	10.6	17.5 <sup>a</sup>
Other (categoricals)	76.7	73.0	82.2	79.7	86.0	87.6	87.8	88.3	82.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

From David B. Walker, *THE REBIRTH OF FEDERALISM* (New York: Chatham House, 2000) (Table Int-3)

Sources: Outlay data from Office of management and Budget Analysis, unpublished data, 1991. Advisory Commission on Intergovernmental Relations, *Characteristics of Federal Grants-in-Aid Programs to State and Local Governments: Grants Funded FY 1993*, M-188 (Washington, D.C., January 1994), 7. Catalog of Federal Domestic Assistance (Washington, D.C., August 1997).

a. Includes ISTEAF and TANF.

TABLE 3

## FEDERAL GRANTS-IN-AID RELATIVE TO STATE AND LOCAL OUTLAYS, TOTAL FEDERAL OUTLAYS, AND GROSS DOMESTIC PRODUCT, 1960-2000

Fiscal Year <sup>a</sup>	Federal Grants-in-Aid (Current Dollars)					Federal Grants (Constant 1992 Dollars)		Grants for Payments to Individuals	
	Amount <sup>b</sup>	Percentage Increase or Decrease (-)	As a Percentage of			Amount	% Real Increase or Decrease (-)	Amount <sup>d</sup>	Percentage of Total Grants <sup>d</sup>
			Total State-Local Outlays <sup>c</sup>	Total Federal Outlays	Gross Domestic Product				
1960	7.0	7.7	23.4	7.6	1.4	33.4	7.4	2.5	35.7
1961	7.1	1.4	21.2	7.3	1.3	33.8	1.0	2.6	36.7
1962	7.9	11.3	22.0	7.4	1.4	37.1	9.8	3.0	37.2
1963	8.6	8.9	22.7	7.7	1.4	39.3	5.9	3.3	38.0
1964	10.2	18.6	25.2	8.6	1.6	45.8	16.5	3.6	35.0
1965	10.9	6.9	24.9	9.2	1.6	48.7	6.3	3.7	33.9
1966	12.9	18.3	27.0	9.6	1.7	56.5	16.0	4.3	33.2
1967	15.2	17.8	28.5	9.7	1.9	64.8	14.7	4.8	31.3
1968	18.6	23.4	31.2	10.4	2.1	75.7	16.8	6.1	32.7
1969	20.2	8.6	29.4	11.0	2.1	77.7	2.6	7.2	35.9
1970	24.1	19.3	30.9	12.3	2.4	86.9	11.8	8.7	36.3
1971	28.1	16.6	31.4	13.4	2.6	94.9	9.2	10.5	37.5
1972	34.4	22.4	35.1	14.9	2.9	110.5	16.4	13.9	40.6
1973	41.8	21.5	40.2	17.0	3.2	128.8	16.6	13.9	33.2
1974	43.4	3.8	36.7	16.1	3.0	122.6	-4.8	14.8	34.1
1975	49.8	14.8	36.7	15.0	3.2	126.6	3.3	16.8	33.7
1976	59.1	18.7	39.1	15.9	3.4	139.4	10.1	20.1	33.9
1977	68.4	15.7	41.2	16.7	3.5	149.7	7.4	22.7	33.2
1978	77.9	13.9	47.0	17.0	3.5	159.5	6.5	24.7	31.7
1979	83.4	7.1	43.2	16.5	3.3	157.4	1.3	27.5	33.0
1980	91.4	9.6	43.0	15.5	3.4	155.7	-0.1	32.6	35.7
1981	94.8	3.7	39.6	14.0	3.1	146.4	-6.4	37.8	39.9
1982	88.1	6.7	32.8	11.8	2.7	127.4	-14.9	38.8	44.0
1983	92.5	5.0	34.0	11.4	2.7	127.7	0.3	42.5	45.9
1984	97.6	5.5	31.9	11.5	2.6	129.5	1.4	45.3	46.4
1985	105.9	8.5	32.0	11.2	2.6	135.6	4.7	49.3	46.6
1986	112.3	6.0	31.5	11.3	2.6	139.7	3.0	54.2	48.3
1987	108.4	-3.7	27.1	10.8	2.4	131.4	-7.1	57.7	53.2
1988	115.3	6.4	26.9	10.8	2.3	133.9	2.7	62.1	53.9
1989	122.0	5.8	26.6	10.7	2.3	136.2	1.7	66.5	54.5
1990	135.4	11.0	26.9	10.8	2.4	144.7	6.2	75.7	55.9
1991	154.5	14.1	28.3	11.5	2.6	158.6	9.6	90.7	58.7
1992	178.1	15.3	30.7	12.9	2.9	178.1	12.8	110.0	61.8
1993	193.6	8.7	31.5	13.7	3.0	188.6	5.9	121.5	62.8
1994	210.6	8.8	32.7	14.4	3.1	200.5	6.3	131.1	62.3
1995	225.0	6.7	33.2	14.8	3.1	208.2	3.8	141.2	62.8
1996	227.8	1.2	31.7	14.6	3.0	205.5	-2.0	142.8	62.9
1997	234.2	3.1	31.2	14.6	2.9	205.8	1.5	144.2	61.6
1998 <sup>e</sup>	250.9	7.1	N/A	15.0	3.0	215.9	4.9	156.8	62.5
1999 <sup>e</sup>	271.3	8.1	N/A	15.7	3.1	228.3	5.7	166.0	61.2
2000 <sup>e</sup>	284.3	4.8	N/A	15.9	3.1	233.8	2.4	176.1	61.9

From David B. Walker, THE REBIRTH OF FEDERALISM (New York: Chatham House, 2000) (Table Int-1)

Sources: ACIR computations based on Office of Management and Budget, *Historical Tables, Budget of the United States Government, FY 1992*; Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (monthly); ACIR, *Characteristics of Federal Grants-in-Aid Programs to State and Local Governments: Grants Funded FY 1991*, M-182 (Washington, D.C., March 1992); *Significant Features of Fiscal Federalism*, vol. 2, *Revenues and Expenditures*, M-185-11 (Washington, D.C., September 1993), 13; *Historical Tables, Budget of the United States Government, FY 1999*, on-line via GPO Access.

Note: Number of Federal grant programs funded: 1960, 132; 1967, 379; 1984, 404; 1985, 426; 1991, 543.

a. For 1955-76, fiscal years ended 30 June; subsequent years, 30 September

b. See *Special Analysis H of the 1990 Budget of the United States* for explanation of differences between grant-in-aid figures published by the National Income and Product Accounts, Bureau of the Census, and OMB.

c. As defined in the National Income and Product Accounts

d. Revised from previous editions of *Significant Features of Fiscal Federalism*

e. Estimated.

**TABLE 4****FEDERAL GRANTS AS PROPORTION OF TOTAL AID, BY FUNCTION, SELECTED FISCAL YEARS, 1960-95**

Fiscal Year	Health	Income Security	Education, Training, Employment	Transportation	Community and Regional Development	General Government	Other <sup>a</sup>
1960	3.0	37.5	7.5	42.7	1.6	2.4	5.3
1965	5.7	32.2	9.6	37.6	5.9	2.1	6.9
1970	16.0	24.1	26.7	19.1	7.4	2.0	4.7
1975	17.7	18.8	24.4	11.8	5.7	14.2	7.4
1980	17.2	20.2	23.9	14.2	7.1	9.4	7.9
1985	23.1	25.6	16.8	16.1	4.9	6.5	7.0
1990	32.4	26.0	117.3	14.2	3.7	1.7	4.7
1991	36.1	23.2	17.2	12.8	2.8	1.4	3.9
1992	40.1	24.4	16.1	11.8	2.5	1.3	3.9
1993	41.1	24.3	15.6	11.5	2.9	1.6	3.5
1994	41.0	24.5	15.5	11.2	3.7	1.0	3.1
1995	41.6	24.5	15.2	11.5	3.2	1.0	3.0

From David D. Walker, *THE REBIRTH OF FEDERALISM* (New York: Chatham House, 2000) (Table 8-12)

Sources: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, vol. 2, *Revenues and Expenditures*, 1992, M-180-II (Washington, D.C., September 1992), 61. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, vol. 2, *Revenues and Expenditures* (Washington, D.C., October 1997), 39.

Includes natural resources and the environment, agriculture, energy, veterans' benefits and service, administration of justice and national defense.

**TABLE 5****STATE AID TO LOCAL GOVERNMENTS, SELECTED YEARS, 1964-96**

Year	Total (Millions)	Education (%)	Public Welfare (%)	Highways (%)	General Support (%)	Other (%)
1964	\$12,968	59.1	16.3	11.8	8.1	4.8
1969	24,779	60.0	17.7	8.5	8.6	5.2
1974	45,600	59.4	16.2	7.0	10.5	6.8
1978	65,815	61.0	13.0	5.8	10.4	9.8
1981	91,307	62.7	12.1	5.2	10.5	9.5
1985	119,608	62.7	10.6	5.8	10.3	11.4
1988	149,009	64.0	11.9	4.7	10.0	9.5
1990	175,028	62.5	12.4	4.4	9.5	11.2
1991	186,469	62.3	13.1	4.4	9.1	11.1
1992	201,313	62.1	12.9	4.2	8.1	12.7
1993	214,095	61.3	14.6	4.3	8.3	11.5
1994	222,635	61.0	13.8	4.3	8.1	12.8
1995	240,978	61.5	12.8	4.3	8.2	13.2
1996	252,102	62.3	12.4	4.2	7.9	13.2

From David B. Walker, *THE REBIRTH OF FEDERALISM* (New York: Chatham House, 2000) (Table 8-8)

Sources: Adapted from Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, vol. 2, *Revenues and Expenditures*, 1993, M-185-II (Washington, D.C., September 1993), 41. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, vol. 2, *Revenues and Expenditures* (Washington, D.C., October 1997), 44. Council of State Governments, *The Book of States, 1998-99*, vol. 32 (Lexington, Ky.), 433.



## MAINTAINING FISCAL EQUILIBRIUM IN A FEDERATION: GERMANY

By Paul Bernd Spahn

The modern German federation was established only after World War II—for the Western states in 1949—and half a century after its inception it appears to be strong and more robust than ever—despite the incident of unification with the formerly socialist East. Germany is widely seen as having acquired functioning democratic institutions and a reliable political system that has even influenced the design of intergovernmental relations at the supranational level in Europe. Nevertheless, at the beginning of a new millennium, Germany—perhaps more so than many other nations—finds herself at the junction of a historic choice between solidarity and subsidiarity. This is because, over the years, subsidiarity, and hence regional diversity, has been sacrificed consistently in favor of national solidarity. Solidarity has now attained a level at which the flexibility and responsiveness of subnational governments, notably the states, is seen to have been impaired severely. In particular, interregional equalization appears to be grossly inflated—conspicuously after German unification—an assertion which has even found the support of the Constitutional Court in its recent ruling on the *Finanzausgleich*.

### 1. HISTORICAL BACKGROUND AND SETTING

The present state of German federalism can only be understood against its historical background. During most the 19th century, Germany consisted of a patchwork of mini-states subject to hegemonial interests of both German-speaking superpowers (such as Prussia and Austria) and centrally controlled European nation states (such as France, Russia, and the United Kingdom). The German ambition at that time was the creation of a strong nation state to match competing European interests both politically and economically. The unifying force was clearly German language and culture as well as economic motives, notably the creation of a common market without barriers among German states. The language criterion was so decisive that unification was impossible under Austrian rule, a monarchy that, at that time, had different aspirations in the Balkans and Southern Europe. When the German Reich was finally established in 1871, the Prussian hegemon controlled about two thirds of economic resources in Germany, truly a highly asymmetric construct which would render the federation vulnerable to centripetal tendencies and abuse of power.

Although formally a federation, with representatives of the constituent German states cooperating in a similar way as today's Council of the European Union, the system had all characteristics of a monarchy with the Emperor and his nominated cabinet exerting the sovereign power of the Reich. True, there was an elected parliament, which became a source of continuing political quarrels, especially after the opposition to the ruling parties had won a significant majority, but it remained virtually powerless and without significant political influence.

After World War I, the Weimar constitution aspired to establish the accountability of government to an elected parliament, but failed to render the latter politically viable. A highly fragmented party system—representing a rickety society at a time of major social and political upheavals—and the national parliament fell prey, at last, to the ploys and threats of the Nazis, which ended the short-lived democracy between the two wars. Hitler's ascending to command had proceeded via Berlin and through Prussian institutions, the other states of the federation being impotent or unwilling to counterbalance his usurping of power. This is why the Allies would abolish the state of Prussia immediately after the War thus eliminating one important asymmetry and source of political instability.

The newly created zones (later Länder or states) did not necessarily respect historic boundaries, and—after the Nazi experience—regional balance and symmetry became guiding principles for the reconstruction of post-war Germany—at least in the West at that moment. A concession to German history was, however, the creation of so-called city-states, Hamburg and Bremen—the “Hanse” cities—and after unification Berlin, which introduced a minor asymmetric element into intergovernmental fiscal relations that has more recently found the attention of the Constitutional Court. As a general rule however—since the devastating war had left all German regions equally poor and deprived of economic resources—balanced regional development and uniformity of living conditions throughout the nation became attractive features for policy making and institution building. These principles were not only incorporated in the new federal constitution, the Grundgesetz (GG); they became so entrenched in peoples minds and penetrated all domains of collective decision making—including non-government decisions such as collective bargaining—that they would survive even the quandary of unification in 1990. Indeed, German unification—with the formerly socialist East representing roughly 20 percent of the population, but only less than 6 percent of total value added—was, and still is, a major challenge for the German political system and its economy.

This brief historic overview may help to understand some key elements of the German national character and institutions: the desire to regroup the nation in line with language and cultural heritage<sup>1</sup>; the readiness to share the fruits of national economic development and growth on an even footing (interpersonal, sectoral, and regional solidarity); the joint representation of state governments in the second chamber of the federal parliament (the Bundesrat); the acceptance of uniform standards and harmonized taxes throughout the nation including a homogeneity of policies at lower tiers of government. Therefore, in an ultimate sense, the philosophy of the German brand of federalism is highly symmetrical as to potential outcomes. It may, however, imply vast asymmetries in the functioning of institutions and the workings of political and bureaucratic procedures.

In order to achieve the uniformity of living conditions and homogeneity of policies, for instance, there must be uniform—typically centralized<sup>2</sup>—guiding principles for the whole nation. This by itself introduces a new type of asymmetry at the vertical level. While other federations such as the United States or Canada accept concurring sovereignties at various levels, with full taxing and expenditure powers for each tier, the German model of federalism can be characterized as asymmetrical power sharing. In this different paradigm, the federation (apart from its exclusive competencies such as foreign affairs and defense) sets out a general framework for policy making for all Länder (and eventually municipalities), while the latter implement and administer such policies within these general setting. The historic roots of this form of power sharing can also be found in the German Reich where the states (and municipalities) had already had a long tradition of administration that the center could build upon, while the Reich itself had no comparable infrastructure on its own (except for its exclusive responsibilities such as defense).

Moreover, history explains the fact that the modern German states exert their sovereignty only conjointly at the national level—through the Bundesrat, the states' house, which consists of representatives of governments, not elected officials like in the US Senate. In the second chamber of parliament, no individual state is accorded privileges other than its vote, which is exerted en bloc and weighted roughly by population<sup>3</sup>. The result of the majority vote is binding for all, and the policy outcome is uniform across the nation. In particular, the tax law is identical, even for state and municipal taxes<sup>4</sup>, and the states are denied any form of own taxation. Tax revenue is typically shared and apportioned among layers of government according to the constitution (income taxes) or law (VAT), and disbursed horizontally among regional entities according to formulae with strong equalization components.

Homogeneity of policies is also fostered at the national level through the voting mechanism for the national parliament (Bundestag), which follows the model of proportional representation while excluding all parties that fall below 5 percent of the vote. This provision tends to neutralize extremist and factional parties, which had once played a key role in ruining the Weimar democracy. This mechanism represents another example of asymmetric institutions designed to foster homogeneity and ultimately symmetry of outcomes at the national level.

However, the rules equally protect minorities rather effectively through various asymmetric provisions: direct mandates according to majority voting are combined with proportional representation whereby the majority voting system favors singular (and even non-partisan) candidates; and parties that attain at least three direct mandates will be represented in parliament although their proportional vote may fall below the margin<sup>5</sup>.

Although the political landscape has varied quite considerably during the history of the Federal Republic of Germany—with new entrants in parliament such as the greens and the former communists after unification—the political system and its institutions rely heavily on consensus-forming according to the preferences of the median-voter. He or she will ultimately determine the pace of politics at the national level with the states and municipalities being compelled to implement and administer such policies within a common national framework.

The almost complete lack of policy discretion at lower tiers of government, and the “emptiness of the agenda” of state parliaments combined with the inability of states to use own tax instruments is exacerbated by a host of intergovernmental transfers that are all destined to foster national homogeneity and uniformity of living conditions. It

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<sup>1</sup> Legally, a German citizen is not defined by language, however. The criterion is still “blood relationship”, a rather doubtful remnant of Nazi ideology. This criterion proved to be highly controversial (and expensive) in recent years because it encompasses the descendants of German emigrants, even from the time of czarina Katharine, who are now alienated from German culture, while it excludes the children of foreigners, born and residing in Germany.

<sup>2</sup> Indeed, centralizing such principles is the rule, but uniform principles can also be established through horizontal coordination among states. This is effected in conferences of state ministries and conforming treaties among governments. One prominent example is the cooperation in education and culture through the *Kultusministerkonferenz*.

<sup>3</sup> Despite these constitutional provisions, there have been some (successful) incidents of “pork-barreling” between the federal government and some states with decisive votes, most recently in the context of securing support for the tax reform of the year 2000.

<sup>4</sup> Municipalities are, however, accorded some discretion to set tax rates within predetermined levels.

<sup>5</sup> This provision has worked mainly in favor of the PDS, successor party of the former communists, and hence in favor of East German citizens.

begins with the formula apportionment of the jointly appropriated VAT onto regions (mainly population based and highly equalizing); it proceeds through the horizontal redistribution of resources among states according to the Equalization Law (*Finanzausgleich*); and is completed through a number of asymmetrical vertical grants by the federal government in favor of “states in need” however defined, mainly—though not exclusively—to the formerly communist states in East Germany. This interregional solidarity is pushed to a point where the average command of public resources per capita is now higher in the “needier” states than in some of the richest states in the West. It is this outcome that has spurred a constitutional challenge by three more affluent states of Southern Germany: Baden-Württemberg, Bavaria, and Hesse. Thus the issue of solidarity versus subsidiarity was officially raised for the first time, although it had been discussed in academic circles already for some while.

## 2. SOLIDARITY VERSUS SUBSIDIARITY: WHAT IS AT STAKE?

Solidarity is a „sacred cow“ in Germany—notably as regards the new states of Eastern Germany. This is less for moral than for political reasons: East Germans have now become the “decisive voter”, more so than the Hispanics in the United States. The costs of this solidarity are yearly transfers of resources from West to East the volume of which is enormous: it corresponds to more than twice the official development aid of all industrialized countries to all developing countries in the world.<sup>6</sup> This by itself has introduced new asymmetries in intergovernmental relations that will continue to haunt German politics and decide regional economic developments.

Solidarity with East Germans was expected to produce two types of immediate benefits: one political (national integration and political stability); the other economic (the alignment of productivity levels and employment opportunities between regions). Ten years after unification, neither of these outcomes has materialized. There is still a large degree of dissatisfaction in the East, sometimes even restorative political sentiments; and Westerners surreptitiously deplore East German “ingratitude”. The unemployment rate remains twice as high in the new states compared to the old. True, large transfers have evened out regional income differentials, but failed to spur significant productivity increase and growth in the East. These transfers are even suspected to eternalize existing gaps by preserving outdated economic structures, by discouraging entrepreneurial spirit, and by inducing moral hazard.

Irrespective of the asymmetries in favor of the East—which no German politician would dare to censure—, interregional solidarity had already come under attack before unification. In particular the equalizing effects of *Finanzausgleich* had been criticized not only because of questionable distribution criteria, but also because of entailing economic inefficiencies. Unification has rendered this issue only more pressing. Excessive solidarity is seen to entail absence of accountability, dearth of regional growth initiatives, lack of interest to develop own resources, and even moral hazard and waste at the state level. Economists and public finance experts have increasingly taken the view that the “corporatist” German approach to federalism is outdated and constitutes even a risk in the age of globalization. According to this view, modern government is expected to meet the challenge of markets—in the same way as the private sector—, and it should agree to competition among public entities and institutions.<sup>7</sup>

It is obvious that German federalism must also be contemplated in the context of European integration. It is true that the European Union (EU), in her quest for an intergovernmental decision-making machinery among sovereign national states, has greatly benefited from German experience with its cooperative approach. The impact of German institution is clearly noticeable at the European level: the European Council (shaped according to the *Bundesrat*); ECOFIN (a derivative from the German planning councils); “guidelines” set by Brussels (according to German “framework legislation”); the European Central Bank (whose statutes follow the law on the *Bundesbank*); and so forth. But the German model has one important constituent that is absent at the supranational level: solidarity. This limits its usefulness for supranational integration where interregional cohesion is much weaker indeed. A “corporatist” model of federalism is therefore not acceptable for Europe—neither now, nor in the foreseeable future. Moreover, the pace of institution building at the European level has to look for new paradigms given the fact that Agenda 2000 aims at extending the EU toward Central and Eastern Europe. How could this affect German federalism?

It is interesting to note that European integration has already induced the strengthening of regions—both economically and politically; that it has fostered a process of decentralization even in unitary states; and that elements of “competitive federalism” are now increasingly being discussed throughout Europe, and in Germany in particular, not only by

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<sup>6</sup> It is difficult to establish an exact amount for the transfer because of regional asymmetries in the expenditures and revenues of the federal government. Official figures concentrate on direct intergovernmental transfers, which total between 140 and 150 DM or one third of West Germany's GDP. This figure is, however, understated because federal outlays and tax expenditures are unevenly distributed among regions and highly biased in favor of the East. Also the participation of Eastern states in the proceeds from VAT on a per capita basis is a concealed equalization method because it allows them to tap the (higher) tax potentials of the West indirectly.

<sup>7</sup> See, for instance, Kronberger Kreis (2000).

economist-academics, but also by politicians and lawyers. In particular the concept of subsidiarity—cherished in the Maastricht-Treaty as protecting the sovereignty of nation states and lower tiers of government against supranational interference—has become an attractive guiding principle for reorganizing the relationship between the German federation and its states. In this vein of “competitive federalism” the governments of some states—notably Bavaria—have begun to question the existing financial constitution asking for less intergovernmental solidarity in exchange for greater autonomy at the state level—and requesting, in particular, the right to levy some own taxes.

The recent ruling of the Constitutional Court on the *Finanzausgleich*<sup>8</sup> has to be understood before this background. It is obvious that a Court whose role is to control the validity of norms cannot transgress the framework set by the constitution, or ask for its outright revision in the spirit of competitive federalism. The arguments of the Court will always be constrained by the constitutional status quo. However, its verdict has given some support to an in-depth revision of the general philosophy of the *Grundgesetz*, and it has spurred farther-reaching discussions of intergovernmental fiscal relations in Germany. In this context the following points of the Court’s findings may be noteworthy:

- ◆ The arguments underline “the preservation of the historic individuality”<sup>9</sup> of the states and “a degree of competition among the individual states as secured by the federal principle” (section 213) as well as the “innovation-fostering function of political competition among the states, and vis-à-vis the federation” (section 214). This takes up elements of a more fundamental criticism by competitive federalism theorists.
- ◆ The verdict requests the legislator not only to revise the existing law on equalization, but insist on a “law on general standards” (*Maßstäbengesetz*) which is to specify the constitutional principles as to their content that would reign the equalization process (section 277). This law would attain almost constitutional rank, and is supposed to be drafted in the spirit of Rawls’ “veil of ignorance” (section 282)—albeit intricate to realize in practice.
- ◆ In this vein of thought, the Court has even expressed its unwillingness to tolerate legislation that, in practice, conveys equalization to the sole responsibility of the *Bundesrat* (section 284). A simple parliamentary majority would not justify equalization at the expense of a minority of states—even though their governments may have actively and positively been involved. It conveys a responsible, balancing, and neutrally appraising role to the federal government, a duty confined by elementary, general, and overarching legal principles.<sup>10</sup>

The conflict on equalization, and hence the degree of interregional solidarity, as opposed to greater freedom to act of lower tiers of government, and hence subsidiarity, is illustrative for the fundamental issues that are at stake in Germany at the beginning of a new millennium. If ever the German federation and its public sector is to become more lively, more active and entrepreneurial, more creative and inventive at lower tiers of government, it is time to redesign not only equalization in the light of the Court’s ruling, but also to tackle more fundamental issues that go beyond the constitution, and bring stronger competitive elements to bear in the German federation.

### 3. THE ASYMMETRY OF SOLIDARITY

It is consistent with the corporatist nature of German fiscal federal arrangements that taxes are not only uniform throughout the nation but, what’s more, that their proceeds are jointly appropriated. This is true for all major taxes with about 75 percent of total revenue (including the main municipal tax, the *Gewerbesteuer*). Revenue from exclusive state taxes is only 4.4 percent of the total. This leads not only to a jumble of political responsibilities; it also tapers financial autonomy through the packaging of tax policy and a mix-up of joint financing schemes. These limitations at the fiscal edge are now widely considered to narrow state sovereignties in particular. The provisions that reign equalization among the states solidify the ambiguity of German intergovernmental fiscal arrangements. They further blur political accountability and restrain the principle of subsidiarity.

Intergovernmental solidarity has two dimensions: First there is the need to share resources between layers of government (vertical equalization); second, there is the need to apportion the states’ share among various state jurisdictions (horizontal equalization). It is useful to epitomize the horizontal equalization mechanism in three stages:

- ◆ First, there is the distribution of joint taxes, in particular of VAT, among states which exhibit implicit regional equalization effects;

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<sup>8</sup> BVerfG, 2 BvF 2/98 of November 11, 1999, Nos. 1 – 347; <http://www.bverfg.de/>.

<sup>9</sup> This and the following citations of the Court are own translations.

<sup>10</sup> This is in sharp contrast to the *de facto* behavior of the federal government which used pork-barreling to buy votes in the *Bundesrat* in favor of a proposed tax reform recently. The concessions even included the guarantee of specific benefits to city states that had been censured by the Constitutional Court.

- ◆ Second, there is an explicit regional redistribution program effected horizontally among states in a “brotherly fashion” (Finanzausgleich proper); and
- ◆ Third, there are redistributive effects resulting from asymmetrical vertical grants of the federation to the states (supplementary federal grants).

### 3.1. Vertical solidarity

The vertical equalization among the federation and the states is based on article 106 sections 3-9 GG. The constitution presumes that it is possible to define “necessary expenditures” at both levels—state and central governments—which are identified by a medium-term financial planning exercise, and to achieve a “fair compensation” (billiger Ausgleich) between both levels of government (article 106, section 3). According to the objectives of the constitution, there is no “vertical fiscal imbalance” in Germany as exists in other federations with exclusive tax assignments (such as Australia). This may be considered an advantage although the political and technical implementation of this constitutional rule is fraught with problems.

The constitution assigns half of the revenue from income taxes to both the federation and the states—with municipalities participating in the share of personal income taxes. This rule is technically simple as the shares are given and the horizontal apportionment of the revenue strictly follows the residence principle.<sup>11</sup> However a federal law requiring the consent of the Bundesrat governs the vertical splitting of the proceeds from VAT. VAT sharing assumes the decisive role in securing “fairness” among the federation and its constituent states, and is therefore highly politicized. Indeed, the states’ shares of VAT have increased considerably during the last decade reflecting the need to reach consensus with the old states on the incorporation of the new states into the intergovernmental fiscal machinery. A compromise was found only at the expense of the federal share in VAT.<sup>12</sup>

TABLE 1

#### THE STATES’ SHARE OF VAT IN PERCENT

1991-92	37.0
1993	39.0
1994	40.1
1995	44.0
1996-2000	49.5

At present, the federal share of VAT is 50.5 percent with the states cashing-in the remaining 49.5 percent of a base adjusted for specific needs of the federation and municipalities.<sup>13</sup>

### 3.2. Horizontal solidarity

The core of the Court’s verdict is, however, devoted to horizontal equalization with its different critical aspects. As mentioned above, horizontal equalization proceeds in three steps:

At a first level, three quarters of VAT are apportioned to the states according to population. Another quarter is reserved for those states that are considered “financially frail”. They receive supplementary transfers from VAT in order to bring their fiscal potential up to at least 92 percent of the average of total state taxes<sup>14</sup> per capita.

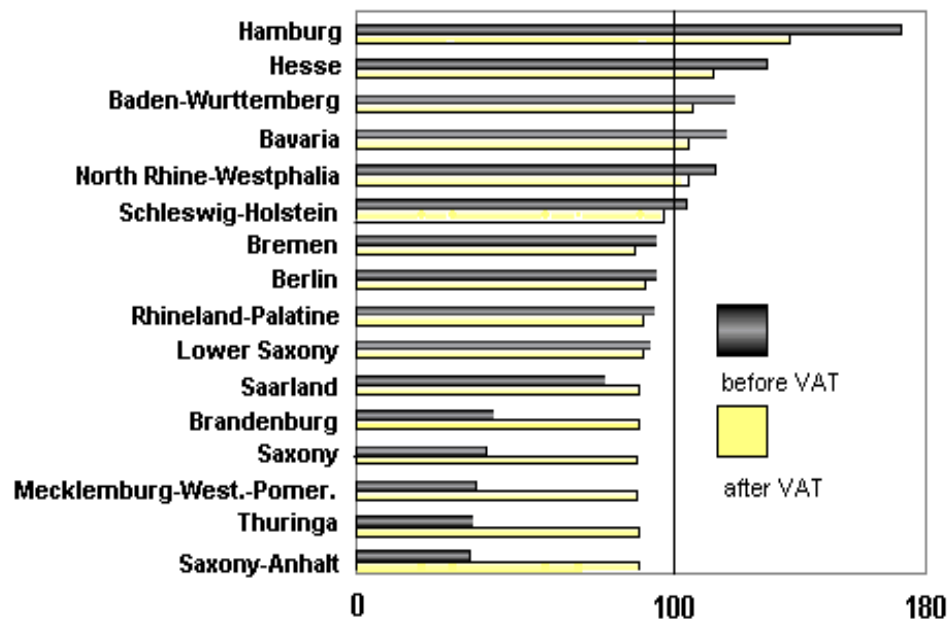
<sup>11</sup> The horizontal distribution of income taxes is not without problems however. The regional distribution of the corporation tax requires a formula apportionment of income for firms with multiple regional activities (*Zerlegungsgesetz*), and the assignment of personal income taxes according to residence favors residential areas over production sites—which could be critical for municipalities and city states.

<sup>12</sup> It should be noted, however, that the federal government was partially compensated by higher federal taxes (in particular on mineral oil) and by a federal “solidarity” surcharge on the income tax.

<sup>13</sup> At present (2000), the federation is entitled to an initial deduction of 5.63 percent of VAT in compensation for supplementary contributions to the national pension system. The municipalities are participating in the sharing of VAT since 1998 (article 106 section 5a GG). Their entitlement is 2.2 percent prior to the sharing of VAT among the federation and the states.

<sup>14</sup> State taxes are defined in paragraph 7 (1) *Finanzausgleichsgesetz*.

The implicit redistribution effects of VAT sharing are often underestimated. When considering only the new states of the East (without Berlin), their tax potential was only 43.8 percent of the national average per capita before VAT distribution, but reached a level of 84.6 percent of the national average after VAT revenues had been included.<sup>15</sup> It implies that these Eastern states acquire roughly twice as much VAT revenues per capita than their Western counterparts. The redistributive effects of VAT sharing among states are illustrated in figure 1.<sup>16</sup>

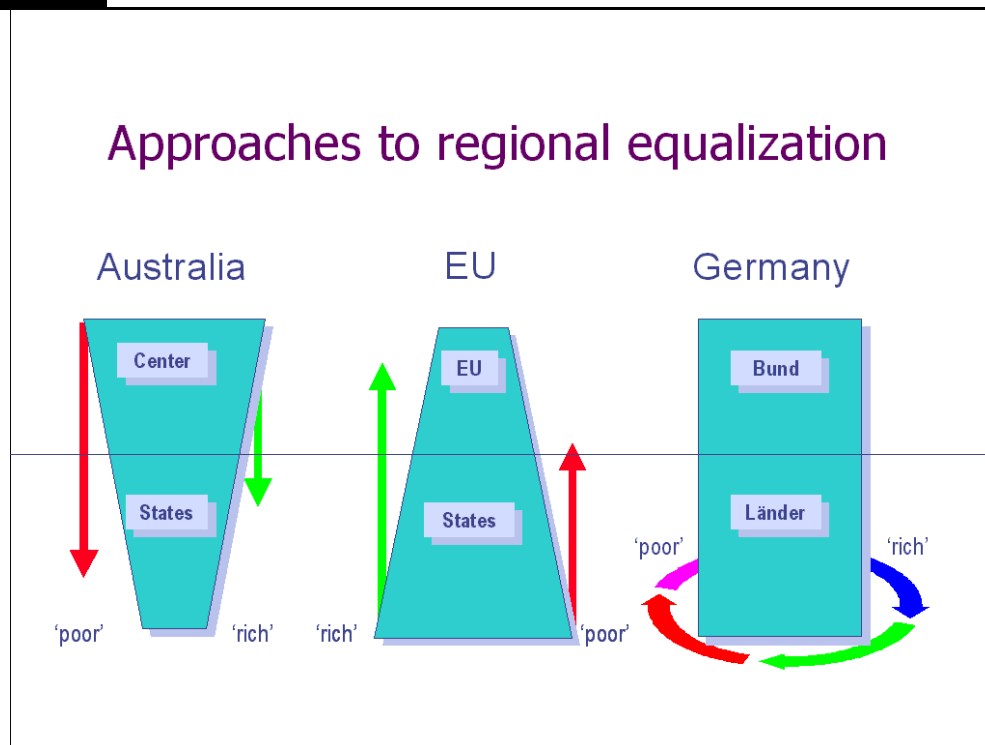
**FIGURE 1**

At a second level, there is the *Finanzausgleich* scheme, a redistribution of resources among the states. Such a scheme is logical for a situation where there are no vertical fiscal imbalances. If such imbalances did exist—as in Australia in favor of the Commonwealth, or in the EU in favor of the member states—, regional equalization schemes would typically be implemented in the form of vertically asymmetrical per capita grants (downwards in Australia, upwards in the EU). In the absence of such vertical imbalance, however, regional equalization must be arranged horizontally among the participating states (see figure 2). Germany is unique in having created such a system, which is, of course, based on a federal law reigning the mechanics of the scheme with uniform rules.

<sup>15</sup> State taxes as in footnote 14—benchmark for compensation through supplementary VAT transfers—do not comprise VAT itself. This is why the share including VAT will remain below the yardstick of 92 percent mentioned before.

<sup>16</sup> Source: BverfG (1999).

FIGURE 2



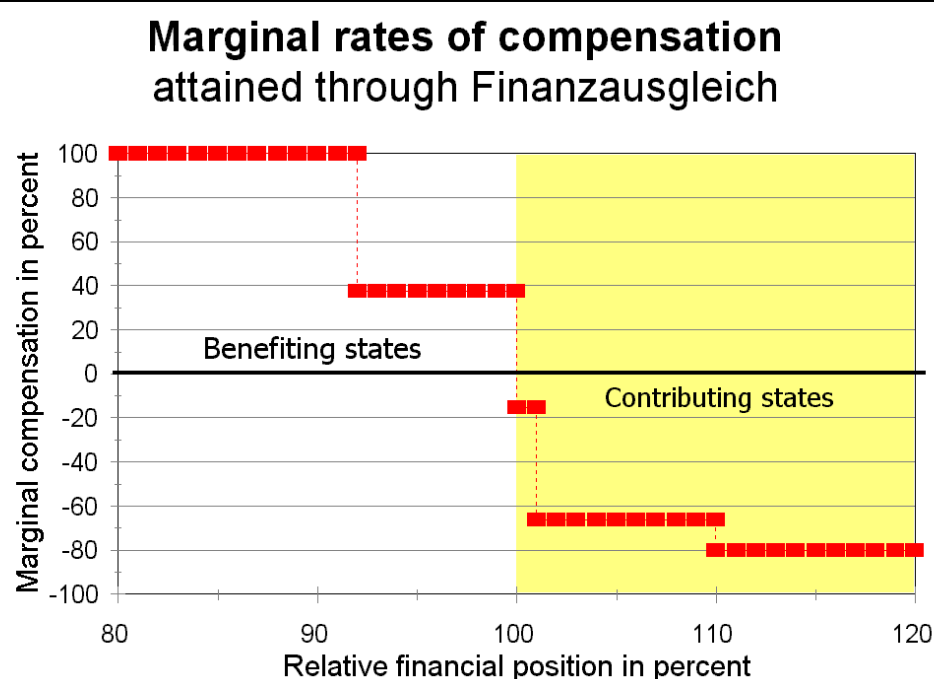
Whatever approach is taken, there must be clear procedures and firm criteria that govern equalization. At the international level, interregional equalization schemes have adopted varying philosophies.

- ◆ In the United States, for instance, an explicit regional redistribution program is nonexistent, but there are implicit equalization effects resulting, for instance, from the workings of a progressive national income tax. Also, there are regional asymmetries entrenched in the multitude of federal programs entailing either transfers to persons, or specific-purpose or bloc grants to regional jurisdictions. Moreover, the regional pattern of equalization will fluctuate in accordance to variations in the local “take-up” rate of such programs and grants.
- ◆ On the contrary, Australia has put in place an explicit and ambitious equalization scheme that aims at full budget equalization. In establishing a point of reference for such a scheme, Australia does not only attempt to evaluate standardized taxing powers of her states, but also standardized expenditures adjusted for needs and costs differentials among jurisdictions.
- ◆ In Germany (like in Canada) the focus of equalization is on taxable capacity only, with little or no concern for specific burdens. As the tax law is uniform throughout Germany (except for some limited discretion of municipalities to vary their tax rates), there is no need to standardize taxable capacity among regions (as in Canada), because *effective* tax collections can be considered to reflect the regional variations of tax potentials.<sup>17</sup>

<sup>17</sup> A uniform state tax regime is, of course, immune against horizontal tax competition among states in a legal sense. However, there could be incentives for the states to relax their tax administration in an effort to attract and foster regional economic activities. Such incentives are to be expected if the shortfall of revenue from lenient tax administration is fully compensated through equalizing grants, which is true for a number of states in Germany. Although there has been suspicion of leniency in some cases, it is, of course, difficult to prove in practice.

The definition of differentials in tax capacities requires a benchmark. It is found in a standardized “equalization yardstick” (Ausgleichsmesszahl) for state fiscal potentials, which is roughly the average tax revenue per capita multiplied by the population for each state. The procedure is, however, more complex. In particular it comprises an asymmetric bias in favor of city-states whose populations are weighted by a factor of 1.35 (compared to one for the other states).<sup>18</sup> This yardstick is compared with the effective financial situation of each state, and the gap is subsequently equalized according to a formula. States below the average (ausgleichsberechtigte Länder) receive a compensation that is to be financed, in progressive steps, by the states above the average (ausgleichspflichtige Länder). The sum of payments received always equals the sum of disbursements; the scheme is thus a complete clearing mechanism. The progressive “tariff” of the redistribution scheme reflecting the degree of interregional solidarity among states is depicted in figure 3. On one side, states whose financial position relative to the national average fall below 92 per cent will benefit from marginal transfers that complement 100 per cent of the difference; for states with a relative position between 92 and 100 per cent, the marginal transfers closes 37.5 per cent of the gap. On the other side, the contributing states see their marginal own financial resources reduced by rates ranging from 15 per cent (for a relative position between 100 and 101 per cent of the national average) up to 80 per cent (for a relative positions above 110 per cent of the average).<sup>19</sup>

FIGURE 3



The equalizing effects of the *Finanzausgleich* are considerable. The program guarantees that the fiscal capacity of all states attains at least 95 percent of the average tax capacity. The marginal burden on the contributing states reaches 80 percent, and it may even exceed the 100-percent mark under certain conditions.<sup>20</sup>

<sup>18</sup> The equalization yardstick also accounts for tax revenues of the state's municipalities (at 50 percent). For local taxes, of which municipalities can vary the tax rate, an average national tax rate is used to standardize revenue. An unsystematic element of the scheme is the compensation for some “special burdens” according to paragraph 7 (3) FAG, which is taken care of by lump-sum corrections. The weighting procedure for the population is ruled in paragraph 9 (2) FAG for the states, and in paragraph 9 (3) for local governments; the latter uses a progressive scheme in line with the population of the jurisdiction. The differential weights for city states and larger municipalities can be interpreted as accounting for some “agglomeration costs” of larger jurisdictions.

<sup>19</sup> Canada avoids the negative impact of high implicit marginal “tax burdens” through its asymmetrical (level-up, but not down) revenue equalization system.

<sup>20</sup> This is the case if the sum of payments needed for the deficient states exceeds the sum of payments for the contributing states as calculated according to the formulae. In this case, the discrepancy is distributed evenly onto contributing states.



At a third level, there is a final corrective of the distribution of public resources in the form of asymmetrical vertical grants by the federal government: so-called supplementary federal grants (Bundesergänzungszuweisungen). Such transfers according to article 107 (2) GG have been widely used after unification while they were almost insignificant before. They also were decisive in establishing consensus among the various jurisdictions with the aim of compensating the formerly socialist Eastern states. In particular, factual “gap-filling grants” (Fehlbetragsergänzungszuweisungen) have been introduced that guarantee at least 99.5 percent of the average fiscal capacity for all states. Moreover, nine states out of sixteen receive federal grants to relieve the costs of “political management” (politische Führung), and the new Eastern states as well as some Western counterparts receive federal grants in compensation of “special burdens”.

The volume of the highly controversial „gap-filling grants“ of the federal government was 5.8 bill. DM in 1998; the special grants for the new Länder were 14.0 bill. DM. The high volume of these federal grants has become subject to criticism not only by economists, who tend to stress the inefficiencies of “softening” budget constraints, but also by politicians and lawyers—and specifically the Constitutional Court—, who stress the excessive redistribution effects of this type of grants. The Constitution had reserved such forms of asymmetrical vertical intervention by the federal government for exceptional circumstances (such as unification, for instance); there was no intention to use them as regular instruments for “filling gaps” in the budgets of a majority of states.

The importance by volume of each of the three steps of horizontal equalization is shown in the following table for the year 1998.

TABLE 2

VOLUME OF REDISTRIBUTED RESOURCES (in bill. DM)		
VAT (only supplement payments)	<i>Finanzausgleich</i>	Federal grants
17.6	13.5	25,7

The redistributive impact of the latter two stages of equalization is depicted in figures 4a and 4b (see also figure 1 for the implicit equalizing effects of VAT sharing).

If the equalizing effects of the various steps of the *Finanzausgleich* are measured in terms of the coefficient of variation, the following picture is obtained: At the beginning of the 70s, the average variation of fiscal capacity per capita before stage one (VAT distribution) was about 17 percent, and only 9 percent after stage three (asymmetrical federal grants). However, the latter played only a negligible role both in quantitative terms and in reducing regional inequalities. The equalizing impact of VAT sharing was about as important as the effect of the *Finanzausgleich* proper.

FIGURE 4a

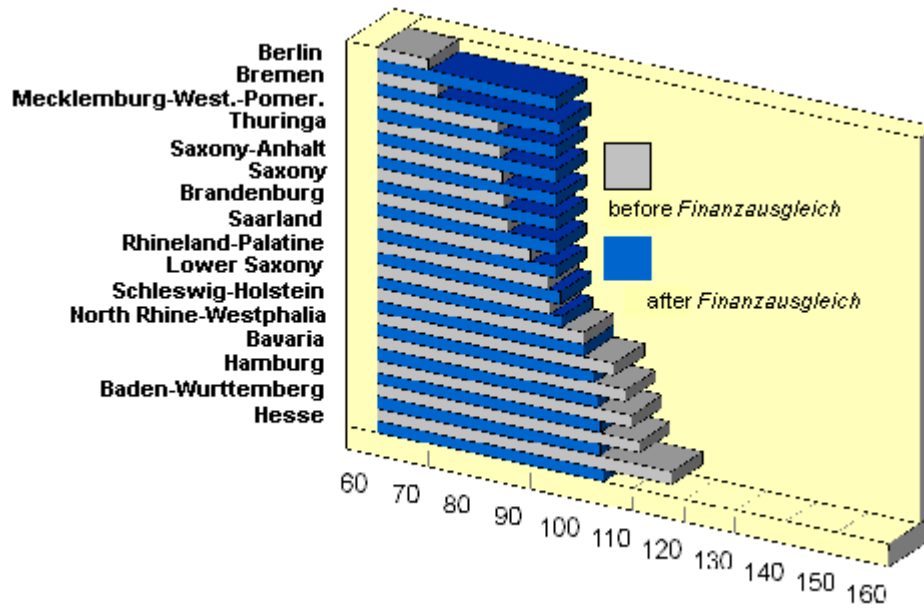
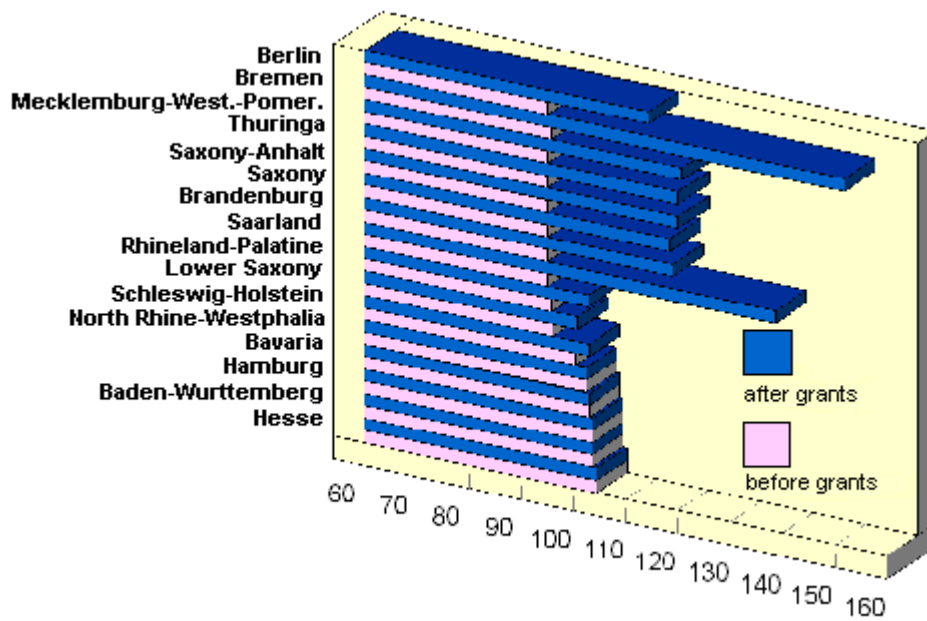


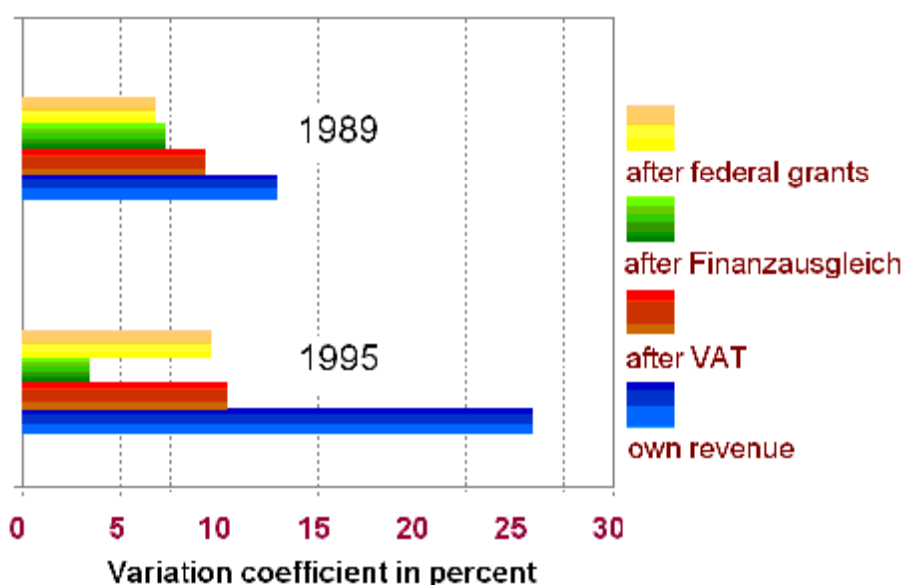
FIGURE 4b



If the effects of the three stages of equalization immediately before unification (1989) are compared with those of the actual scheme, which was introduced in 1995, the picture changes dramatically (see figure 5<sup>21</sup>): Expectedly, the pre-equalization variation coefficient is much larger than before (25.9 percent), but—surprisingly—VAT sharing alone is capable of reducing the variation coefficient to almost pre-unification levels (10.3 percent compared to 9.2 in 1989). Furthermore, the equalizing stance of the *Finanzausgleich* had been remarkably enlarged: After the second stage of equalization, the variation coefficient of 1995 falls to 3.3 percent (compared to 7.2 in 1989). Most remarkably, however, the third stage—asymmetrical federal grants—widens the discrepancies again rather than equalizing further. The variation coefficient attains almost the same level as before the *Finanzausgleich*. Of course, this is mainly explained by the preferential treatment of Eastern states, but even for the Western states the federal grants program would increase regional discrepancies rather than mitigate them.

FIGURE 5

### The impact on regional variation of the three stages of equalization



#### 4. THE CONFLICT BETWEEN SOLIDARITY AND SUBSIDIARITY

It is increasingly being realized in Germany that homogeneity as to outcomes has its price. The ensuing degree of regional redistribution has clearly been pushed beyond limits: not only has fiscal capacity per capita been totally evened out (at a level of 99.5 percent of the national average after federal “gap-filling” grants); when taking all federal grants into account, the variations among states would amplify again.<sup>22</sup>

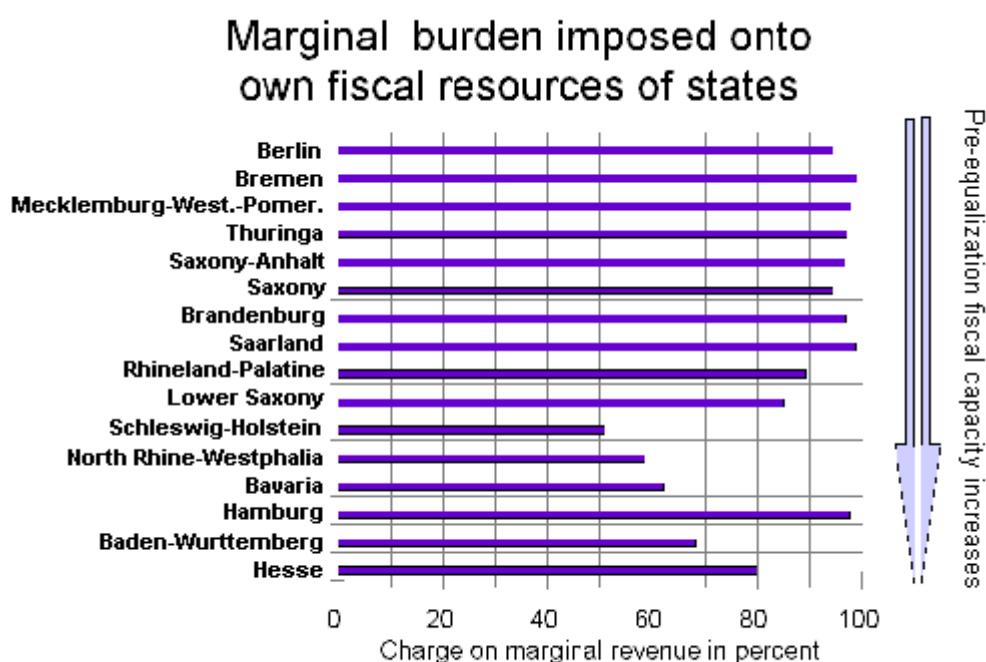
While interjurisdictional solidarity through equalization certainly facilitates consensus in an intergovernmental framework, this is not without political and economic costs. The redistributive process among states and among the federation and lower tiers of government breaks the link that should exist between expenditure decisions and their financing. This reduces the accountability of policy makers and it diminishes the influence citizen-voters can exert onto politicians. Moreover, the states lose any interest in developing their own tax bases, for instance through more effective tax

<sup>21</sup> This graph is based on own calculations derived from data supplied by the Ministry of Finance (*Finanzbericht*).

<sup>22</sup> The Federal Constitutional Court has also criticized this high degree of equalization, but it has recognized, in its ruling of 1999, the 95-percent mark—obtained after the redistribution of stage two—to conform with the constitution.

administration or better economic policies.<sup>23</sup> In a formal sense, interregional solidarity tends to reduce the financial autonomy of states even further—which is severely curtailed by the constitution anyway. This jeopardizes the independence of their budgeting, and hence policies. Moreover, equalization arrangements putting high penalties on any excess fiscal capacity relative to the national mean tend to encourage inefficient budget behavior, especially if combined with a federal grants scheme that effectively bails out non-performing governments.

FIGURE 6



Source: Ebert and Meyer (1999), p. 198

The analysis of the implicit marginal burden inherent in the combined system of interstate equalization poses the question, how much of a fictitious increment of own revenues of a state will ultimately remain at the disposition of that state; conversely, what the implicit marginal burden on incremental own revenue would be. If a state is guaranteed a minimum, and if that state's resources fall below that minimum, any increment of own resources is virtually "taxed" or diverted through the system of equalization. This explains the lack of interest of such states in developing their own tax base. Figure 6 indicates the high degree of implicit marginal burden on own taxes inherent in the German system of intergovernmental grants.<sup>24</sup>

A further aspect of the system is related to potential moral hazard by state authorities. A grants system that takes actual revenue and expenditures into account favors irresponsible budget behavior. If the community through the principle of intergovernmental solidarity almost automatically carries budget deficits, there is no incentive whatsoever to avoid such deficits. On the contrary: A country can spend more than corresponds to its original fiscal capacity, knowing, or confiding in, that the community of states or the federal government will ultimately bail it out. Although it is difficult to prove such behavior in practice, it is true that the *Finanzausgleich* and the federal grants "soften" any hard budget constraint there may be at the state level, which entails economic inefficiencies and waste of public resources.

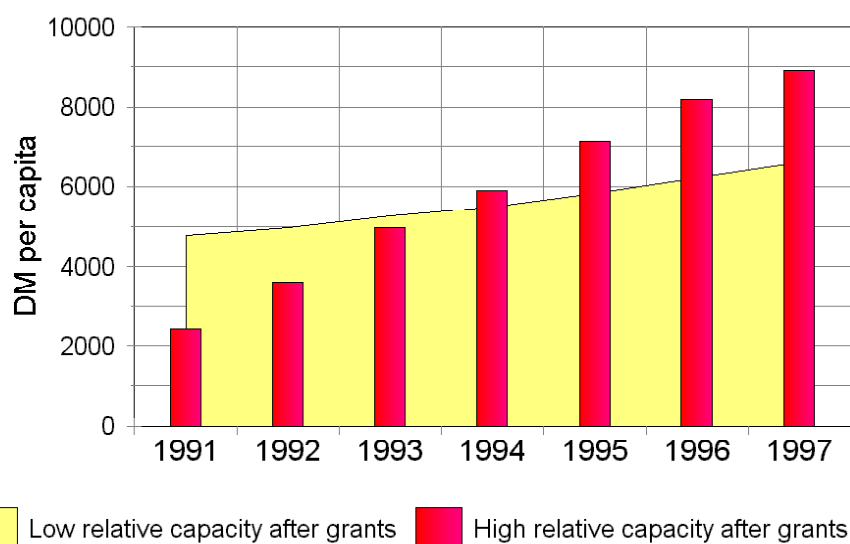
<sup>23</sup> Such features of grant arrangements are not unique for Germany only. For instance, François Vaillancourt has drawn my attention to a statement by the minister of finance of Newfoundland according to which 85 percent of new revenues from opening the Voisey bay nickel mine would be lost as reduced equalization.

<sup>24</sup> The data underlying this graph are taken from Ebert and Meyer (1999), p. 108

An indirect indicator for the inherent drift toward moral hazard is perhaps found in the debt ratio of the different states. If it were so that the consolidation of state budgets through compensating grants would counteract tendencies toward state indebtedness, then those states that benefit most from the Finanzausgleich (including federal grants) would likely to be at least as good in terms of their debt per capita ratio than the other states. In order to examine that proposition, this indicator was derived for those eight states that top the list in terms of fiscal capacity post redistribution (among them all Eastern states) and compared to the same indicator for the “poorer” eight states post redistribution (among them the more affluent states ante redistribution), the following picture is obtained (see figure 7).

**FIGURE 7**

### State indebtedness per capita for two groups of states



The eight “richer” states before equalization (that end up in the category of comparably “poorer” states after federal equalization grants)<sup>25</sup>, have continuously, but moderately, extended their per-capita debt during the period 1991 through 1997 (from DM 4,740 to DM 6,610). However, their “poorer” counterparts before equalization (that end up as comparably “rich” states after grants)<sup>26</sup>, have demonstrated a much more aggressive behavior as to debt per capita over that same period. True, the stronger debt dynamics of this group is explicable because it includes the formerly socialist states with their special situation (they started with zero debt after unification), but it is hard to accept that their per-capita debt should have outstripped by now that of their counterparts in an almost unbridled manner. This empiricism could be considered an allusion of moral hazard being encouraged through the system of intergovernmental fiscal relations in Germany. It would call for a more fundamental review of the relationship between interregional solidarity and subsidiarity in that country, and of equalization policies and constitutional provisions in particular.

<sup>25</sup> These are the states Baden-Württemberg, Bavaria, Hamburg, Hesse, Lower Saxony, North-Rhine-Westphalia, Rhineland-Palatinate, Schleswig-Holstein with a total of 62.8 million inhabitants).

<sup>26</sup> These are the states Berlin, Brandenburg, Bremen, Mecklenburg-Vorpommern, Saarland, Saxony, Saxony-Anhalt, Thuringia with a total of 19.2 million inhabitants.

## 5. STRIKING THE BALANCE BETWEEN SOLIDARITY AND SUBSIDIARITY

In view of mounting criticism of the German *Finanzausgleich* and of the equalizing federal grants programs, it is not surprising that there is a host of proposals for reform. However, given the political importance of this issue, it is also understandable that such propositions can hardly reckon to gain broad support because they typically question acquired financial positions relative to the national average.

This is not the place to discuss reform proposals at length.<sup>27</sup> However, a broad outline for reform of the German financial machinery may be given, which takes into account both the criticisms of the Constitutional Court and some principles of “competitive federalism” without abandoning the idea of interjurisdictional solidarity.

The Constitutional Court has mainly criticized the lack of clear criteria for defining “special burdens” and has asked for more transparency in intergovernmental fiscal relations. If this is taken seriously, there is a need to define clear criteria for both vertical and horizontal equalization. It is unclear in particular how to define criteria for the sharing of resources between the federal government and the states. The Court reckons that this would be possible on the basis of objective data, which is likely to be an illusion. It is impossible, for instance, to evaluate the need for defense at the central level against education at the state level without a political process and conforming value judgments. Need criteria are more easily established at any one subnational level among entities with similar responsibilities. For instance, it is feasible to define criteria for distributing resources for primary education among states: number of children in school age; student-teacher ratios; and so forth.

However, there is a clear constitutional dilemma here: While the German constitution asks for a quantitative approach for sharing resources at the vertical level, where it is virtually impossible, it prescribes population as the sole criterion for distributing resources horizontally,<sup>28</sup> where a quantitative needs-oriented approach would in principle be possible. Moreover, since horizontal equalization is exclusively confined to fiscal capacity, not expenditure needs, the Court requests that alien elements that have crept into the system (such as bonuses for states with sea harbors) should either be eliminated, or if accepted in principle, be rendered more general. In this case, other types of “special burdens” that may be warranted would have to be considered. It would ultimately lead to adopting the Australian philosophy of equalization.<sup>29</sup> Given the tradition of intergovernmental fiscal relations in Germany, it is highly unlikely that the legislature would follow this avenue and take on a more comprehensive approach.

If one were to follow the Australian road however, at least in principle, equalizing grants would have to be designed to take into account (1) the relative fiscal position per capita for all current revenue; (2) relative need criteria; and (3) the impact of specific federal transfers that affect the state's relative position as defined at stage (1). Moreover, the elements (1) and (2) would have to be standardized rather than be based on effective revenue or expenditure. In Germany there is already some standardization as to the revenue of municipalities, where an average tax rate is used rather than the effective rate. For the remainder of fiscal revenue, fiscal capacity is already largely “standardized” by the very fact that the tax law is uniform throughout the country.

The latter statement is however confined to legal aspects of taxation only. In principle, standardization would have to take further aspects into account, such as regional differences in the tax base or in the effectiveness of tax administration and collection. This is indeed possible as the Australian example demonstrates. If the view is taken that such differences are negligible in Germany, there is no need to standardize revenue beyond the present provisions for municipalities. However, the necessity to standardize will expand with the scope for greater taxing autonomy of states and municipalities. This is essential for all proposals that embrace the idea of granting the states greater taxing autonomy.

Relative needs criteria are to be translated into “necessary” expenditures—again at a standardized level. The basic approach is to define the costs of providing standard public services among various governments at any one level. An ideal procedure would be to form appropriate expenditure categories for which these needs are quantified in accordance with statistical methods that could vary among categories. This is easier within the Anglo-Saxon world of vertical power sharing than in the highly entangled fiscal arrangements in Germany, which would seem to call for a certain degree of

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<sup>27</sup> See, for instance, Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (1992); Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (1992), Nos. 363ff.; Peffekoven (1994); Huber and Lichtblau (1997); Renzsch (1999); Rosenfeld (1999); Kronberger Kreis (2000).

<sup>28</sup> This is the reason why the legislature was so ingenuous to “weigh” populations in favor of city states, a procedure criticized by the Court.

<sup>29</sup> The Australian approach is to standardize budgets—fiscal capacity as well as revenue needs and costs—in order to determine the relative position of any one state relative to the average for the assignment of the Commonwealth's general revenue grants. See, for instance, Rye und Searle (1997), or Spahn and Shah (1995).

„disentanglement“ (Entflechtung)—indeed popular request in Germany.<sup>30</sup> However, in spite of meshed expenditure functions and a complex net of financial arrangements including cofinancing, there is a clear solution to solving such problems if element (3) is taken into account properly. It would imply that the various forms federal grants would have to be considered as strengthening own fiscal capacities of states. It means that parts of the federal grants that are now accorded post Finanzausgleich would have to be accounted for prior to horizontal equalization.<sup>31</sup>

If it were possible to define a “standardized deficit” for each state, which would correspond to its number of population multiplied by the sum of standardized expenditures minus standardized revenue plus specific grants and cofinancing means from the federal government, this would establish a „neutral“ and fair basis for the horizontal equalization. „Neutral“ means in this context that no receiving jurisdiction has an incentive to neglect its own revenue potential, nor to manipulate its budget, for instance by increasing its expenditures in regard of implicit or explicit bail-out provisions inherent in the system.

How far interregional solidarity should go is a matter of political choice. The Constitutional Court has sanctioned a leveling off of 95 percent of the national average as conforming to the constitution, but has expressed qualms as to further compensations that go beyond that target. This should suffice to guide politicians in reviewing the law. Moreover, the population criterion mandated by the constitution as the guiding principle for interregional equalization could then be employed without further corrections at the subsequent level of horizontal Finanzausgleich, where „special burdens“—that would now have been taken care of by specific federal grants at an earlier stage—would no longer play any role. In practice, it would relieve the states from compensating „special burdens“ within the mechanism of interregional equalization.

The amount to which the financially stronger states would be asked to contribute to interregional solidarity will depend on the implicit “tax rate” that mirrors the compensation rate depicted in figure 3. Public finance experts have typically expressed the view that this schedule should be linear—rather than highly progressive as is the case now. The rationale for this is mainly to avoid abrupt upsurges of marginal fiscal increments or siphoning-off rates. What the slope of this schedule could be is, again, a matter of political choice.

To this point, the reform reflections of this paper are based on a personal interpretation of the rulings by the Constitutional Court. They should hence conform to the Grundgesetz. However, more competitive elements may easily be introduced and reconciled with this approach although they would imply a constitutional amendment. Competitive elements could enhance subsidiarity and hence strengthen local and regional administrations both politically and economically without jeopardizing interregional solidarity. I think in particular of the right of states to levy some own taxes. An autonomous tax policy—at least “at the margin”—is an essential and constituent element of state sovereignty. It strengthens the accountability of politicians and bureaucrats vis-à-vis their citizens, and thus contributes to render state budget policies more responsive, effective and efficient.

Own taxing rights could simply be introduced in analogy to the right of municipalities to vary their rates of the taxes on businesses and land. In particular, it would be feasible (and equitable) to allow states to levy a surcharge (in analogy to the church tax) on the national income tax collected in their jurisdictions, or preferably, an own tax on the federal income tax basis. This would be administratively easy to implement, it would render the state’s tax share more visible to the citizen-voter, and thus strengthen accountability. Of course, the corresponding revenue of this state tax or surcharge would be immune against applying the principle of solidarity, that is, against any form of interregional redistribution. It would remain exclusively at the disposition of the state authorities. Of course, the federal government would have to “make room” for such a state surcharge in order to keep the total tax burden on citizens constant. The realization of this proposal would require a constitutional amendment not only with regard to allowing the states to levy such taxes; it would also affect the present 50:50 partition rule for the vertical distribution of income taxes.

If such right to levy their own taxes will continue to be denied to German states, this could lead to serious pressure to levy non-tax revenue—for instance student fees to finance education—which would undermine interregional solidarity in other ways. Moreover, in the era of the Internet, there are new possibilities of levying charges for public services according to the quid pro quo principle. It implies that new forms of raising own revenue are likely to emerge and expand. This would entail a continuing dilemma: If such extra revenue will remain out of the equalization mechanisms as established now, there will be a continuing debate on what the constitution means with “current revenue”—the basis for

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<sup>30</sup> This line of criticism was opened up in the mid-70s by Scharpf, Reissert, and Schnabel (1976). See also Rosenfeld (1999).

<sup>31</sup> Federal grants as a last step of equalization make sense only if they are understood to compensate for temporary, special burdens—as in the Grundgesetz. This is true for the transfers destined to alleviate the special situation of the new states. These transfers should be retained as a last (fourth) step in correcting state fiscal capacity. However, they should definitely, and anticipatorily, be phased out over time in order to underscore their temporary nature.

equalization. The “poorer” states will put pressure on the “richer” to have such revenue included in the mechanics of interregional solidarity.<sup>32</sup> If such revenue would be integrated in the interregional solidarity programs however—in other words: the states would forego this revenue that was derived from taxing their own citizens on the understanding that it would benefit the regional community—, this would eternalize the lack of incentives to mobilize own resources and to manage regional budgets more efficiently at the state level. Given the history of German federalism and the reluctance to change rules that would seem to dismantle interregional solidarity, this latter option is likely to be chosen.

Given this prospect, however, it is questionable whether the German governments will be in a position to compete with other nations and regions in a globalizing world. Excessive solidarity at the expense of regional diversity and freedom to act could jeopardize their ability to meet the challenges imposed onto them by the new economy. To the extent that regional public decision making is decisive for economic development and growth, this could inflict upon the national economy and welfare of the whole nation.

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<sup>32</sup> This corresponds to the actual situation in Germany which the Constitutional Court has expressly sanctioned. Also in Canada new tax bases are added regularly to the equalization formula as they become used by the provinces (the last examples being videolotteries and casino revenues).



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## **REFORMING INTERGOVERNMENTAL FISCAL RELATIONS IN GERMANY: THE BAVARIAN POINT OF VIEW**

*By Otto Beierl*

I feel very honoured to have the opportunity today to talk to you about our efforts at reform in the field of fiscal relations between the Federal Government and the federal states in Germany, and in what way the state of Bavaria has become the driving force behind this process.

« Please note that I shall refer to what we call 'Bund' in German as the 'confederation' or 'federal government', and our 'Länder' are the 'states' or 'federal states' »

### **1. DEMAND FOR REFORMS**

Finances can very well express a federal governmental structure, because the fair and balanced distribution of government spending and public revenue is essential for the smooth functioning of a confederation. In other words through financial order we create the conditions necessary for the independence of the confederation and the individual federal states. In this way their political autonomy can unfold within an independent, self-reliant system where duties can be performed and budgets managed.

These federal financial regulations as an expression of the federal principle were of such importance to the drafters of the constitution of the Federal Republic of Germany in 1949, that they have been laid down in the constitution in a chapter of their own and are thus protected by it. This does not mean, however, that these financial regulations are therefore cast in iron and cannot be amended according to economic and political change. I think the fact that we have been able to cope financially with the German reunification since 1990 shows that these financial regulations are flexible enough to meet new challenges. I will come back to that in greater detail afterwards.

Also today, in the year 2001, and in the age of globalization and progressive European consensus we are responsible for a fundamental modernization of our federal and financial system. Over the past years and decades symptoms of paralysis have been on the increase in the administrative practice among the confederation and the states, but also among the states themselves, which handicap our competitiveness.

Where are these weaknesses in our system of financial relations between the confederation and the states, and among the individual states themselves, what changes have we already been able to bring about, and what are our suggestions - from Bavaria's point of view - to tackle modernization?

### **2. TAX LEGISLATION**

In Germany the confederation has the right to legislate only in matters of customs duties and fiscal monopolies. For all other taxes, the revenue of which the confederation is entitled to in part or in full, the legislative authority lies with the states as long and as far as the confederation does not exercise its right to legislate. In addition the confederation has legislative authority if and as far as an equalization of living conditions throughout Germany or the safeguarding of legal and economic unity require a federal ruling of national interest. It comes as no surprise that the confederation has exercised its rights extensively in administrative practice. However, a centralization of national fiscal policy leads to a reduction in the states' fiscal responsibility: fiscal independence is reduced to freedom of spending; the other side of the coin in budgetary autonomy - the procuring of revenue - is in practice subject to federal regulation. The negative consequences of this division of responsibilities are obvious. Within the framework of its initiative for a modernized federal structure Bavaria therefore demands that in the future the states themselves shall have legislative authority over those taxes which only they are entitled to at any rate (inheritance tax, tax on donations, real property tax, motor vehicle tax). We believe - for example in the case of inheritance tax - that it is not justified to have an identical basis of assessment and the same amount payable in the states of Schleswig-Holstein and Bavaria. In our opinion it is sensible to have a uniform evaluation basis for taxes on earnings to which both the confederation and the states are entitled to (income tax and corporation income tax), because in a small, interlocking economic area varying tax laws create more red tape than competitive edge. But it should be up to the states to determine the tax rates, or at least they should have the possibility to determine the tax factor.

### 3. DISTRIBUTION OF PUBLIC REVENUE AMONG THE CONFEDERATION AND THE STATES

#### 3.1. General Regulations

The regulations governing tax sovereignty concerning public revenue serve to ensure that the confederation and the federal states (including the municipalities) obtain an appropriate share of the total proceeds produced by the national economy so that they are in a position to do their job and bear the financial burden it creates. As mentioned earlier the distribution of public revenue among the confederation and the states is determined and safeguarded by the constitution so that this process cannot become subject to the free interplay of political forces, and to safeguard the objectives mentioned above.

Concerning the distribution of public revenue Germany has opted for a mixed system: for certain taxes sovereignty is exercised only by either the confederation, the states, or the municipalities (in this case we have a system of separation); other revenue is distributed among the confederation and the states (and in part the municipalities), in this case the system is based on consolidation (commonly shared taxes). Table 1 shows an overview.

The federal taxes make up a portion of roughly 17% of the total tax revenue, the taxes for the states only amount to about 5%, the municipalities get approximately 7%, and about 71% of the total tax revenue comes from the commonly shared taxes (see chart 1).

#### 3.2. In Detail: The Distribution of the Turnover Tax (Value Added Tax, VAT)

Concerning the commonly shared taxes it should be noted that the participation quota concerning the revenue from income tax and corporation income tax is laid down in the constitution itself, whereas the participation quota concerning the revenue from turnover tax among the confederation, the states, and municipalities is merely governed by federal law which is passed with the approval of the Senate of the Federal Parliament (the *Bundesrat*). The distribution of turnover tax is the flexible element in vertical financial equalization to account for shifts in the financial demands of the confederation and the states and to adjust them. Such shifts can occur in particular due to a changed pattern of expenditure - because expenditures or the federal law have actually changed - or because there has been a change in the amount of public revenue from federal, state or local taxes.

For the statutory determination of the quota of the turnover tax the constitution has laid down the following basic rules:

- ◆ There is a uniform claim by the confederation and the states to have their necessary expenditure covered within the scope of their regular income items. According to the constitution all earnings and expenditure coming from the municipalities are to be added to the states' financial volume.
- ◆ The confederation's and states' requirements for financial cover are to be tuned in such a way that there is a fair balance which avoids an overload for the taxpayer but which at the same time safeguards equal living conditions throughout Germany.

In practice these basic rules create some considerable problems; some of the details are discussed controversially among the confederation and the states. In one way this has to do with the scope of the regular income items: how is the financial share from the confederation paid to finance the joint tasks to be dealt with? How shall they deal with the earnings which have to go to the EU or the proceeds to the confederation from the German Central Bank?

The scope of the necessary expenditure is also contested: are the estimated budgets (and the budgetary planning, respectively) of the two government levels to be taken into account as they are or should they be modified?

During the several annual negotiations attended by the confederation and the states concerning the distribution of turnover tax these above-mentioned criteria play an important role, but ultimately the questions they imply are not really settled - they are resolved with a political compromise between the premiers of the confederation and the states. In conclusion it should be pointed out that the constitution stipulates a redetermination of the quota according to which turnover tax is shared if the ratio between the confederation's and states' earnings and expenditure follow a significantly different course or if a limited fixing of the quota has expired.

As difficult and contested the regulations concerning the detailed adjustment of the turnover tax may be, they are also an important element of security. They prevent the confederation from trying to carry out its departmental policy-making at the expense of the states.

Still, in accordance with the ruling of the Federal Constitutional Court in 1999 concerning the financial equalization among the states (which I will address later), Bavaria would like to change this situation as well. If the actual expenditure is referred to as authoritative in comparing the regular income items in relation to the **necessary** expenditure this bears the consequences that there is no incentive to be economical: if one government level increases its expenditure the other has to bear half of that cost. The confederation and the states have decided to eliminate this weakness.

### 3.3. Conciliation of Interests

When we speak about this distribution of public revenue we always refer to the distribution among the confederation on the one hand and the 16 states on the other. This is a highly significant aspect as all states have similar interests when the distribution is subject to negotiations again every couple of years, it makes therefore sense for them to team up for the negotiations to have a more powerful say. This is the reason why the confederation frequently applies the philosophy "share and rule", meaning it tries to break up the solidarity among the states to challenge the confederation by making special grants or benefits to individual states. However, each state is fully aware that a good result on the vertical level of distribution - i.e. among the confederation and all the states - eases the subsequent debate dealing with the financial equalization among the 16 states, which is carried out after horizontal distribution of public revenue has been dealt with. These interests are looked after without regard to party-political issues. The premiers of the German federal states therefore have a familiar quotation: "state interests overrule party interests".

## 4. THE DISTRIBUTION OF PUBLIC REVENUE AMONG THE STATES

Distribution of tax revenue among the states (state taxes, states' share in the revenues from income tax and corporation income tax) is carried out according to the principle of local yield: the tax money remains where it has been collected by the fiscal authorities. The local revenue is so to speak a natural indicator for the size of the share, because it reflects pretty accurately its citizens' and economy's actual efficiency to produce revenue - that is to say the region's efficiency to produce revenue. If a company's management and its place of operation are not in the same location for corporation income tax or if an employee's place of work (where income tax is collected) and place of residence are not in the same area there are regulations which govern the splitting of such revenue per location.

There has been an ongoing debate on the issue of income tax and whether it should be collected according to the place of residence or be divided between the place of residence and the place of work. This is particularly important for the three city states of Hamburg, Bremen, and Berlin which have a great number of commuters coming from the surrounding areas (Lower Saxony, Schleswig-Holstein, and Brandenburg). Their wage and income tax, respectively, go exclusively to the surrounding states, but at the same time they use the local infrastructure (theatres, schools, universities, hospitals) of the city states. Bavaria has come to the conclusion that these are spillovers which should be dealt with on a bilateral basis between the city states and its neighbours and could be solved by means of compensation payments. A modified distribution of public revenue would not be the right approach to this problem concerning the cities and their surrounding states.

In essence the states' share of the turnover tax is distributed according to the number of inhabitants, but up to 25% of the revenue goes to financially weak states - mainly the new German states - depending on their financial strength. In this way legislature makes sure that the tax receipts of financially weak states are raised to up to 92% of the average tax receipts of all states per inhabitant.

## 5. FINANCIAL EQUALIZATION AMONG THE STATES

### 5.1. Prevailing Law for Financial Equalization and its Weaknesses

Guests from abroad who visit Germany to gather information on our fiscal system often look at me in disbelief when I explain to them our system of financial equalization among the states. Allegedly (so they heard) there is this fiscal system in Germany that makes sure that richer states pay billions from their own budgets to poorer states - and all that on top of the distribution of public revenue which has already provided these states with at least 92% of the average tax receipts of all other states. At the end - after the confederation has made additional grants - all states are to have nearly 100% of the average tax receipts per inhabitant. There are even cases, they say, where formerly poorer states have actually overtaken formerly richer states in their financial strength. And all I can say is that - yes - it is true. But why?

Our system of financial equalization among the states strives for balance in a field of conflict, i.e. between the federal states' sovereignty and their loyalty to the confederation. The applicable constitutional directive stipulates the safeguarding of an appropriate adjustment if financial strengths vary. This has also to be taken into consideration in the

pursuit to create equal living conditions. There can be no federalism without accepting difference and variety. Therefore these conflicting issues, the federal states' sovereignty and their loyalty, which are present in all states, have to be adjusted time and again.

Bavaria takes the view that the same that we hope to achieve for our citizens should also hold true for the states: good performance must be worth it. Only if it pays to perform well there is an incentive to do so. Additional competition among the states creates an incentive to create in turn room for financial manoeuvre and thus open up opportunities for political diversification. The citizens identify themselves with their state's politics. If sensible policy-making attracts attention, special efforts made are being rewarded which also counteracts a disenchantment with politics.

Of course that does not mean that we intend to withdraw and discontinue our solidarity particularly with Germany's new states. After all it was Bavaria's proposition for a revised financial equalization to integrate the new states financially as of 1995, which was accepted by mutual agreement by the confederation and all 16 states. After transitional financing by the German Unity Fund, which was backed by the confederation and Germany's western states, and from which about 160 billion German Marks were paid to the eastern states between 1990 and 1994, they became fully integrated in the financial equalization among the states as of 1995 as proposed by the state of Bavaria. Estimates pegged additional financial requirements at roughly 30 billion German Marks per year, a sum of which two thirds were covered by the confederation, and one third by the states. When these issues were settled in 1992 and 1993, there was simply not enough time to give much thought as to the rationality and the incentive power of such a system - at the forefront we had the difficult task of integration.

However, over the past few years the system's lack of incentive momentum has become increasingly apparent, followed by a subsidy-minded mentality that cannot be kept up over the long term. The deficiency payments have increased year after year and it was impossible to predict when the financial equalization among the states would eventually live up to its basic idea: to be a help for self-help. People had settled in with this system of deficiency payments which did not call for individual responsibility. As a result of the near perfect balance, created in particular by the federal additional grants made after the financial equalization among the states, there has indeed been no incentive to try very hard.

If the city state of Bremen for example produced 100 German Marks in additional revenue, all it was eventually left with was one single German Mark, the other 99 Marks were "taxed away" because of a reduction in compensation payments to this state (chart 2 shows the results for the other states).

The scissors between the five federal states that pay for the financial equalization among the states (Bavaria, Baden-Württemberg, Hesse, North Rhine-Westphalia, and Hamburg), and the receiving states has opened up considerably towards the donor states. The state of Hesse, which is most affected by this situation, pays by far more than 10% of its state budget into the financial equalization, and thus to other states (chart 3 shows an overview of the payments made to the receiving states in 2000).

## **5.2. On the Way to Reorganization**

What was to be done? In 1997 Bavaria together with Baden-Württemberg and Hesse started talks about a new type of financial equalization: the compensation payments should be reduced sensibly, but above all greater incentive to perform well should be created. Although the motivation to perform well was clearly missing the receiving states refused to discuss possible changes. And because the eleven receiving states had the majority of votes at the *Bundesrat* there was no choice than to appeal to the Federal Constitutional Court in the end. The judgment pronounced by the Federal Constitutional Court on 11 November 1999, agreed with our point of view. According to this judgment the law governing the current financial equalization will only be an interim solution until the end of 2004 at the latest. An obligation to pass two new acts was placed on the legislature: 1. (Firstly) An act of standards which is to define in an abstract and general way the objectives of adjustments as well as the factors underlying an adjustment in vertical and horizontal equalization on the basis of the regulations laid down in the constitution. 2. (Secondly) The Legislator is to draft a new version of the law based on the above-mentioned act of standards, governing financial equalization for each fiscal year. The act of standards is to become effective no later than 1 January 2003, the new law of financial equalization no later than 1 January 2005. Failing this the current law governing financial equalization would become null and void according to the judgment of the German Constitutional Court.

Long, difficult, and extremely unyielding negotiations among the states followed. For one and a half years the donor and receiving states' positions were nearly irreconcilable. In the end, after non-stop negotiations for three days the states' premiers and the finance minister arrived at a solution on 23 June 2001, which all states and the confederation agreed to.

### **5.3. Reorganization as of 1 January 2005**

This reorganization of the federal financial equalization as of 2005 is basically in tune with Bavaria's objectives: reduced deficiency payments and greater incentive for better performance. A comprehensive solution became possible because the confederation agreed to assume financial responsibility for the 'German Unity Fund' (formerly financed by both the confederation and the states) as of 2005, and in addition the confederation will pay a "settlement contribution". The entire package including the regulations for the eastern states is limited to 2019.

I am afraid there will not be enough time to discuss the reorganization in detail, but there are three issues which I find particularly important: firstly, with the confederation's settlement contribution in the amount of 2.5 billion German Marks in addition to the protraction of the annual payments for the German Unity Fund, which the states had to come up with so far, it has become possible to provide each of the 16 states with a financial profit compared to the status quo. As of 2005 Bavaria will be relieved of about 380 million German Marks. Secondly, the scale according to which money is skimmed off for financial equalization now creates greater incentive: the maximum amount which can be skimmed off in donor states has gone down from 80% to 75%, and it will only apply if a state reaches 120% of the average financial strength of all states (up to now they started skimming off at 110%). In addition a system of premiums will be introduced according to which 12% of the state's above-average tax receipts must not become subject to financial equalization. And thirdly, the eastern states have been provided with a high degree of security. Up until 2019 they will receive further support from the confederation in the amount of 306 billion German Marks. When this recovery program will definitely have come to an end in 2019, the eastern states will have received special grants for 30 years - for a whole generation - and by then they will have successfully caught up economically with the western states.

With this financial equalization we have introduced subsidiary character and competition among the states - efficient principles to organize our federal structure.

## **6. OUTLOOK ON EUROPE**

In Bavaria we believe that the principles of competition, a subsidiary character, and diversity should also become the role model for the architectural structure of Europe's nations. The nations of the European Union face the dual challenge of expansion and consolidation.

The approaching eastern expansion of the EU which will take place over the next few years will also come as a great financial challenge to Germany as EU's biggest net payer. However, the extent of financial solidarity towards the new European neighbours must not be overstrained considering the somewhat limited efficiency of the present EU nations. From our experience with German reunification we know that economically less efficient member states will certainly need at least 30 years to catch up. And we will tackle this task as well.

TABLE 1

## VERTICAL APPORTIONMENT OF TAX REVENUE

**Federal Taxes, State Taxes, and Municipal Taxes.** The revenue of the following taxes accrues wholly to one tier of government in Germany:

FEDERAL TAXES	STATE (LAND) TAXES	MUNICIPAL TAXES
- Spirits monopoly	- Inheritance tax	- Municipal trade tax
- Insurance Tax	- Real property transfer tax	- Real property tax
- Customs duties and other levies required by the European Union	- Motor vehicle tax	- Local excise taxes and taxes on certain non-essential spendings (e.g. dog tax, beverage tax)
- Excise taxes on tobacco, coffee, sparkling wine and mineral oil	- Beer tax	
	- Tax on betting and lotteries	
	- Gaming casinos levy	
	- Fire protection levy	

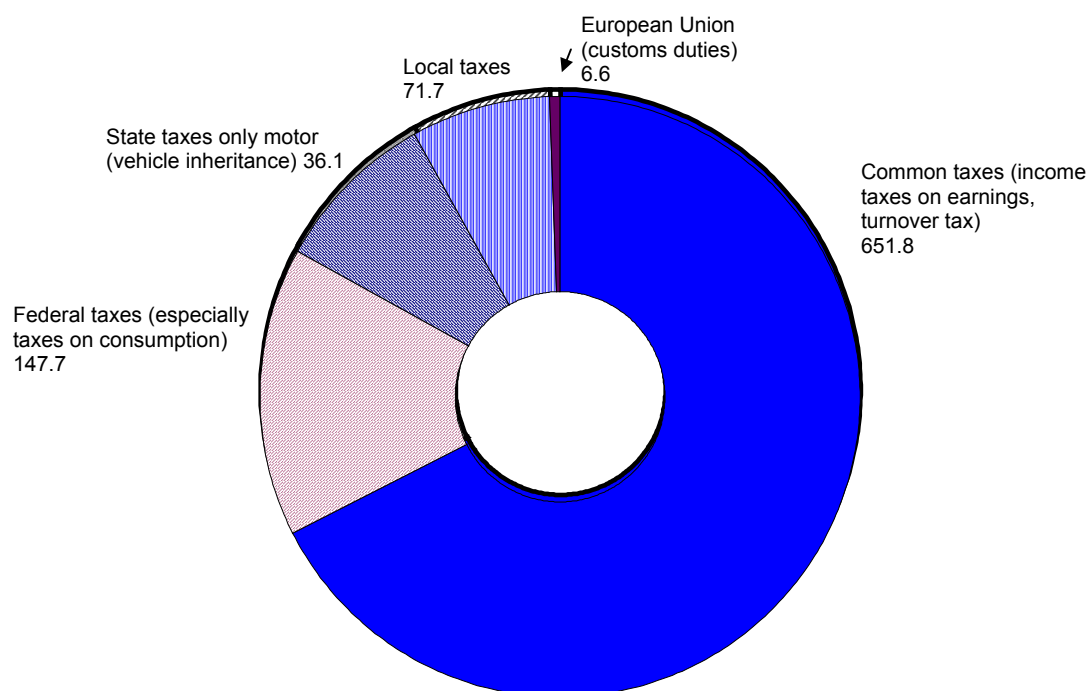
**Joint Taxes.** The revenue of the most important taxes is shared by the Federation, the States (*Länder*) and the Communes as follows:

	Wages and Income tax	Corporation tax	Turnover tax
Federation	42,5 %	50 %	52,2 %
States ( <i>Länder</i> )	42,5 %	50 %	45,7 %
Communes	15 %	---	2,1 %



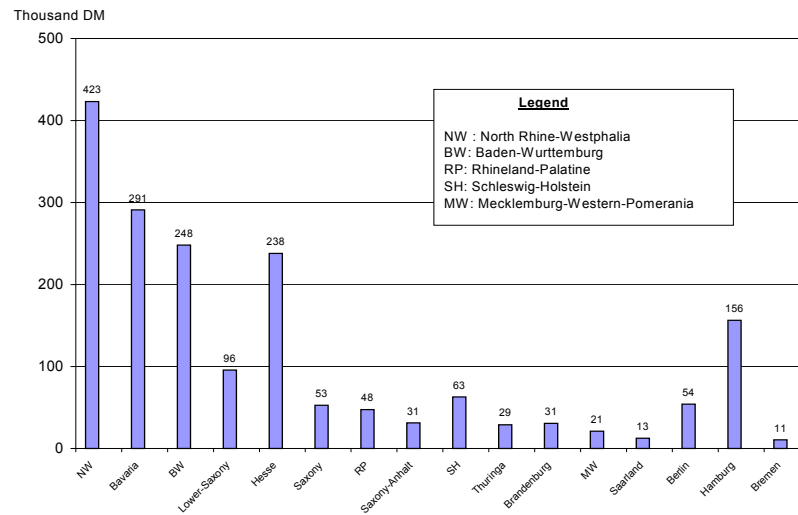
CHART 1

**DISTRIBUTION OF TAX REVENUE IN 2000 IN BILLION GERMAN MARKS**  
(total DM 914 billion)



## CHART 2

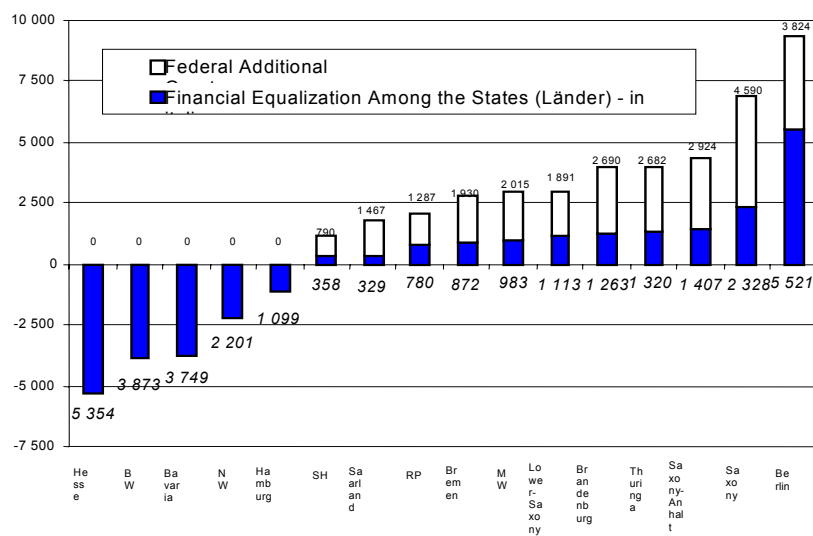
**REMAINING SURPLUS OF A STATE (LAND) RESULTING FROM A 1 MILLION DM INCREASE IN TAX RECEIPTS  
WITHIN THE STATE, AFTER EQUALIZATION**  
(According to Prevailing Law in 2000, Thousand DM)



## CHART 3

**FINANCIAL EQUALIZATION AMONG THE STATES (LÄNDER) AND FEDERAL ADDITIONAL GRANTS IN 2000**  
(Million DM)

Adjustment  
(Million DM)



# **FISCAL FEDERALISM IN SWITZERLAND: A SURVEY OF CONSTITUTIONAL ISSUES, BUDGET RESPONSIBILITY AND EQUALIZATION**

*By Bernard Dafflon*

## **1. INTRODUCTION**

This paper deals with the institutions and actual problems of fiscal federalism in the case of Switzerland. It is divided in five sections. Starting in section 2 with a short summary of some issues in fiscal democracy, which have relevance to Swiss decentralised public finance, the paper describes in section 3 the main components of the fiscal structure and the assignment of functions and revenue sources at decentralised levels. Then it develops in three directions: budget policy (section 4), taxation (section 5) and fiscal equalisation (section 6).

Since the Constitution of 12th September 1848, Switzerland has been, in institutional terms, a relatively complex system of three layers of government: (1) the communes, at the local level, (2) the Cantons, at the intermediate level and the Confederation, at the national level - which are interconnected by many vertical and horizontal relationships. At the end of 1998, there were 26 Cantons and 2903 communes (see Table 1 for some general indicators about the Swiss Cantons).

Fiscal federalism in Switzerland can be characterised in terms of overall fiscal restraint and minimising the centralisation of fiscal power. It is a "bottom-up" federalism. Constitutional arrangements, both at the federal and the cantonal levels, certainly explain this performance. The subsidiarity principle - which recommends that competencies in the provision of public services should be vested to the lowest possible level in the fiscal hierarchy - has been probably more scrupulously respected in this country than in many other federations because of both constitutional guarantees and a traditional mistrust of global nation-wide policies. In addition, the Cantons and the communes are seen as laboratories of innovation in public policies and management, without widespread risks of failure. As a consequence, the power to decide and finance the provision of public services has remained largely (and jealously) in decentralised hands, in the Cantons or in the communes. Many forms of co-operative federalism have flourished in the last decades, whether in formal institutions like the inter-cantonal treaties ("concordats intercantonaux") or informal, like the inter-cantonal conferences of Ministers or high civil servants for various functions.

However, the fairly extensive autonomy of cantonal and local governments for their finance is not unlimited. Competition between jurisdictions is a first limit. Second, many cantons have introduced their own constitutional rules with regard to (balanced) budget and debt limitation (section 4). Fiscal competition is partly softened by rules of tax co-ordination and harmonisation (section 5). However, autonomy in public expenditures, direct access to many revenue sources and, above all, differences in the Cantons' economic potential (see Table 1, columns 6 to 8) have led to relatively important regional disparities, expressed in the fiscal burden of the Cantons and in their financial capacity (Table 9 thereafter). These disparities are at the core of the Swiss equalisation policy, although there is no claim for perfect equality between the Cantons or the communes (section 6).

## **2. FISCAL DEMOCRACY**

In fiscal federalism, institutions play an important role in shaping the relations between the layers of government. It is therefore of interest to shed some light on the working of the institutions in Switzerland, particularly on the rules and principles, which govern the assignment of functions and revenue sources to decentralised jurisdictions. Four institutional characteristics are essential in the working of Swiss federalism: (1) the vertical division of power in the Constitutions, (2) direct democracy, (3) initiatives and referenda and (4) horizontal co-operation between governments at the cantonal and communal levels.

### ***2.1. The vertical division of power***

The Swiss federal system emphasises the sovereignty of subcentral jurisdictions, i.e. the Cantons and the local communities. This sovereignty is derived from the federal and cantonal constitutions, which list not only the tasks of each government level, but also fix their right to levy some sorts of taxes. Thus, the assignment of competencies and revenue sources is guaranteed at each level of government. The vertical division of power, intended to prevent stable majorities from being able to exploit minorities, is strongly safeguarded in the Constitution (KNAPP, 1986; ZIMMERMANN, 1987).

Article 3 of the new Federal Constitution of April 18th, 1999 guarantees the Cantons' sovereignty in all the spheres in which the Constitution does not explicitly provide for the federal government's competence. Article 42 Cst defines in a restrictive manner the assignment of functions to the Confederation: *"it shall accomplish the tasks which are attributed to it by the Constitution."*<sup>1</sup> Therefore each new competence of the centre requires a constitutional amendment, which necessitates the consent of both a majority of the voters and a majority of the Cantons. In contrast, article 43 Cst stipulates that *"the Cantons shall define the tasks which they shall accomplish within the framework of their powers."* At cantonal level, there is no need for a constitutional explicit clarification. The autonomy of the Cantons is also guaranteed by the legislative power with two Chambers which have equal power (art. 148 Cst.). The National Council (House of Representatives) is elected on the basis of population in the Cantons according to the system of proportional representation. The Council of States (the Senate) consists of 46 delegates of the Cantons, two for each canton and one for each half-canton (Appenzel Rh. Int. and Appenzel Rh. Ext., Basel-City and Basel-Land, Nidwald and Obwald) whatever its population, size or economic and financial power. The Cantons regulates the election of their Senators.

- ♦ Up to now, fiscal/financial arrangements have been discussed either at the federal-cantonal levels or at the cantonal-local levels. The federal government addresses itself always and exclusively to the Cantons. It could not by-pass cantonal governments to address local governments either to impose or to negotiate fiscal or financial matters or the provision of public services. The inverse is also true: local governments cannot by-pass cantonal authorities; they have no direct access to federal bureaux or institutions. In this way, federal decisions concern the Canton only; and each canton organises communal competencies on its own. This vertical division of power leaves a high degree of autonomy to the Cantons but also creates problems for the larger municipalities. On one side, the Cantons have their own fiscal systems, which are independent of the federal system. The Cantons are therefore able to set their own tax rates, and they decide on the provision of public goods and services on their own. Although the modification procedures are long and complex, each voter/taxpayer in a canton or in a commune is able in the end to compare the costs and benefits of the public activity under consideration and to decide on the amount of public expenditure in a vote or in a referendum. On the other side, large municipalities or agglomerations, like that of Zürich, which alone has more residents than the five neighbouring Cantons, create spillovers over cantonal boundaries, but have not the ability to negotiate directly over those limits. Although agglomerations have a statistical definition, and have been an expanding economic reality for the last decade, only the new 1999 Federal Constitution gives them an institutional recognition.<sup>2</sup> What will be the effective consequences of this article is not yet clear.

## 2.2. Direct democracy

Direct democracy participation is provided in most cantonal constitutions for the communes so that citizens themselves may take part in the decision-making process on all important political and economic issues. In local public finance, this competence concerns: current budget, individual investment items of the capital budget, annual tax coefficients, user charge regulations (taxation according to the benefit-principle in general), local public property sale or purchase, horizontal co-operation in the form of inter-communal association or special purpose district for the joint production of public facilities, and the amalgamation of communes.

In addition to participation, control and audit competencies of some sort exist in all direct democracy. The communal assembly of citizens, or the communal "parliament" where it exists, elects a finance committee for the length of the political term of office. This committee has not only traditional audit competencies, but also the duty to report to the assembly about the financial aspects of capital expenditures, changes in taxation. In addition, it has the powers to investigate financial matters without warning, if necessary. In some cantons, it may lodge a complaint against individual members of the local authorities for misuse of public funds.

## 2.3. Initiative and referendum

When democracy is representative, which is the case in a large majority of the Cantons and in large cities, voters express their preference about political and economic issues mainly via referenda, which may be brought up for vote several times during a year. Together with popular initiatives, these institutions play a role of moderator for cantonal and local governments, as usually all important public decisions are subject to the voters' approval. At the local level, the most common items which might be included in the initiative or the referendum procedure are: individual investment

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<sup>1</sup> Title 3, chapter 2 of the new Federal Constitution of 1999 provides the enumeration of federal competencies. The constitutional articles also fix the role of the Cantons for those functions. It follows that for a large number of public expenditures, the Cantons have only residual autonomy and act rather as "agencies" for the centre.

<sup>2</sup> The Federal Constitution of 1999 contains for the first time an explicit reference to the communes and municipalities. Art. 50 says: "(1) The autonomy of the communes is guaranteed within the limits fixed by cantonal law. (2) In its activity, the Confederation shall take into account the possible consequences for the communes. (3) In particular, it shall take into account the special situation of cities, agglomerations, and mountainous regions."

items of the capital budget, taxation, user charge regulations, property sales, co-operation in inter-communal associations or special purpose districts, and the merging of communes.

Obviously these institutions of the federal system do not have a unique purpose of (economic) efficiency in the performance of expenditures and taxation. The more direct and democratic the institutions are, the better is their general capacity to strengthen the system of checks and balances, by both dividing and sharing political decision-making power. They give citizens/voters/taxpayers multiple access to government, increase their capacity to control the budgets and reduce political and bureaucratic leeway in rent-seeking behaviour. In Hirschman's terminology, they not only have the "exit" (Tiebout-style mobility), but also the "voice" solution. The outcomes are that the growth of government activity has been significantly lower than in representative democracy (POMMERHNE and SCHNEIDER, 1978), the size of government is limited (POMMERHNE, 1978) and public expenditures are driven by the demand side (KIRCHGÄSSNER and POMMERHNE, 1990).<sup>3</sup>

#### 2.4. Co-operative federalism

The federal and cantonal Constitutions permit intensive horizontal co-operation at the cantonal and communal levels of government. This horizontal co-operation is important for the principle of fiscal equivalence (OLSON, 1969), so that the circles of deciders, beneficiaries and payers coincide. The Cantons and communes are free to conclude agreements with one another on co-operation in the most varied areas and so establish themselves the optimum size of area necessary for the performance of government tasks, for example the provision of certain public goods, from University funding (inter-cantonal co-operation) to school districts and water provision (inter-communal co-operation).<sup>4</sup> Yet it must be said that whereas inter-cantonal "concordats" are quite a success for many cantonal public policies and functions (financing the Universities is a good example), they have failed with regard to taxation, left widely unrespected or without real content as for the law on (formal) tax harmonisation (see section 5), under the motive of tax competition or the arguments of regional growth policies.

- ◆ Horizontal "face-to-face" co-operation between the Cantons has taken another form which was not foreseen in the Constitution. When the need for a nation-wide steering policy arises, fiscal federalism in theory suggests that this should be realised at the centre, by the federal government. This is not always the case in Switzerland where the Cantons have organised themselves horizontally in a set of powerful Committees, the so-called Conferences of Cantonal Ministers, one for each department in the administrative division of government executives, of which the Conference of the Cantonal Ministers of Finance (CCMF) is the most influential. From a constitutional point of view, fiscal/financial relations between the federal government and the Cantons cannot be tailored according to individual cantonal particularities or wishes. Equality of treatment applies, except within the equalisation law. Although each canton could challenge or negotiate individually fiscal/financial arrangements with the federal government, no single canton would have much chance in succeeding in modifying fiscal/financial arrangements for its own objectives, since any change applies (and indeed should be acceptable) to the other cantons. Within the Conferences, the Cantons negotiate common policies without interference from the centre, then present a common package to the federal government. The objective of the CCMF is to discuss fiscal/financial matters which are of common interest to all or a large number of the Cantons. It has been organised not so much to co-ordinate and harmonise fiscal and financial affairs of the Cantons (horizontal relations), as to intervene more persuasively in federal-cantonal relations and to interfere in federal-only fiscal and financial matters. The Conference is not a constitutional institution. Yet, fiscal matter cannot be decided at the federal level without previous consultation of the CCMF. It is a powerful pressure group, regularly consulted by the federal Finance Administration. It has been successful in negotiating global financial packages in which the point of view of the Cantons differs from that of the federal government. It has played an important role in shaping federal finance, the federal tax system and tax harmonisation, which was to remain "formal", and has a dominant position in federal equalisation policies (DAFFLON, 1995).
- ◆ The Conference of the Canton (CdC) also exerts a powerful balance against federal policy proposal. The whole process of a New Fiscal Equalisation package, which is presently under discussion, is a joint venture of the Federal Ministry of Finance and the CdC.

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<sup>3</sup> In most Cantons, constitutional or legislative initiatives are possible on taxation, current or capital expenditures, which require a minimum number of citizens' signatures. Referenda against capital, unique or recurrent expenditures are also possible. The institutional and legal conditions about the distinctions between compulsory or facultative referendum, unique and recurrent expenditure, capital or current expenditure, the number of signatures required, the time allowed for collecting the signatures, differ widely from one canton to another. While the influence of referenda in general on the outcome of the public budget are known, the influence of the detailed cantonal referendum conditions, as a measure of budget orthodoxy, on public deficit and the indebtedness of the Cantons are actually under scrutiny in two studies (NOVARESI, 2001, University of Fribourg and PUJOL, 2000, University of Geneva). Also KIRCHGÄSSNER, FELD and SAVIOZ, 1999.

<sup>4</sup> New forms of inter-cantonal co-operation, called FOCJ for "Functional, Overlapping and Competing Jurisdictions", are developed in FREY and EICHENBERGER, 1999.

- ◆ At the local level, the main incentives for inter-communal co-operation are, traditionally, economies of scale and regional spillovers and, more recently, limited managerial skills in many small municipalities, especially when local governments function as production agencies for the centre (Cantons or Confederation), as for example in the field of national environmental policies. Contrary to other federal countries, there are no de-concentrated “federal agencies” which act as regional producers of services for the provision of public services that have to respect minimum standards set by the central government, as “principal”. The Cantons, as “agents”, decide the form and how they intend to implement those services. Usually, these are in turn assigned to the local tier. There is no duplication of similar producing organisations at the decentralised levels.

There is no doubt that the opportunity to create inter-communal institutions has been largely used by the communes and has improved efficiency in producing and delivering local public services. But the multiplicity of inter-communal special purpose districts has also created many institutional problems: a democratic deficit in the regime of communal assembly, higher information and participation costs for individual citizens who henceforward belong not only to one commune but to several other “clubs”, strategic blockages of votes by negotiating communes when a qualified majority is required, and the like (DELLA SANTA, 1996). Despite these inconveniences, it may be precisely this executive flexibility of federalism which has long made it resistant to attempts of centralisation on the part of the federal government vis-à-vis the Cantons, or on the part of the Cantons vis-à-vis the communes. It also explains why so many small communes can survive without merging and why the compulsory merging of too small communes is not easily accepted by the citizenry (DAFFLON, 1996a).

### 3. THE PUBLIC SECTOR: FACTS AND FIGURES

This section summarises the overall present situation of the public sector in Switzerland at the three tiers of government. All figures are based on 1998. Tables 1 to 11 also exist for the period 1990 to 1997:<sup>5</sup> but there have been no significant changes over this last decade. Section 3 is divided in four sub-sections: a) general indicators concerning the Cantons, b) the size and growth of the public sector, c) public expenditures and d) public revenues. Whenever possible, the current state of research on fiscal federalism in Switzerland is mentioned.

#### 3.1. General indicators

The institutional issues presented in section 2 have of course a price to be paid in terms of economic efficiency and equity. The solutions and practical arrangements do not exactly correspond to the canon of fiscal federalism in the textbook. And they do not permit to level out all differences in the economy and the public sector. A few statistical data will illustrate this argument. Table 1 gives five general indicators about the organisation and the economy of each Canton: the number of communes, the surface in km<sup>2</sup>, population, national income in the Cantons (NIC) total and per capita, public expenditures and revenues.<sup>6</sup>

Marked differences exist in the organisation of local government, the number of communes, in size, population and national income, that one probably does not find in another federation (FRENKEL, 1986).

- ◆ The area of the smallest Canton (Basel-Town, 37 km<sup>2</sup>) is 0.5 per cent of the area of the largest (Grisons, 7 105 km<sup>2</sup>).
- ◆ The population in the least populous Canton (Appenzell Rh. Int.; 14 873 residents) is 1.25 per cent of that in the most populous (Zurich; 1 187 609 residents).
- ◆ In 1997, the Canton with the highest NIC was Zurich, with a total 67 114 millions SFr., that is 21 per cent of the national NIC for 17 per cent of the population. The variation in per capita NIC is rather large: from 68 320 SFr. in Zoug to 31 012 SFr. in Jura, that is a ratio of 2.2 between the two Cantons with the highest and the lowest per capita NIC (or a range from 154 points to 70 points, for an average 100 points = 44 500 SFr. per capita).

There are also:

- ◆ Marked differences in the growth of per capita NIC between 1980 and 1997 (in real values): in 13 of the 26 Cantons, the rate of growth has been higher than the average 15 per cent (an average 0.9 per cent annual for the 17-years period), with a maximum at 36 per cent and a minimum at 1 per cent (Table 1, column 8).
- ◆ Graph 1 also presents the comparative position of the Cantons in comparing their NIC per capita for 1997 in nominal values (national average: 44'500 Sfr.) and the growth of per capita NIC between 1980 and 1997 in real value (Table 1, columns 7

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<sup>5</sup> Available by the author.

<sup>6</sup> Tables are given at the end of the text.

and 8). The graph shows that, despite some thirty years of national fiscal equalisation policy and as many years of regional development policies, the eight richest Cantons (top right hand box) are also ahead in term of growth. The canton of Geneva is the only exception, being a canton with higher-than-average NIC per capita, but a lower-than-average rate of growth (down right hand box).

- ◆ On the opposite side, eleven Cantons have remained in a bad position (down left hand box) with at the same time a NIC per capita and a rate of growth below national average. Only five Cantons (Appenzell Rh. Int., Uri, Lucerne, Fribourg, Tessin and Vaud) registered a slight improvement, with still lower-than-average NIC per capita but higher-than-average rates of growth.
- ◆ From this performance, one cannot say that both equalisation and regional development policies have been very successful. Though it must also be remembered that the federal equalisation policy has not a total "gap-filling" objective in setting revenue sharing formulas or equalising grants (see section 6 below).
- ◆ The indices of fiscal burden in the cantons and communes: from 57 points in Zoug to 132 in Jura, for an average 100 points (Table 9).
- ◆ The financial capacities of the Cantons, represented in the official indicators (Table 10) vary from 30 point in Jura to 206 point in Zoug, for an average of 100.

### 3.2. Size and growth of the public sector

Differences in the public expenditures of the Cantons and the size of the cantonal public sector expressed in proportion of NIC are important: it runs from 11 per cent in Schwyz and Zoug to 28 per cent in Bâle-Ville and 29 in Geneva and to a record 35 per cent in the canton of Jura (Table 1 column 12). Yet, this comparison must be interpreted with caution.

- ◆ Another image is given if one considers per capita public expenditures in the Cantons (Table 1 column 13). For example, in Bâle-Ville, a "town-Canton" with only 3 communes in the same urban area, the cantonal layer plays a central role: per capita public expenditures are much higher (2.33 x) than the national average; this is also the case with Geneva, another "town-Canton". A more centralised delivery of public services internalises urban benefit spillovers and reduces co-ordination and information costs. On the other hand, the Canton of Jura, with 83 (too small ?) communes, has a low financial capacity. Therefore the Canton stands in for a certain amount of services which cannot be privately sponsored or paid, and these expenditures weight more on the cantonal less developed economy (Table 1, column 12 compared to column 13). But no significant inverse correlation can be found between the financial capacity of a canton and the importance of its per capita public expenditures.

Table 2 shows the size and growth of the public sector over the period 1970 to 1998. In 1998, total public expenditures amounted to 143 459 millions SFr. or 32 per cent of Gross National Product (GNP) (without social security; 39 per cent with social security insurance). In proportion to GNP, the size of the public sector is still quite low compared to other countries in Europe. The growth of public expenditures has been relatively important between 1970 and 1980 both in relative and absolute values. It has continued to grow over the past decade (1980-1990) in absolute amounts, but the relative share of the total public sector in GNP has remained stable around 26-27 per cent. It has regained in proportion since the beginning of the nineties, partly because the economic situation has deteriorated and partly because social aid expenditures and unemployment benefits have increased above average.

- ◆ The rates of growth of public expenditures for each layer of government followed a different trend over the period. One can read it in diagonal from column 6 line "Communes" to column 9 line "Cantons" and column 12 line "Confederation". Between 1970 and 1980, only the average rate of growth for the Communes, at 141 %, was higher than the total average; between 1980 and 1990, this was the case only for the Cantons; and between 1990 and 1998, for the Confederation. For the total period, the figures give a creeping centralisation towards both the Cantons and the Confederation (both around 500 per cent, column 13) to the detriment of the Communes, with a total rate of growth of 475 % below average.
- ◆ The actual shares of the Confederation, the Cantons and the communes in total public expenditures correspond in aggregate values to 33, 40 and 27 per cent. The repartition has remained stable for the centre, for almost thirty years around 31 per cent; yet, increasing to a 33 % in the last 8 years. At the cantonal level, the share of total expenditures has remained around 40 per cent for the last two decades. At the local level, it decreased from 29 to 27 per cent. In difficult time (1990-1998) a soft trend towards centralisation at the federal level with the Communes losing weight is perceptible.

### 3.3. Public expenditures

The assignment of functions between the three tiers of government has continually changed over the 150 years of the Confederation's existence. The "optimum" division of competencies is of course never definitive and the question of which tasks should be assigned to which level of government has never been finally answered (DAFFLON, 1992). The division of public expenditures may be explained in terms of subsidiarity and centralisation. However, it must be said that the whole process has been laborious and rather conservative, political strategies and bureaucratic locking often jeopardising the results.

Articles 54 to 125 of the 1999 federal Constitution contain an exhaustive and detailed enumeration of the federal competencies. The Constitution always states whether a function is an exclusive federal or cantonal matter and, with shared responsibilities, the limits of central interference in the cantonal functions.

#### 3.3.1. Exclusive functions and shared responsibilities

Total expenditures for each function performed by the three levels of government are summarised in table 3. Responsibility is shared, to some degree, by the three layers of government in almost all fields of public intervention. Obviously, the Confederation is solely responsible for foreign affairs and to a less-than-full extent for national defence (90 %). But other items, like education, culture, sports and recreation, health, environment, roads, generally remain the main responsibility of the Cantons and the communes.

Table 4 indicates the respective shares of public expenditures in proportion of the total budget of each of the three layers (column "within" – vertical) and the proportion between the three tiers (column "between" – horizontal). If we look at which governmental tier is the biggest spender in single items :

- ♦ the **communes** have the highest share in the budget items: environment (63 %), culture, sports and recreation (56 %), administration (44 %);
- ♦ the **Cantons** in: public order (67 %), health (56 %) and education (53 %);
- ♦ the **Confederation** has an exclusive position in foreign affairs (100 %), a dominant position in defence (90 %) and assumes more than half the public expenditure in economy (52 %), transportation and finance (both at 51 %).
- ♦ Although the Cantons and the communes together spend more, the **centre** has the largest single share in social affairs (44 %).

The exclusive competence of one layer of government in a function (as indicated a contrario by a value 0 in the table 3) occurs only in a few cases. Otherwise, the division of powers and the principle of subsidiarity apply. Thus, general functions must be subdivided. For example, under the heading of "Social Affairs" in general (see table 3), the federal government plays an important role (44 % of total social expenditures), though not dominant. The division of functions shows that it has the first role in social security only (old-age pensions: 82 %, and invalidity: 71 %). Illness insurance and individual social aid are both more important in the Cantons and the communes (with total of 64 % and 82 % respectively). The item "other social insurance" (mainly family allowances) is cantonal (51 %). This type of vertical assignment exists for almost all sub-functions, but it differs within each individual Cantons between the cantonal and the local layers.

The general trend in the division of responsibilities between the three layers of government has almost not changed for the last thirty years. When one particular function requires more resources relative to others, the growth of expenditures for that function runs almost parallel in the three levels. This is a very conservative situation. The various attempts to modify the existing constitutional division of tasks between the federal government and the Cantons have either invariably and lamentably failed or produced insignificant results.<sup>7</sup> Changes in the relative position of the three tiers may however happen, due essentially to external circumstances. For example, with the economic crisis of the nineties, the federal government was first faced with higher unemployment. Thereafter, the Cantons were concerned with individual social aid because individual unemployment often persisted longer than the period of unemployment benefits. Whereas the individual social assistance of the Cantons represented only 66 % of the communal expenditures for this function in 1988, it has doubled in ten years and raised to almost the same amount (97 %) in 1998. In fact, in this period the burden of the financial solution has shifted from the local to the cantonal level. This experience will certainly shape the future of

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<sup>7</sup> See the following reports from ad hoc or special committees: Stocker Report 1966 on the revision of federal conditional grants and subsidies, the special reports for a new assignment of functions and responsibilities between the Confederation and the Cantons, first bunch of measures in 1971, second bunch of measures in 1978. In the actual proposal regarding the New Fiscal Equalisation, the chapter concerning a new (vertical and horizontal) division of functions between the Center and the Cantons is heavily and fiercely debated.



this particular task and its assignment at the federal (unemployment insurance) and the cantonal levels (individual social allowances), with the main responsibility being taken away from the communes.

### 3.3.2. *Subsidiarity*

The fundamental principle in the distribution of tasks between the various levels of government is subsidiarity. Competencies are vested at the local level and can be transferred to the cantonal level only insofar that the lower level is no longer in a position to provide a service "efficiently". In most cantons, a constitutional amendment decided by popular vote or, at least, a law decided by the cantonal parliament, sometimes subject to referendum, is necessary. The same principle is valid between the cantonal and federal levels. A transfer of competence from the Cantons to the federal government must be passed by constitutional law, with a double majority vote of the people and the Cantons.

Sure, it has not been too difficult to reach agreement on the concept of "subsidiarity". The key questions are not semantic, but start with

- a) the definition and measurement of "efficiency",
- b) who decides when the provision of a local (decentralised) public service is no longer "efficient" and
- c) at which level the responsibility should be "centralised" ?

Opinions also diverge about which "efficiency" criteria are appropriate for the organisation (and the reorganisation) of functions within the three layers of government.<sup>8</sup> Economies of scale, homogeneity of preferences, spillovers and congestion costs, are generally accepted as efficiency criteria (DAFFLON, 1992). Poorer governments which argue that they ought to receive more equalisation payments dispute the criteria of financial capacity and budgetary resources. WISEMAN (1989) argued that efficiency criteria must be related to the capability of strengthening political checks and balance through appropriate procedures and not to the tax-and-expenditures outcomes as such. This is probably the closest theoretical argument for Switzerland. The resulting allocation of expenditure functions and of policy-making within the communes, the Cantons and the Confederation does not obey simple rules that ensure neatness, tidiness and smoothness. Instead, an elaborate system of compromises (call it "checks and balance") limits horizontal and vertical coercion, which has led to the budgets of the different levels of government becoming increasingly entangled.

- ♦ Education (table 5) is a good example of the subsidiarity principle. Total expenditures in table 4 show that the main responsibility lays at the cantonal level, with around 53 per cent of total public outlays, followed by the local level (35 %) and the Confederation (12 %). However, when various functions are distinguished "bottom-up" within education, the image stands out in contrast. Kindergartens and public schools are principally in local hands (with respectively 63 % and 56 %). For the public (primary and secondary) public schools, however, the communes have command mainly of the school buildings and the equipment. The teachers' salaries are predominantly paid at the local level, but according to cantonal standards. The Cantons also decide almost exclusively the teachers' qualification, and the schools' programmes (for the latter, sometimes in co-ordination with other cantons within the Conference of the Cantonal Ministers of Education – see section 2.4. on co-operative federalism). Special schools are in some cantons local, cantonal in other. Professional, teachers' school, colleges and technical schools are predominantly if not exclusively placed at the cantonal level. The federal government does not intervene very much. Except for the Federal Polytechnics, the Universities are cantonal, but they are partly financed by all the cantons through horizontal transfers per student, according to their residence, and through federal grants-in-aids.<sup>9</sup>

The subsidiarity principle implicitly carries with it the acceptance of asymmetry in the provision of public services. But it is difficult to assert whether this couple "subsidiarity -asymmetry" is a formidable tool to recognise diversity, whether differentiation is needed to attain a somewhat uniform service delivery or will foster national integration or disintegration at the same time. Again, education and primary schools can serve as an illustration. Subsidiarity and asymmetry are certainly needed and useful if the objective is to preserve or promote cantonal historical and cultural diversity: Geneva and Zürich have neither the same approach nor the same tradition in teaching History, which in turn differs in a bilingual Canton like Valais or Fribourg. There is no objective necessity for uniformity. But the Cantons have to harmonise and partly succeeded in harmonising their public school programs because of the increasing mobility (private and professional) of parents between the Cantons. This has been achieved and is operative through intercantonal agreement ("concordat intercantonal").

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<sup>8</sup> WALSH 1993, p. 32-35 summarises the normative arguments.

<sup>9</sup> The largest part of 1 803 millions SFr. (1 138 millions = 63 %) goes to the two Federal Polytechnics in Zurich and Lausanne and research Institutes. 500 millions SFr (27 %) served for granting the Universities; and 323 millions SFr (18 %) for the Swiss National Fund of Research.

Yet, for example, the Cantons were unable to agree on the beginning of the school year (Spring or Autumn) to the point that it had to be fixed in the federal Constitution (article 62 in the 1999 Constitution) after a popular vote in September 22 1985 with the double majority of the voters and the Cantons. Nowadays, teaching a second national language is at the crux of a difficult dispute. While a majority of the Cantons (and all the French speaking Cantons or with a French speaking majority) advocates learning in first priority the second national language (German for the French speaking, and inversely) for reason of national cohesion, the Canton of Zürich decided in 2000 that, in public schools, the place of English will be as important as French as a second language for reason of economic realism and globalisation. This has been criticised by many Cantons, included German-speaking ones, qualifying the decision an arrogant, disruptive and anti-confederal move. A federal parliamentary proposal is now in the way to oblige all the Cantons to consider the other national language as the first priority. If it succeeds, this will be another step towards creeping legal centralisation.

### 3.3.3. Centralisation

Table 2 gives the relative shares of each level of government in total public expenditures for the period 1970 to 1998. These figures give over the first period almost stable proportions of the division of the public sector between the three layers. In the 1970-80, the proportions were 32 per cent for federal expenditures, 39 per cent for the Cantons and 29 per cent for the communes. In 1998, these percentages were respectively 33, 40 and 27, which represents a slight increase of the federal and cantonal shares to the detriment of the communes.

Although statistical data show that the relative shares of each tiers have not much changed over the past 30 years, centralisation creeps in the ways in which cantonal and communal governments perform. A distinction, described in the literature of fiscal federalism as "agency" or "choice" models, may be useful for understanding the issue. In the last three decades, the federal government has increasingly confined itself to the issuing of framework laws and has delegated the implementation of nation-wide functions to the Cantons (which in turn often have transferred the tasks on to their communes) - the "agency" model.

- ◆ One of the most impressive example of this is the implementation of the federal environmental legislation. The federal government systematically issues normative legal rules (on the basis of art. 74 Cst.). The Cantons have to give impulses to their implementation, co-ordinate (public) provision and control the results. The communes are the executive agencies. The importance of local public expenditures in environment is clear from Tables 3 and 4: it amounts to 63 % of the public outlays for this function. Incentive conditional grants are distributed along the way.<sup>10</sup>
- ◆ Health is another illustration of the "agency" role of the Cantons and the communes. The federal government is responsible for only a tiny proportion of health expenditures (around 1 per cent), mainly because health insurance is governed by a federal framework law. But implementation of the law remains in the hands of the Cantons in the main (56 per cent) and of the communes (43 per cent), with evident problems along this way (DAFFLON, 2000).

At the lowest level, there is continual dispute in the Swiss Cantons about the effective extent of autonomy in local public expenditures, first and foremost because no single measure of independence is appropriate (WOLMAN, 1990) so that the Cantons and the communes have divergent claims. A second difficulty in measuring a decentralisation concept is that the fiscal-financial relations between local and cantonal governments vary from one canton to another according to the 26 cantonal Constitutions. Yet, the general trend in all the Cantons has been that (1) under the constraint of a current balanced budget, the "choice" role of the communes has made more and more way for the "agency" role and (2) the change in the relative weight of the two roles is inversely related to the population size of the communes: larger municipalities have been better able to maintain a higher proportion of the "choice" role.<sup>11</sup> In general one can say that probably not more than 1/4 of total local current expenditures are made in response to standards set by higher

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<sup>10</sup> From 1960 to 1990, public expenditures for waste water sewage and purification plants amounted to 32 billion SFr. Local governments paid 63 per cent of the total bill, the Cantons 26 per cent and the federal government 11 per cent. A. BARANZINI, *Structures et coûts des stations d'épuration en Suisse et gestion efficace des eaux usées*, Swiss Journal of Economics and Statistics, 1996, 4/1, pp. 515-538.

<sup>11</sup> Since this was written, a new study has been published in the form of a Working Paper (DAFFLON and PERRITAZ, 2000) focusing on the mandatory functions at local level in the canton of Fribourg and the correlation between the size of the communes and the independent proportion of their budget /account.. The results are that on average 20 % of local current revenue sources are assigned to mandatory functions fixed by the canton, 15 % is due to the inter-communal provision of public services (mainly for the reason that individual communes are too small for such functions) and 9 % corresponds to debt servicing. Thus, 56 % of current revenues remain for the own choice of the local authorities (which does not mean that the total is free for new choices: it must also finance the financial consequences of past decisions and the running management costs). Based on year 1997 only, an inverse correlation between size and independent expenditures exists (the smaller the commune, the lower is the independent part of its current expenditures), but the results are not significant. This is neither an invalidation nor a confirmation of point (2) in the text. There are three questions to be solved. From the conceptual side, there is no agreement about the definition (and thus the measurement) of local public expenditures imposed by the canton or the federal government (mandatory function: "dépenses liées"). From the technical side, the sample is given by the communes in one canton only, for one year 1997 because no such statistical data are available: we had to get all the figures from the communal accounts. For generalisation, the analysis should be extended first to several years in the same canton, and second, if possible, to several cantons.

government levels, less than 1/4 correspond to ad hoc inter-communal institutions co-ordinating particular functions, which leaves more than 1/2 for current expenditures resulting from the own preferences of local residents.

Now then, what can be said about the tension between subsidiarity and centralisation ? There is no simple answer, but a very pragmatic approach and case by case solutions. However, two points deserve attention. First, a higher level of government cannot interfere so easily so as to impose its own idea of "efficiency" upon a lower level of government. The democratic procedure must be respected. The amalgamation of two or several communes is a good example: this has proved almost impossible on a compulsory basis with the argument that communes are often too small to perform correctly the functions assigned to them. And the voluntary amalgamation of communes responds to another logic than strict fiscal consideration (DAFFLON, 1998). Second, if a function needs more centralisation, it will not be enacted by agencies of the higher-level government, but by lower-level acting as agencies. Thus, the communes will first organise in special "inter-communal" jurisdictions rather than giving up a function to the canton. And many federal standards are implemented by the cantons: law and justice are but two examples. In general, one finds no duplication of service precincts, federal agencies acting in the cantons, or cantonal agencies acting in the communes. The Communes act as implementation agencies of the canton or the Confederation, most often with the capacity of performing more than required minimum service level if they want so, with the additional difficulty (from an analytical point of view) to distinguish what is the required standard and what is "choice" component.

### 3.4. Public revenues

In 1998, public revenues of the Confederation, the Cantons and the communes amounted to 1142'000 millions SFr. Since 1985, 1998 was the tenth year where total revenues were not sufficient to cover total public expenditures at each level of government. The total deficit runs to 1 459 millions SFr. which represents almost 2.5 per cent of GNP.<sup>12</sup> The three levels of government were in the red. Details of public revenue sources are given in table 7. Taxation is the most important single source of revenue for the three levels of government (table 8). The tax system contains a certain degree of flexibility. These variables are largely in the command of the cantons and the communes and consequently determine the volume of financial resources at their disposal, thus the extent of their autonomy.

#### 3.4.1. General characteristics

The main characteristics of the fiscal-financial system are the following.

1. Each level of government and each government within the same level has direct access to many, but at least two major revenue sources: at the federal level, direct taxation and VAT; the cantonal level, direct taxation and grants + revenue sharing; at the local level, direct taxation and user charges. Direct access to taxes and user charges is important in order to maintain financial autonomy.
2. Based on VAT with an actual normal rate of 7.5 %, the main consumption and expenditure taxes are exclusive and belong to the federal level. Taxation on motor vehicle is cantonal; the communes can levy minor taxes on dogs, entertainment and games.
3. Direct taxation is a joint taxation of the Confederation (individual income + corporate profit), the Cantons and the communes (individual income and wealth + corporate profit and capital). For the Cantons and the communes, taxation of individual income and wealth and of corporate business profits and capital ("direct taxation") is the major source of revenue (43 and 47 per cent).
4. For the communes, revenues from public property (7 %), user charges from local public services (mainly: water, sewage and purification plants, garbage collection) and indemnities (in total 28 %), are in sum the second most important revenue sources. However, these sources are limited. Revenues from immovable properties, whether public or private, are subject to the federal legislation on rent control. The total amount of user charges for one single function cannot exceed total costs (i.e. user charges must be genuine cost-prices for public services, and not disguised taxes) owing to the jurisprudence of the Federal Court of Justice with regard to the quid-pro-quo rule in benefit taxation.
5. The Cantons and the communes have a rather low dependence on transfer payments: the Cantons receive 17 % of total revenues in the form of specific grants from the Confederation, and the communes 13 % from the Cantons.

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<sup>12</sup> Without the deficit of the social security. In 1993, the highest deficit ever was 16 325 Millions SFr. or 4.6 per cent of the GNP. This result did not respect one of the Maastricht criteria, namely that the total deficit of the public sector, including social security, should not exceed 3 per cent of GNP.

### 3.4.2. Tax sovereignty

There is a long unending debate about the conceptual definition of tax sovereignty. Tax sovereignty concerns both the ability of a government to decide which taxes it should invent and raise, the direct access to taxation and the management of taxes. Let us summarise the general setting in the formula:

$$T = t \times [B - (D_1, D_2, D_3, \dots D_i, \dots D_n)] \times (K_{\text{Fed}} + K_{\text{canton}} + K_{\text{commune}})$$

Where	T	revenue from a tax
	t	the tax rate schedule
	B	the gross tax base
	D	the possible deductions from the tax base
	K	the annual coefficient aiming at a balanced (current ?) budget.

Referring to this formula, the extent of tax sovereignty can be measured in the following sequences of choice :

- the use of the ability-to-pay principle (taxes) versus benefit principle (user charges);
- the object of taxation, implicit in [...] in the formula above;
- the circle of taxpayers (including the definition of the taxpaying unit);
- the computation of the tax bases (for example, for the taxation of income: the definition of gross income [B], and the adjustments to taxable income, specific deductions and exemptions) [D<sub>i</sub>];
- the tax rate schedules [t], including the amount of deductions and exemptions in the previous letter [D<sub>i</sub>];
- the annual coefficient of taxation [K<sub>j</sub>];
- collecting the taxes;
- the procedure in case of tax dispute.

**Full tax sovereignty** comprises letters a) to h) in the list above. **Partial tax sovereignty** exists where a government can decide a) and some but not all items listed between b) and e). **Tax flexibility** means that a government can at least decide on the coefficient of taxation (f) but has no access to defining the kind of taxes it can raise. **Compulsory taxation** qualifies taxation where a government has no choice over a) to f) and must raise taxes (or user-charges) according to the regulations set by a higher level of government.

- ◆ In Switzerland, tax sovereignty lies primarily in the Cantons and secondarily in the Confederation to such an extent that it is stated in article 128 to 134 of the New Federal Constitution. The Cantons are largely free to structure and frame their tax system and to decide the tax burden. This freedom is restricted only by the Federal Court's jurisprudence that prohibits, in particular, double taxation or unjustified tax rebates. In addition, the Cantons are bound by three articles in the federal Constitution which allocate indirect taxation (VAT in article 130 Cst., and special consumption taxes in article 131 Cst.) exclusively to the centre and another that forbid taxes in the form of tariff barriers (art. 133 Cst.) which could impede the free movement of goods between the Cantons. In this situation of joint taxation, tax sovereignty means that there are 27 laws, with obvious problems of competition, co-ordination and harmonisation (DAFFLON, 1986 and section 5 below).
- ◆ The autonomy of the communes to manage their finance varies from one canton to another. In principle, the Cantons regulate the financial room for manoeuvre of their communes by establishing budget principles, uniform accounting model, taxation rules and debt limits. Local governments have a limited tax sovereignty in that they can choose between ability-to-pay taxes and user charges where appropriate. They are however tied to the tax system of their Canton. For many taxes, local governments have only tax flexibility: they must apply the cantonal laws and limit their decision to an annual coefficient of taxation [K<sub>commune</sub>] in percentage of the Canton's taxes. Local taxation is also compulsory for a limited number of taxes.
- ◆ If a commune chooses to raise user-charges and fees, it can also define the main components (object of taxation, circle of users and thus payers, computation of the user charge base and the tariff), however within the limits set by case law of the Federal Court of Justice (KNAPP, 1982, pp. 358-364).

The objectives of fiscal sovereignty are:

- (1) To enable each level of government and each government within a level, to finance its own budget independently and according to its own criteria. This includes the capacity of financing public services in response to the preferences of their own electorate (the "choice" model) as well as those expenses which correspond to minimum standard (merit) goods and services set by a higher level of government (the "agency" model), net of conditional grants.

- (2) To decide redistributive policies: first in selecting ability-to-pay or benefit taxation; second, in choosing the magnitude of redistribution, for example, through the tax rate schedules or the amounts of exemptions and deductions on the income tax (subject to the limits described in section five).

These, however, create two problems. One is tax competition. The other is the necessity of an equalisation policy (between the centre and the cantons; and within a canton, between the canton and the communes) because of disparities in the tax burden which do not correspond to objective differences in local government functions, but to their geographical position off the main economic centres.

#### 3.4.3. *Direct access to many revenue sources*

An important characteristic of fiscal sovereignty is direct access to many (fiscal) sources. In table 7, several finance sources are listed respectively for the federal government, the Cantons and the communes.

Direct access to a number of diversified tax or non-tax sources secures regular annual receipts compared with a situation where a government can rely on one tax only. It enables a better distribution of the fiscal burden and avoids exasperating particular categories of taxpayers in case of higher fiscal needs. This can also be understood in the view of the low dependence of the Cantons on transfer payments from the federal government and of the communes on transfer payments from the Cantons. This is observed in table 8 from the percentage of the various categories of revenue for the three levels of government.

- ◆ In 1998, the Cantons received only 24 per cent of their revenues from the Confederation (7 per cent from revenue sharing and 17 per cent in the form of conditional grants). The net "tax / transfer payments" ratio, as KING observed (1984, p. 185), was 2.0, whereas the "own resources / transfer payments" ratio was 2.8. These ratios give some idea of the independence of cantonal finance on federal transfer payments. They are slightly higher than those computed by KING for Canada and USA. The usual interpretation is that the Swiss Cantons do not depend much on federal payments and benefit from a fairly high degree of fiscal autonomy.
- ◆ The communes received only 16 per cent of their revenues from the Cantons in the form of revenue sharing (3 per cent) and grants (13 per cent). Although these proportions were about 5 percentage points below for the cantons as well as for the communes in the early eighties, the actual figures do not represent a very high degree of financial dependence compared to other OECD countries. And in any case, these proportions contrast with the degree of centralisation in public expenditures, which is much higher because the agency role of decentralised governments has gained in importance during the last decade compared to the "choice" model.

#### 3.4.4. *Tax administration*

In principle, each level of government and each government within a same level may have its own tax administration. Thus the Cantons have a legal obligation to collect the federal direct tax (FDT) on individual income, corporate profits and capital and on capital gains. They also participate in managing the federal withholding tax and stamps duties. But since there are 26 cantonal tax laws and as many tax administrations and no tutelage of the federal government over State and local tax administration, there exist 26 ways of managing the cantonal taxes and the FDT. In order to gain economies of scale in the tax administration and coherence in the tax practice, many formulas exist for co-operation between the three tiers of government.

In addition, because the powers of the State tax administrations are limited to the territorial area of the State to which they belong, whereas economic activities may spill over cantonal limits, a decentralised tax administration creates problems and conflicts. These have been solved in the first place by negotiations between the Cantons, eventually (and more often) through the jurisprudence of the Federal Court of Justice. Secondly, a federal law on the harmonisation of cantonal direct taxation has been enforced on 1 January 1993 to introduce some order in the Cantons' taxation for neutrality and equity reasons. Within the following eight years (on the 1st of January 2001 at the latest), the cantons must adapt their own tax legislation to a common unique framework (see also section 5 below).

At local level, no such difficulties exist. In most cases, the communes can only decide annual tax coefficients for the various accessible tax sources, but have no access to defining the kind of tax they raise : it is a "take-it-or-leave-it" situation. In many cantons, the communes can contract with the cantonal tax administration to collect communal taxes.<sup>13</sup>

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<sup>13</sup> In the Canton of Fribourg, the cost for a commune is 1.5 ‰ of the net tax revenues. The cantonal tax administration collects communal taxes and acts for the commune in all aspects of tax litigation. The tax proceeds are paid to the commune on a monthly base.

## 4. BUDGET POLICY

The Swiss Cantons have their own Constitutions, independent power over their budgets and their own financial resources and, above all, they have the power of taxation. Cantonal autonomy in the area of fiscal policy contrasts with the budget principles and the rules of taxation to which member States in other federations are subject. Legislative authorities at the federal level, in the 26 Cantons and in every single municipality must decide the budget (current + capital) before the beginning of the year and, of course, keep books recording revenues and expenditures. Since the mid 80s, budget and bookkeeping techniques have been harmonised. Annual budgets as such do not give a legal base for expenditures and taxation. Each item in the current as well as in the capital budgets must be founded on particular laws that have been debated separately in parliament and enforced prior to the budget discussion.

The federal Constitution does not impose budget principles on the Cantons. There is no federal constraint on deficit financing, except that all tiers of government have no access to borrowing from the Central Bank. The main **external** limitation on budgetary sovereignty of the Cantons is intrinsically **competition** with other cantons: if a canton pursues an inefficient fiscal policy with a poor cost-benefit relationship, it will price itself out of the market. Individuals and firms will move "à la Tiebout" to another canton ("exit", in Hirschman's terminology); or the voters or some groups of them will use initiatives and referenda in order to obtain a modification of the "public goods / tax" mix in comparison to that of other cantons ("voice"). Competition is even more important at the local level, particularly between communes in the same urban agglomeration.

### 4.1. Budget orthodoxy

The fairly extensive autonomy of cantonal and local governments for their finance is not unlimited. There are also internal limitations in cantonal Constitutions or laws. Two rules are generally respected, at the level of the Cantons in their own financial laws, and in the communes under cantonal supervision (DAFFLON, 1996).

- ◆ The first rule is concerned with the requirement of a more or less balanced budget for providing goods and services. Due to financial regulation, for most local and cantonal governments it is quite difficult to run or to accumulate deficits in their (current) budgets. If a large budget deficit occurs, taxation would have to be increased. In many cantons, the amortisation must not only be recorded in the book, but also correspond to an effective instalment of the loans. At the communal level, if a local authority would not follow this rule, the cantonal government might decide to raise the annual coefficient of taxation in place of the commune.<sup>14</sup> In general, the Cantons apply the "golden rule": local current revenues net of current expenditures are sufficient to serve the debt interest and bear the running costs of past and new investments. Whether this rule includes the effective annual reimbursement of the debt on a pay-as-you-use basis (for capital expenditures financed by borrowing) varies from one canton to another. This also necessitates a clear line between current and capital expenditures and, of course, separation of the current from the capital budget. Again, the definition is not identical from canton to canton: in particular with regard to the possibility (i) to transform capital expenditures into current outlays through leasing contracts to shortcut limitation, if any, or (ii) through outsourcing of certain expenditures to external budgets not accounted for by the public sector.
- ◆ The second rule concerns borrowing and **debt limitation**. Public debt is allowed in many cantons only for financing capital expenditures, and if the local and/or cantonal government has the financial capacity to pay the interest and amortisation of the debt out of its current budget. The rates of amortisation are fixed according to the kind of investment and its possible length of use (pay-as-you-use finance). This of course requires a distinction between the current budget, which must be balanced, and the capital budget, which can be financed by borrowing.

These two quite (more or less) strict requirements express the principle of accountability or budgetary responsibility. They must be viewed in the perspective of the cantons' and communes' financial autonomy and a large access to own revenue sources as described above. On the one hand, cantonal and local governments have a fairly large (though diminishing) amount of autonomy to decide and offer public services, and direct access to taxation. On the other hand, it is expected that these governments will act in a responsible way and will finance without excess borrowing what they are asked to produce, either by law ("agency") or in response to their electorate's own demands ("choice"). This is definitely a classical approach to fiscal federalism (TOLLISON and WAGNER, 1986). The interests of the public debt of the

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<sup>14</sup> For example, in September 1994, the Council of State (executive government) of canton Berne has imposed on the commune of Berne (the capital city of the Canton and also the federal city) an increase of the tax coefficient from a multiple of 2.2 to 2.4 of the cantonal direct taxes levied in the commune. The reason was that the electorate of the commune had rejected for the third time the 1994 budget, which presented a deficit and required for balance an increase of taxation. In Fribourg, the Canton controls on a yearly basis the books and the public debt of the communes. It intervenes if the current account is not balanced or if amortisation of the debt and the effective reimbursement of loans are not sufficient according to legal minimum rates. Cantonal intervention takes several forms, but it can go so far as to impose a higher tax coefficient to the commune at fault in order to restore its financial situation.

cantons in 1998 represented on average 6 per cent of total cantonal own revenues; and 7 per cent for the communes (tables 6 and 7).

- ◆ Finally, there is also a large debate about the effectiveness of financial referenda on the size of the public sector, on the one hand, and on the reinforcement of budget discipline, on the other hand (see section 2.3.)

#### **4.2. Macroeconomic policy**

The decentralisation of government functions raises problems for macroeconomic control at the national level. This is because cantonal and communal accountability involves the access to own revenue sources together with the right of the Cantons and the communes to borrow. Uncontrolled access to capital markets and mismanagement of the budgets by cantonal and local government could jeopardise the efforts, if any, to stabilise the economy. For this reason, so the textbook argument runs, central government ought to have some monitoring or control power. But one must distinguish whether the assignment of responsibilities and revenues to the cantonal and communal tiers is in balance and regular, or volatile and subject to strong cyclical variation. In the first case, control can be restricted to the golden rule, that borrowing is allowed only for infrastructures, and the time-path of capital investment. In the second case, borrowing may be needed not only for investment, but also to compensate for cyclical variation in the budget (higher social assistance expenditures, with less revenue, in downwards cyclical turn).

Yet, effective decentralised public finance may be somewhat distant from the textbook theory. Stabilising tax adjustments is a mere conjecture in the Swiss situation: the electorate has to vote the tax law at the cantonal level, or the tax coefficient at the local level: while it may accept variation in taxation, whether to restore a balanced current budget or for new investments, it is unlikely to do so just for macroeconomic reasons. In addition, the time path required for such a decision is probably foreign to upward or downward changes in the macroeconomic trend.

On the other side, the economic classification of public expenditures, in table 6, gives an interesting first insight for macroeconomic policy. At the federal level, current and capital grants-in-aid account for 59 % of total expenditures, whereas expenditures for personnel and interest payment correspond to 10 % and 7 % respectively. This means that about 76 % of the total budget belong to categories of expenditures that are very difficult, if not impossible, to modify in the short term for macroeconomic purposes. Consumption (11 %) and investments (2 %) amount to as low as 13 % of the total federal budget. This is by no mean sufficient for any kind of functional finance.

With 19 % of total expenditure for consumption (11 %) and investment (8 %), the cantons are in a similar position.

Not surprisingly, one finds that the communes spend much more for consumption (20 %) and investment (13 %), up to about 33 % of their total expenditure.

Because of the difficulty to act on personnel expenditures and transfers in the short term, one must recognise that any macroeconomic policy cannot be driven by and at the Centre only. It requires some form of consensus between the three government tiers and vertical co-operation. This is not an easy matter because regional and local interests are divergent. In particular, more and more investment projects require important financial resources and long term planning: when such a project is ready to be voted, it is doubtful whether any government will accept to postpone it for macroeconomic reason. And inversely, it is not so easy to accelerate a project for macroeconomic reason without taking the time to present a detailed investment programme. A canton or a commune may be very reluctant to abandon or postpone an investment for the sake of a central co-ordinated macroeconomic policy. This explains also why the fiscal and budget policy plays only a limited role in stabilisation, compared to the position of the monetary authorities through the Swiss National Bank.

### **5. TAX CO-ORDINATION AND HARMONIZATION**

The extensive freedom in shaping the tax system enables each of the Cantons to determine the tax price level for a specific bundle of public goods and services within its own jurisdiction. In the theory of fiscal federalism, Cantons and communes may use their tax systems to compete for firms and individuals to migrate to another Canton or commune. Yet, fiscal sovereignty is not unlimited. Allocative inefficiencies would arise if decentralised jurisdictions were to adopt widely varying forms of taxation. Each individual and business firm would have an incentive to move in that jurisdiction whose particular tax system gave him the best tax break. Under a non-neutral tax system, the location of individuals and productive capital might be guided by particular pecuniary advantages afforded under varying kinds of taxes irrespective of public provision. But tax competition between jurisdictions has no efficiency properties comparable to market pure competition; it is rather in the nature of oligopoly (TULKENS, 1985, p. 45). Furthermore, it is not possible for subcentral

jurisdictions to decide a sharp redistributive policy through taxation. Acceptance of this policy will not only vary on ethical grounds, but also depend on the mobility of individuals and business enterprises, that is: their capacity to avoid, through voting-with-their-feet, the incidence of high redistributive taxation. Minimising these distortions calls for a substantial degree of co-ordination and tax harmonisation, that is for a co-operative effort to secure a system of taxation that minimises excess burden and yields a desirable pattern of incidence (WEINER and AULT, 1998).

In the Swiss situation, FREY (1981) and WEBER (1992) show that tax-induced migratory movements are small. Not only the price-service ratio of public policies, but a number of other private determinants influence the choice of residence or location. Legal entities know that they can obtain a tax break in almost any new location, even though this is neither formally nor officially publicised. In addition, with initiative and referendum, the citizens have not only an "exit", but also a "voice" solution. Since tax co-ordination has existed for many years, problems of tax harmonisation have been discussed in terms of neutrality and in the context of reducing administrative and implementation costs, rather than from an equity point of view.<sup>15</sup>

## 5.1. Tax co-ordination

### 5.1.1. Vertical co-ordination

Vertical co-ordination concerns the assignment of tax authority to the various levels of government. It should be clear which jurisdiction is entitled to tax which items from which taxpayer. Attention must be given to the geographical distribution of tax yield. A good tax under subcentral authorities should have a tax base that is widely and evenly distributed throughout the country (KING, 1984, pp. 210-211). In addition, one can say the general objectives of vertical tax co-ordination:

- i. stable and predictable revenue sources at the three levels;
- ii. high proportion of own resources of total cantonal and communal revenue;
- iii. sufficient tax room at the cantonal and communal levels;
- iv. efficient decentralised taxation and accountability;

Are fulfilled in the Swiss case:

Referring to table 7, one can see that in Switzerland vertical co-ordination is obtained

- ♦ partly through the attribution of exclusive tax sources to each level of government according to the doctrine of the separation of sources. This is clear for consumption and expenditure taxes where there is no overlapping of the tax bases between the Confederation, the Cantons and the communes.
- ♦ On the other hand, for "direct" taxation, personal income, corporate profits and capital<sup>16</sup> are jointly taxed at the three levels. The vertical apportionment between the three levels of government is rather complex and often left implicit. It is obtained in two ways: a moderate taxation at each level so that no single government exhausts the entire tax capacity; and, the assessment of priority, first to the Cantons, then to the communes and lastly to the Confederation. It has been traditionally admitted for direct taxation that the federal share should not exceed one fourth of the total. Minimum taxable income at the federal level should be higher than in the Cantons and the tax rate schedule more progressive. Yet, the Cantons receive back 30 per cent of the federal direct tax (FDT) in the form of revenue sharing, of which 13 per cent is affected to inter-cantonal fiscal equalisation (see below section 6.2).
- ♦ Note also that Switzerland has a particular characteristic: the vertical tax co-ordination is written in its Constitution. Following art. 196 Nr 13 of the transitory provisions of the 1999 Cst., the FDT may be levied until the end of 2006 only. The consequence is that, some years before this limit, the federal government must justify the further necessity of levying a direct tax at the central level in concurrence with the Cantons and the communes, and explain its motives. The decision to continue to levy a FDT necessitates the double majority of voters and cantons, which is a powerful mean for the Cantons to obtain compensatory advantages, notably in the equalisation policy.

With the enforcement of VAT on 1 January 1995, and with it, the extension of expenditure taxation to services, the most orthodox federalists claim that the joint attribution of direct taxation to the Confederation and the Cantons should end. The argument is that the overall burden of indirect (consumption) taxes is still lower in Switzerland than in most other European

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<sup>15</sup> It is significant that all initiatives for a nation-wide or canton-wide uniform system of taxation on income and wealth of individuals and on corporate profits and capital have been rejected in popular votes because it would restrain the fiscal flexibility of lower levels of government and increase their dependence on transfer payments. Differences in cantonal and communal tax burden are viewed as the price of autonomy (DAFFLON, 1986).

<sup>16</sup> The federal direct tax on business capital has been suppressed by the law of October 10, 1997 from 1998 onwards.



countries. This gives a freedom of manoeuvre which should be used to reduce the direct tax burden which, combined to social security contributions, is higher than average. For some, there should be a crystal-clear order in taxation under the slogan: "VAT. is federal / direct taxation is cantonal". Opponents argue that the abolition of the FDT will set back income redistribution through ability-to-pay taxation because the tax rate progressiveness of the FDT is higher than in any canton. In addition, the abolition would create difficulty in the federal → intercantonal equalisation policy.

- ◆ Vertical co-ordination between the Cantons and their communes is secured because, as explained in section 3.4.2., local governments have no sovereignty on these matters, but only tax flexibility. The most debated question is whether local governments can taper at this source in priority, to the detriment of the cantonal tiers. The usual solution is that communal tax coefficients are subject to an upper limit fixed in the cantonal law in proportion to cantonal taxes (for example: in the Canton of Fribourg, this limit is fixed at a maximum level of 125 % of the cantonal tax).

### 5.1.2. Horizontal co-ordination

Horizontal co-ordination serves to apportion tax competencies and the tax yields among the jurisdictions at the same level where the tax base has its origin in several communes or cantons. In Switzerland, this has been obtained through the jurisprudence of the Federal Court of Justice. Two objectives have been pursued: avoidance of double taxation, and, preventing that taxpayers with taxable activities in more than one jurisdiction avoid the progressiveness of the tax rate schedules through geographical splitting of the tax base. Although the technical rules are rather intricate (DAFFLON, 1986, pp. 32-36), horizontal co-ordination applies itself along the following general guidelines :

- ◆ the income tax is entirely paid in the canton and the communes of residence;<sup>17</sup>
- ◆ any income obtained in other jurisdictions is assessed in the jurisdiction of residence according to the rules of the jurisdiction of residence (and not the rule of the jurisdiction where the income has been gained);
- ◆ immovable property is taxed in the jurisdiction where it exists;
- ◆ when corporate business takes place in several jurisdictions, the yields of the profit and capital taxes are distributed between those jurisdictions according to financially measurable components of the activity (for example: turnover, the volume of sales, total insurance premiums for insurance companies).

### 5.2. Tax harmonisation

Different jurisdictions at the same level of government will generally find it desirable to adopt at least roughly similar systems of taxation. There are three reasons; two of them pertain to the criteria of fiscal neutrality. First, where the inter-jurisdictional mobility of certain economic units is of a high degree, taxation of these units, if it is employed, should be of similar form across the jurisdictions. Second, the rates at which these units are taxed locally should not vary greatly among the jurisdictions except to the extent that differences in rates correspond to differences in benefits to these units from the services provided. In this way allocative distortions in both resource use and incidence resulting from the tax system itself can be kept to a minimum consistent with other fiscal objectives of the individual jurisdictions (OATES, 1972, p. 147).<sup>18</sup> Third, harmonisation simplifies the tax perceptibility and minimises the administration and implementation costs.

Formal tax harmonisation concerns any attempt to bring the various tax systems decided independently by each jurisdiction towards a uniform system and towards a unique definition of the tax bases (letters b to d in the sequence of choice in section 3.4.). As a result, information and transaction costs are reduced for those who pay taxes in several cantons; administrative and implementation costs are reduced for the tax departments; litigious cases decrease.

Real tax harmonisation is obtained when allowances, the amounts of deductions and exemptions and the tax rate schedules are identical in all jurisdictions. Such harmonisation is at variance with the federal principle and has never been on the political agenda in Switzerland.

In Switzerland, the problem of tax harmonisation arises exclusively for those taxes that are simultaneously levied by the two higher levels of government - federal and cantonal. Despite the new legislation which has entered into force from January 1 2001 after a transitory period of many years, tax harmonisation at the federal and cantonal levels remains fully and exclusively formal. At the cantonal level, formal tax harmonisation has been realised over the years for two reasons. First, collection of the federal direct tax (FDT) on personal income, and on corporate profits and capital is assigned to the

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<sup>17</sup> This has been confirmed by the Federal Court of Justice early in 1999 in a dispute between the cantons of Geneva and Vaud concerning commuters working in Geneva but resident in Vaud who had received income tax assignment from the canton of Geneva.

<sup>18</sup> Since tax breaks are used in all cantonal regional development policies, they do not really give a net advantage to one region over another, which results in a typical prisoner's dilemma situation.

Cantons. Consequently, for obvious reasons of reducing administrative and implementation costs, and thanks to effort-minimising bureaucrats who were reluctant to control several Tax Return Forms (at least, the federal and the cantonal Forms) for one and the same taxpayer, there has been very strong bureaucratic incentives at cantonal level to adopt rules and income concepts (gross income, adjusted gross income, taxable income, itemised deductions and allowances) similar to those of the FDT. Second, more and more taxpayers, corporate or individual, are active outside their Canton of residence, or own immovable assets in another Canton, thus pushing for uniformity of the various rules of taxation (none the less for uniform Tax Return Forms) in order to reduce administrative and legal costs.

Nowadays, formal harmonisation is partly achieved by federal legislation, introduced in 1993 and 1995:

- ◆ The federal law on the harmonisation of direct taxation at cantonal and communal levels, which has been in force since 1 January 1993, provides a framework within which the Cantons (and the communes if they have more than fiscal flexibility) must define their direct taxation laws, particularly with regard to tax liability of persons and legal entities, assets and tax periods. Standardised tax declaration forms are being introduced, much to the relief of people liable for tax in more than one canton. The income and wealth taxes are annualised (they were based on a 2-years assessment up to this date). The Cantons have been obliged to adjust their tax legislation within eight years, that is by 31 December 2000. Actually the law applies directly wherever cantonal tax law has not been brought into line with it. However, since the Cantons still define their own tax scales, tax rates and the amounts of allowances and deduction, wide variations in taxation levels within Switzerland remain. Thus, formal harmonisation solves problems in terms of administrative costs, but not in terms of tax neutrality.
- ◆ The federal law on direct federal tax took effect on January 1st 1995. Matching the provisions of this law with the previous one has ensured vertical harmonisation of direct taxes at the three levels of government.
- ◆ At the communal level, formal and real tax harmonisation has been almost achieved except for the annual coefficient of taxation which depends on the balanced budget requirement. Tax competition is on the agenda of most communes, especially because of inter-jurisdictional mobility within urban areas.
- ◆ What could be concluded from the present situation ? (Partial) Fiscal sovereignty is important at the cantonal level, but comes with increasing problems. The difficulties experienced by Switzerland for the last three decades - in fact right from the beginning of the extension of direct taxation as a major source of revenues for the cantons - show a real need for some sort of central tax law. Recently, the Cantons have had to recognise that tax competition has had negative and undesirable consequences on regional development policies and that economic disparities between the regions and the cantons have not been reduced despite a federal regional and equalisation policies (DAFFLON, 2000). The debate is now vivid in this country.

### 5.3. Tax competition

#### 5.3.1. Some stylised facts

Fiscal competition among regional or local authorities within a decentralised multilevel government has long been an issue for policy makers, especially in a federal system like Switzerland, where the differences in business taxation between (or within) cantons have been rather important over the last twenty years (for a survey see Administration fédérale des contributions, 1990, pp. 63–8). As a matter of fact, empirical evidence shows for instance that in the 1980s the tax burden on the firms' profit varied considerably between the 26 Swiss cantons, with maximum-minimum ratios ranging from 2 to 4 depending on the amount of profits and the formula used to compute them for fiscal policy targets. Similar empirical evidence seems also to exist, though to a lesser extent, for communal business taxation within the same canton (Dafflon, 1991, pp. 58–65). More recently, in fact, the 1999 OECD Economic Survey indicates that in Switzerland the average tax rate on business profits varies from 13 to 31 per cent, when the three-level government taxation is considered altogether (Organisation for Economic Co-operation and Development, 1999, p. 109). Now, such a relatively big discrepancy on business taxation between local governments (see also below section 5.4) provides a framework where fiscal competition and fiscal strategies may eventually impinge on the implementation of the required fiscal policies at the local level. This is so much so when a balanced budget requirement is taken into account. The remainder of this section focuses therefore on the theoretical as well as empirical issues of fiscal competition from a public choice point of view, illustrated with reference to the Swiss case.

#### 5.3.2. A prisoner's dilemma framework

Fiscal competition may be considered as a regional (cantonal) or local (communal) strategy implemented in order to attract – or to retain – business activities for a number of macroeconomic reasons (basically, to enhance regional economic development and growth, and to curb unemployment). In Switzerland, several French-speaking cantons have

recently lowered (or planned to lower) their taxation on business profit and capital, a phenomenon occurring also in the German-speaking part of the country. In particular, the cantonal fiscal authorities have adopted a discretionary fiscal policy with respect to firms (and/or their managers), to boost economic development at the local level in terms of output growth and labour market. Indeed, this fiscal strategy may also help Switzerland in improving, and consolidating, its competitive ranking within a globalised economic system.

However, failure to co-ordinate such a policy at the general government level leads inevitably to a prisoner's dilemma situation. In fact, at the fiscal level international co-ordination is non-existent and seems even to be utopian for the time being. Yet, as pointed out by public economic theorists (see Tulkens, 1985), fiscal competition between local governments within the same country does not represent an optimal solution from a political economy standpoint. To be sure, over the long run fiscal competition decreases the tax burden and, therefore, the fiscal revenues of the local governments as a whole. Even if fiscal competition enables to control, and perhaps to limit, the expansion of public sector economics (Pommerehne et al., 1996; Feld, 1999), empirical evidence at the EU level shows that this kind of competition among regions exacerbates structural budgetary deficits and might put the sustainability of government debt at stake (Commission of the European Communities, 1997). Further, according to a recent OECD report, globalisation creates a framework where the number of off-shore places keeps increasing; governments are thus stimulated to implement fiscal strategies in order to attract those business activities which are highly mobile (see Organisation for Economic Co-operation and Development, 1998). At present, fiscal competition between governments aims indeed at limiting the moving of firms – both in terms of plants and capital – towards off-shore places, by decreasing the tax burden on business profits and their managers' incomes. However, this kind of competition between local governments (but the argument applies to nation-States as well) encompasses a series of drawbacks, namely (i) the risk of diverting profitable trade and investment from the region, (ii) the risk of reducing the revenues of the local government sector considerably, and (iii) the risk of transferring part of the tax burden on less mobile factors or activities (i.e. labour and consumption), a transfer which will impinge on both employment and fiscal equity.

Now, since in Switzerland each canton seems ready to discuss a fiscal agreement with those (newly established) firms producing a relatively high-valued output, over the long run any economic benefit that might result in terms of regional income or employment growth is bound to be nullified by the fiscal competition of other cantons. Whenever a canton's fiscal strategy is successful in attracting a firm by granting it a fiscal bonus, another canton will soon do the same by reducing its tax burden on business profit and capital, and so on, until all cantonal fiscal burdens are eventually reduced to a minimum owing to a lack of co-ordination between local governments. This self-reinforcing, downward process can be illustrated with respect to the empirical evidence over the period 1985–99 for the seven French-speaking Swiss cantons, with a numerical example assuming a business capital of 2 millions Swiss francs and a profit of 320,000 Swiss francs (Table A).

**TABLE A**

**TAXATION OF BUSINESS PROFIT IN FRENCH-SPEAKING  
SWITZERLAND, 1985–99**

<b>Canton</b>	<b>1985*</b>	<b>1995*</b>	<b>1999*</b>	<b>1985–99</b>
Berne	72 028	51 710 ↓	51 681 ↓	– 28%
Fribourg	61 614	59 149 ↓	58 721 ↓	– 5%
Geneva	59 641	59 607 ↓	63 342 ↑	+6%
Jura	85 582	58 723 ↓	58 549 ↓	– 32%
Neuchâtel	90 180	88 897 ↓	88 565 ↓	– 2%
Valais	74 704	65 325 ↓	65 204 ↓	– 13%
Vaud	66 914	64 091 ↓	63 976 ↓	– 4%

\* current value in SFr.

Sources: Administration fédérale des contributions, Charge fiscale en Suisse 1985, Bern: Statistical Series, 18, 1986, p. 67; Administration fédérale des contributions, Charge fiscale en Suisse 1995, Bern: Statistical Series, 18, 1996, p. 69; Administration fédérale des contributions, Charge fiscale en Suisse 1999, Bern: Statistical Series, 18, 2000, p. 69.

The example in Table A includes cantonal, communal and church taxation in current value. It shows that all French-speaking cantons, except Geneva, have reduced their tax burden on business profits over the last 15 years. In particular, the canton of Jura has the highest rate of decrease (32 per cent), owing to its awkward geographic position and its relatively low cantonal income (both in absolute and per capita terms). As regional economic theory explains, in fact, the localisation of firms depends on a number of factors other than fiscal advantages (which are actually annihilated by fiscal competition between local governments). Among these other factors one may include the proximity of markets, and easy (i.e. low-cost) access to motorway and railway networks, two factors which are still lacking the Jura canton.

Analogously, the canton of Valais probably suffers from its geographic situation and thus tries to attract (or retain) firms via an important decrease in business taxation (13 per cent over the period 1985–99). Conversely, the canton of Berne seems to have considerably reduced its fiscal burden on firms (28 per cent) in order to keep up with, or to catch up, the huge economic development of the Basle–Zürich area during the last 15 years. The cantons of Fribourg (5 per cent), Vaud (4 per cent) and Neuchâtel (2 per cent) have also lowered their business taxation for similar reasons, though to a lesser extent.

Now, as Table B shows, these reductions in cantonal fiscal burdens on firms are such that, despite a considerable decrease in business taxation in the French-speaking part of Switzerland, business activities are still attracted by the German-speaking cantons, which have been able to grant better fiscal advantages to firms. As a matter of fact, if the average index in Table B is set equal to 100 for Switzerland as a whole, the index movements for the French-speaking cantons show a relative increase for all of them (except Geneva) over the last five years (1995–9). Clearly, fiscal competition among the seven French-speaking cantons (including Berne) is not enough to outcompete the rest of Switzerland for attracting business activities and thus enhance regional economic development. On the contrary, as pointed out in Table A, fiscal competition is such that, on the whole, all local governments lose a considerable part of their revenues because of the lowered fiscal burden on firms' profit and capital.

**TABLE B**

**INDEX OF FISCAL BURDEN ON BUSINESS PROFIT AND CAPITAL IN  
FRENCH-SPEAKING SWITZERLAND, 1985–99**

Canton	1985	1995	1999
Berne	118.1	95.3 ↓	98.0 ↑
Fribourg	106.8	101.8 ↓	104.3 ↑
Geneva	101.3	117.5 ↑	114.5 ↓
Jura	111.8	104.7 ↓	105.7 ↑
Neuchâtel	138.6	138.6 --	151.0 ↑
Valais	118.6	114.2 ↓	117.1 ↑
Vaud	97.1	105.0 ↑	107.8 ↑
Switzerland	100.0	100.0	100.0

Sources: Administration fédérale des contributions, Charge fiscale en Suisse 1985, Bern: Statistical Series, 18, 1986, p. 74; Administration fédérale des contributions, Charge fiscale en Suisse 1995, Bern: Statistical Series, 18, 1996, p. 76; Administration fédérale des contributions, Charge fiscale en Suisse 1999, Bern: Statistical Series, 18, 2000, p. 76.

Now, when one considers the fiscal competition between (French-speaking) cantonal governments from a public choice point of view, one can notice that each canton merely reacts to the contingent situation, instead of taking the lead and obtaining a durable benefit in macroeconomic terms. In the end, firms are therefore not attracted to a specific localisation, since the ongoing process of fiscal competition among local governments removes any comparative advantage these authorities might have one over the other in the short run. This situation is further reinforced by the problem of asymmetric information. In fact, when a firm is looking for fiscal advantages (basically, a reduction of its tax burden), it often starts negotiations with more than one canton or local authority.

This allows firms to know and compare the various sorts of fiscal advantages offered by competing governments, whereas any of the latter does not know what the competitors are offering. Hence, as is emphasised in the 1998 OECD report, the lack of co-operation between local governments is such that fiscal competition is overall detrimental for the general government sector, in terms of fiscal revenues and economic development (Organisation for Economic Co-operation and Development, 1998, p. 33). Moreover, on the assumptions of unchanged policies and of a balanced budget requirement, any fiscal bonus granted to a firm (or to a targeted group of firms) is bound to be compensated by an increased tax burden for other firms or individuals. This compensation introduces a system of implicit grants which threaten fiscal justice.

### 5.3.3. Out of the dilemma

As far as fiscal competition is concerned, two suggestions may be put forward at the policy level.

In the short run, an authoritative, independent observatory should be established for the general government sector, in order to collect all regional (cantonal) and local (communal) decisions granting any fiscal bonus or other specific advantages to firms. This public agency would be in charge of examining the consequences of such fiscal practices in

terms of resource allocation and distribution, without imposing a penalty during an initial period of (say) five years. It would also elaborate policy guidelines aiming at (1) avoiding the prisoner's dilemma that up to now characterises fiscal competition between local governments, (2) consolidating the ranking of the Swiss economy with respect to international competition, by an overall fiscal policy which is both consistent and co-ordinated at the three government levels (i.e. the federal, cantonal and communal levels), (3) contributing to establishing a world-wide policy agreement on fiscal competition, where controls and penalties are clearly indicated. The old-fashioned concept of local autonomy ought therefore to be revised and adapted to a globalised economic system.

In the long run, a real fiscal harmonisation on business taxation should be put into practice. In fact, the fiscal harmonisation provided by the law of 14 December 1990 between the Swiss cantons – which has become fully operational in January 2001 – has no effect on fiscal competition, because tax rates are excluded from the harmonisation process. If an effective fiscal harmonisation is to see the light in Switzerland, a structural reform ought to be implemented, giving rise to a unique tax, a unique tax rate and a unique fiscal authority. A less rigorous solution would allow cantons to have a limited room for manoeuvre, say a margin of  $\pm 10$  per cent with respect to the tax rate. Fiscal federalism would be kept safe by distributing fiscal revenues between the federal, cantonal and communal government levels, according to an equalisation formula which is sanctioned by law and is not negotiable during annual budgetary discussions (Council of Europe, 1998, p. 23).

#### 5.4. Fiscal burden in the Cantons

It should be clear, at this stage, that tax harmonisation does not imply perfect uniformity in the rates and forms of taxation across the jurisdictions. The consequences of cantonal, and to some extent communal, tax autonomy is that the tax burden can differ substantially from one jurisdiction to another according to their view about the tax system, the combination of the ability-to-pay and the benefit principles, and the progressiveness of the rate schedules. Additional reasons are that the Cantons provide varying levels of consumption of public services and have significant differences in the unit cost of providing public services at comparable minimum standards. The Cantons have also significant differences in levels of income and wealth (computed from Table 1, indices of per capita NIC in individual cantons vary between 70 points in Jura and 154 points in Zoug compared to an average of 100 points). It is in the nature of fiscal federalism that the use of non-benefit taxation by decentralised levels of government, cost differences in public provision and wide variations in NIC introduce disparities in the tax liabilities and, with it, some inefficiencies and inequalities. This is to be expected and can be accepted as far as "efficiency" is not only "economic" but refers to the general capacity of federal institutions to strengthen the system of checks and balances (as, for example, against autonomy; WISEMAN, 1990, p. 120) and as far as those disparities are not too blunt and remain within politically acceptable limits. But significantly higher tax rates (and maybe inferior public services) in some poorer jurisdictions may lead to the need for substantial equalisation payments (next section).

Table 9 gives the indices of tax burden for five categories of taxes in the Cantons and the communes, which together amount to about 90 per cent of total cantonal and communal fiscal revenues. Reliable measures of the relative cantonal and communal tax burden are needed for several reasons. First, the Cantons and the communes must know how much revenue they are capable of raising without too heavy a tax burden in comparison with one another. Second, it is also important to have an idea of the ability and willingness of the Cantons and the Communes to raise revenue and, in relation to the requisite of a current balanced budget, to develop warning-systems of financial stress. Third, if equalisation is needed - it is argued - the recipient governments should not receive financial aid without a minimum effort in taxation. But, however useful these data may be, one must be careful in interpreting tax burden. Two government units may differ in their tax burden indices not only because they wish to provide different levels of public service (the "choice" model), but also because they use relatively different amounts of debt and non-tax revenues (user charges); differences may also reflect lower financial capacity (in NIC per capita) or differences in the unit cost of provision of public services.

Table 9 shows that an individual can pay as much as twice or three times the amount of tax on the same income and wealth, depending on where he lives. Even neighbouring cantons sometimes have considerable permanent differences in tax burden (WEBER, 1992, p. 248): for example, in the Cantons of Zurich and Zoug for individual income taxation (77.2 and 54.1 points for a national average of 100), or Bâle-Ville and Bâle-Campagne (112.5 and 90.9 points). The same Table 9 presents two interesting further pieces of information:

1. Max / min ratios differ from one tax source to another, and compared to the financial capacity of the Cantons. The min/max ratio is 2.2 for NIC per capita (table 1, column 7, between the cantons Zoug and Jura), and 2.3 for the global indices of tax burden (table 9, column 7). But it varies between 2.50 and 6.59 for particular tax sources and the figures differ widely from one Canton to another for each sort of tax so that one may conclude that differences in the economic situation of the individual Cantons, expressed by NIC per capita, do not entirely explain differences in the tax burdens.

Consider, for example, the seven Cantons in the following abstract of Tables 1 and 9 with almost identical NIC per capita (just above 38'000 Sfr.)

Abstract of Tables 1 and 9

Cantons	NIC per capita	expenditures per capita	tax burden				
			income	wealth	profit	vehicle	global
Thurgovie	38 506	6 085	99.6	136.3	95.0	71.3	101.5
St-Gall	38 196	6 578	101.5	90.2	95.7	105.3	100.0
Lucerne	38 832	6 809	115.6	170.8	90.2	97.6	116.8
Grisons	38 878	9 536	80.0	89.9	103.5	138.0	90.6
Berne	38 758	7 257	122.8	103.5	91.2	139.6	120.3
Uri	38 348	11 385	90.7	61.5	105.3	81.6	88.5
Appenzell Rh. Int	38 735	6 883	108.5	84.5	110.4	113.4	106.1

- ◆ The indices of taxation of individual income and wealth in St-Gall, Berne, Appenzell Rh. Int. and Uri (indice for income taxes > indice for wealth taxes) present exactly the inverse tendency from those in Thurgovie, Lucerne and Grisons (indice income taxes < indice wealth taxes).
- ◆ Lucerne and Berne, which have heavier-than-average indices for income tax have adopted divergent practice for the taxation of wealth: the burden is around the average in Berne (103.5 points), but much higher in Lucerne (170.8 points).
- ◆ Although the interval between the indices of the tax burden on profit are not as large as those on income (from 90.2 to 105.3 points = 15.1 points, compared to 80 to 122.8 = 42.8 points), it is not clear to which extent there is an inverse relation between these two kind of taxation (such as "low income tax" ↔ "high profit tax").
- ◆ With 9 536 SFr. of per capita public expenditures, the indice of global tax burden in Grisons is at 90.6 points, whereas with 6'809 SFr. of per capita public expenditures, the indice of Lucerne goes up to 116.8 points. No direct relation between high per capita expenditures and a high tax burden can be explained.

The main conclusion is that Cantons with almost identical NIC per capita distribute differently the tax burden between each source of taxation compared to the average burden: but these differences reflect cantonal preferences in taxation more than disparities in income per capita or differences in per capita public expenditures.

2. For each ratio, the min or max Canton of reference is a different canton, except for Nidwald and Zoug, which appear twice with the minimum. Cantons with minimum indices are: Zoug on income and profit, Nidwald on wealth and capital and Valais on motor vehicle. Cantons with maximum indices are: Jura on income, Valais on wealth, Neuchâtel on profit, Glaris on capital and Berne on motor vehicles. Valais has the highest fiscal burden on wealth and the lowest on motor vehicles. This seems to indicate that the Cantons have definitely different ideas, first, on the relative tax burden within each tax source that can be asked from their own taxpayer compared to the average taxpayer across the Cantons and, second, on the relative burden of taxation which can be asked from each revenue source. There is no nation-wide concept of uniformity of individual tax burden, as in the case of Germany for example.

## 6. EQUALIZATION

The differences in the Cantons in terms of size, geography, population and economic potential are so great that, without equalisation measures, fiscal federalism would perform under regional disparities which would be intolerable. Therefore, the federal government intervenes to correct the primary distribution of resources between the Cantons with three main policy measures: fiscal equalisation, agricultural aid policy and assistance to mountain areas, with the purpose of strengthening structurally weak regions.<sup>19</sup> It is necessary, at this point, to stress the fact that, in Switzerland, there are no constitutional provisions and no claims from the cantonal governments or the citizenry that equalisation measures should compensate entirely for the differences between the Cantons in order to obtain identical economic or fiscal conditions. The pragmatic objective is to render regional disparities politically acceptable so that remaining differences do not endanger the cohesion of the Confederation.

<sup>19</sup> However, BLÖCHLIGER and FREY (1993, p. 231) note that there is no overall co-ordination of regional equalisation measures, and there are also a number of measures with indirect redistributive effects which exacerbate regional disparities. For example, though central government procurement is not intended to be redistributive in nature, it benefits mainly industrialised Cantons with already higher-than-average NIC (JEANRENAUD, 1985).

According to the 1959 federal law on equalisation, the original objective was to enable the Cantons to provide minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than in others. Equalisation related to policies aimed at correcting fiscal imbalance, whether it resulted from differences in the revenue-raising capacities of the Cantons or because, in some jurisdictions, the relative unit cost of providing some defined levels of services was above the national average. Eventually, the fiscal capacity approach dominated the other question of unit cost, in particular because of the difficulty in defining needs, average versus minimum provision and relative costs, which induced strategic behaviour of recipient governments. As a result, three out of four arguments in the formula for computing the financial capacity of the Cantons (see below) now refer to revenue-raising abilities. From the very beginning, equalisation has excluded differences in cantonal outlays for services other than or above minimum standards and differences in the progressiveness of the tax rate schedules that reflect the concept of income redistribution or the mix between benefit tax and ability-to-pay tax at cantonal level. At the local level, many cantons have introduced inter-communal equalisation, with similar ends and means

The most direct means for reducing cantonal disparities is through fiscal equalisation measures,<sup>20</sup> i.e. payments from the federal government to the Cantons with the purpose of reducing differences in fiscal capacity. There are, today, in Switzerland, three sets of policies which include equalisation components. But for the last twenty years they have not proved very efficient (DAFFLON, 1995): discussion are presently taking place to reform the whole system.

### 6.1. Financial capacity of the Cantons

All equalisation programmes have in common the fact that they relate to the financial capacity of the Cantons. The actual formula for computing the financial capacity of the Cantons has four components (table 10):

- a. the NIC (National Income in the individual Cantons) per capita (column 2), as a measure of each canton's financial resources. This component is weighted 1.5 times in the computation of the total index ;
- b. the inverse of the tax burden of the Cantons and the communes (column 3), as described in the previous section ;
- c. the per capita tax revenues of the Cantons and their communes, from different tax sources, weighted by the indices of tax burden in order to obtain comparable values (column 4). This component is also weighted 1.5 times in the total index ;
- d. an approximation of the Cantons' expenditure requirements, taking into account the population density and the relative importance of each canton's agricultural surfaces in the mountain and in the plain (column 5).

The average value of each component, for the 26 Cantons, is given the value of 100 points; all indices are proportionally calculated. The total index for each Canton is the weighted average (column 6), proportionally corrected in such a way that the lowest single index is given the value of 30 points (column 7). The cantons with more than 120 points are considered as having a high financial capacity; the cantons with 60 points and less a low financial capacity. The medium-capacity cantons stand between 61 and 119 points.

With this formula, the min/max ratio is 6.877.6 points in 1998/99, from the Canton Jura with 30 points to the Canton Zoug with 206 points. The formula results in a relative expansion of the financial capacity scale in which the Cantons are positioned comparatively to their relative place with regard to per capita NIC (column 2), where the min/max ratio is 2.5 points between Zoug and Appenzell Rh.-Int. In consequence, the equalising effects of equalisation payments are reinforced.

### 6.2. Federal equalisation programmes

Three sets of federal equalisation programmes have been developed since 1959 for the benefit of the Cantons: (1) conditional federal grants-in-aid to the Cantons, (2) revenue-sharing of certain federal tax revenues, and (3) contributions of the Cantons to certain federal social security expenditures.<sup>21</sup>

<sup>20</sup> Other regional measures, mostly in the form of conditional grants, address either to individual or private firms within delimited regions or to the regions for themselves or for the communes within their jurisdiction. Regions do not necessarily coincide with cantonal frontiers. Usually, the regions group a number of neighbouring communes with some geographic similarities (all the municipalities in a valley, or alongside the same border of a river, for example). Some regions are intercantonal, which creates co-ordination problems when the respective cantonal Constitutions or laws do not contain identical rules. There is no automatic supra-cantonal rules to observe, so that co-operative federalism is negotiated from case to case.

<sup>21</sup> Intercantonal equalisation also exists, principally as contributions for regional spillovers. One example is the contributions of the Cantons without universities to the cantons with universities, in the form of a fix annual sum per student. At the local level, many systems of revenue sharing and grants-in-aid function between the Cantons (not all) and their communes. A number of Cantons have also developed horizontal equalisation mechanisms in which the fiscally strong communes provide direct support for the fiscally weak municipalities.

### 6.2.1. Conditional (specific) federal grants-in-aid

Many items of cantonal expenditures benefit from federal specific grants. For most aided functions, the rate of grants has two components:

- ♦ a basic rate,  $S_{\min}^j$  in the following formula, which may be said to represent the federal interest in minimum standard requirements for cantonal public services and which varies according to incentive or some other technical criteria (economies of scale, spillovers, congestion costs);
- ♦ an equalisation supplement, the second part [...] of the formula, inversely related to the index of financial capacity of the recipient canton.

This type of fiscal equalisation is mainly vertical, from federal to lower levels of government. It is regulated by many special law. The general grant formula for most granted functions is:

$$S_{ij} = S_{\min}^j + [(120 - E_i) / 60 \times (S_{\max}^j - S_{\min}^j)]$$

where	S	=	rate of grant
	j	=	aided function
	i	=	Canton i = 1...26
	E	=	index of financial capacity
	max	=	maximal rate of grant
	min	=	minimal rate of grant
	E <sub>i</sub>	=	120 for E <sub>i</sub> ≥ 120
	E <sub>i</sub>	=	60 for 30 ≤ E <sub>i</sub> ≤ 60

Example:

Consider a the basic rate of grant of 30 % for a function "j" and a maximum rate of 45 %. This means that a canton with a lower-than-high financial capacity would be entitled to receive an additional part of the 15 % to the basic rate for equalising its position. The exact additional rate of grant is proportional to the difference between the two rates, here 15 %, weighted by the relative position of the cantonal index of financial capacity between 120 and 60 points. A canton with 100 points would receive  $(120 - 100) / 60 \times 15 = 5$  % in addition to the basic rate of 30 %, in all 35 % of the recognised expenditure for the particular project in function "j". For E<sub>i</sub>=120, the rate of grant is S<sub>min</sub>; for E<sub>i</sub>=60, the rate of grant is S<sub>max</sub>.

### 6.2.2. Revenue sharing

The share of the Cantons in the federal government's tax revenue derives from several sources, but three revenue sharing programmes only have equalisation components: for the federal direct tax (FDT), the withholding tax (WT) and part of federal customs duties on petrol and motor fuel (DC). Historically, revenue sharing was generally implemented in order to compensate for fiscal imbalance when a cantonal revenue source was centralized (Customs, alcohol monopoly, coinage, stamp duties) or partly shared with the centre (direct and withholding taxation). With time, the main revenue sharing programmes have been connected with equalisation repayments.

- ♦ The Cantons receive 30 per cent of the *federal direct tax* IFD (income, corporate profits and capital). 17 per cent is allocated on the basis of origin, defined as the residence of the taxpayers, and 13 per cent according to financial capacity. The repartition take the form of an exponential formula

$$P_i^{\text{IFD}} = 0,17 \text{ IFD}_i + [2.71828^{-0.0192104 \times E_i} \times \frac{H_i}{1000} \times \frac{0,13 \text{ IFD}}{1'0'00000} \times K]$$

where P stands for the revenue sharing part of canton "i", with the number of population serving as a multiplicand.<sup>22</sup>

- ♦ They also receive 10 per cent of the *withholding tax* IA, net of collection costs: 5 per cent is allocated according to population, and 5 per cent is reserved to the cantons with indices of capacity E<sub>i</sub> < 100. The formula takes the forms  $[100 - E_i]$  and  $[(100 - E_i)^2]$ , the number of population serving as a multiplicand:

<sup>22</sup> Detailed revenue sharing formulas are given in DAFFLON, 1995, pp. 99,112 and 131.



$$P_i^{IA} = 0,10 \text{ IA} \times \left[ \frac{H_i}{2H_f} + \frac{1}{4} \times \left( \frac{H_i \times [100 - E_i]}{\sum_i H_i \times [100 - E_i]} + \frac{H_i \times [100 - E_i]^2}{\sum_i H_i \times [100 - E_i]^2} \right) \right]$$

- ♦ The federal government reimburses to the Cantons part of its revenue from *customs duties and excises on petrol and motor fuel* DC. Half of the receipts from the "normal" duties and the total so-called "supplementary" duties are exclusively attributed to road expenditures. 12 per cent out of this amount is reimbursed to the Cantons: as general payments for 93/100th and for international Alpine roads for 7/100th. Out of the 93/100th, 42/100th is allocated to equalisation, for the cantons with indices of capacity  $E_i < 100$ . The formula takes the form  $[(100 - E_i)^{1,4}]$  with total cantonal expenditures on roads G serving as a multiplicand.

$$P_i^{DC} = DC \times 0,93 \times 0,42 \times \left[ \frac{G_i \times (100 - E_i)^{1,4}}{\sum_i G_i \times (100 - E_i)^{1,4}} \right]$$

### 6.2.3. Cantonal contributions to social security

The third category of transfer payments which include equalising components concerns the Cantons' contributions to three federal social security programmes: the old-age and survivors insurance (AVS), the disabled pension scheme (AI) and family allowance in agriculture (AFA).<sup>23</sup> Total payments of the public sector are :

**TABLE C**

programme	participation of the public sector	federal	cantonal
AVS	20 % of total expenditures	17.0 %	3.0 %
AI	50 % of total expenditures	37.5 %	12.5 %
AFA	total annual deficit	2/3 rd	1/3 rd

- ♦ For the AVS and AI, the formula for the cantonal payment CONT is based on the total amount of pensions paid AVS in a canton "i" weighted by the financial capacity of the canton in the form  $[5/7 (E_i - 100) + 100]$ .

$$CONT_i^{AVS} = 0,03 \sum_i AVS_i \times \frac{AVS_i \times [ \frac{5}{7} (E_i - 100) + 100 ]}{\sum_i AVS_i \times [ \frac{5}{7} (E_i - 100) + 100 ]}$$

- ♦ For the family allowance in agriculture, the cantons with a FDT per capita lower than 4/5th of the national average benefit from a reduction in their contribution proportional to the difference between this average and their own score  $[FDT_i/H_i]$ .

### 6.3. Importance of the transfer payments

The importance of the three equalisation programmes is shown for 1998 in table 11. Payments from the federal government to the cantons were 8 591 millions SFr. or 18 per cent of total federal expenditures. This amount corresponded to 15 per cent of total public resources of the Cantons, or 6 per cent for specific grants, 9 per cent for revenue sharing. Cantonal contributions to the three mentioned programmes of federal social security expenditures amounted to 1 841 millions SFr. or 3 per cent of the Cantons' total expenditures. However, only parts of the payments include equalisation, also given in table 11. On the whole, they represent 2 937 millions SFr. or 34 per cent of total transfer payments from the federal government to the cantons and 147 millions SFr. or 8 per cent of total cantonal contributions to federal social security expenditures. For the 26 Cantons, the net equalising part amounts to 6 750 millions SFr. and corresponds to 12 per cent of total cantonal revenues.

<sup>23</sup> Financial transfers between the Confederation and the cantons in the domain of Social Security are rather complex and include several programmes, top-down or bottom-up, with or without equalising components. On this, see DAFFLON, 1999.

## 7. CONCLUSION

In conclusion, we may summarise the main features of public finance in Switzerland in the following points:

- a) Total public expenditure without social security represented 32 per cent of GNP in 1997, without social security, which is moderate in comparison to other European countries.
- b) Responsibility is shared between the three levels of government in almost all fields of public intervention, with the result that the budgets of the three levels of government are becoming increasingly entangled. However, the principle of subsidiarity is a strong guideline for the assignment of functions in the fiscal hierarchy, as the example of education expenditures shows. But creeping centralisation intervenes more and more in changing the "choice" role of sub-central jurisdictions in an "agency" role. At the local level, more populous municipalities are in a better position for resisting to this change.
- c) The main revenue sources of the public sector are direct taxation on individual income and wealth and on corporate profits and capital, then expenditure taxes and user charges. But the respective proportions of these receipts vary for the three levels of government.
- d) Cantons and communes have low dependence on transfer payments. 77 per cent of the Cantons' revenues and 84 per cent of the communes' revenues are own revenues. These figures contrast with a higher degree of centralisation in public expenditures.
- e) Fiscal sovereignty belongs to the Confederation and the Cantons. Yet, its exercise is tempered by inter-jurisdictional competition and the mobility of taxable units, and limited by co-ordination and harmonisation practices and law. The communes have no authority over taxation, but have full fiscal flexibility.
- f) Budget responsibility is required at the three levels of government. It means that current budgets should be balanced, borrowing can only finance investments and that only limited transfer payments are available. This is a classical approach to public finance. In addition, direct access to many revenue sources is essential.
- g) In addition to cantonal disparities in economic potentials, the use of non-benefit taxation by decentralised levels of government, different cantonal ideas on tax equity and a fairly large amount of autonomy to decide and offer public services result in large differences in the fiscal burden of individuals in the Cantons as shown by the indices of cantonal fiscal burdens for various tax revenues.
- h) Equalisation schemes intervene in order to compensate partly differences in the revenue-raising capacities of the Cantons. But the amounts of transfer payments to the cantons remain modest owing to the objectives of budget responsibility and financial autonomy of the various jurisdictions. There is no claim to obtain identical economic and fiscal conditions across cantonal and communal jurisdictions.

The Swiss experience introduces pragmatism in fiscal federalism. Financial and budgetary autonomy of decentralised governments permits them to engage in specific public policies, alone or in many forms of horizontal and vertical co-operation. Comparison and competition between the individual jurisdictions ensure that only those policies which are in the long term accepted by the population can be carried through.

The correct solution is not declared *ex ante* as binding, but emerges *ex post* after a selection procedure, which, like a process of trial and error, has compared the various approaches with one another. This selection procedure means that policies in the most diverse areas can be continually reviewed, without it being necessary to specify in advance the right solution - which no one knows anyway (BLÖCHLIGER and FREY, 1993, p. 237). In this procedure, the elements of direct democracy and constitutional economics play a crucial role: constitutional guarantee in the vertical division of power, initiative and referendum, the principle of subsidiarity, fiscal sovereignty, access to many revenue sources, and a low dependence on (equalising) transfer payments are the indispensable ingredients of fiscal federalism.

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## ANNEX: TABLES AND CHART

TABLE 1

## SOME GENERAL INDICATORS ABOUT THE SWISS CANTONS, 1998

Cantons	Number of communes	Surface km <sup>2</sup>	1998								
			Population		cantonal NIC 1998			Public finance in the Cantons, 1 000 Sfr*			
			Total	Density	Total mio Sfr	Sfr per capita	Δ % 1980/98	Expenditures	Revenues	Balance (-) deficit	Public sector size (9:6)
1	2	3	4	5	6	7	8	9	10	11	12
Zoug	11	207	96'517	466	6'679	69'755	23	739'499	720'849	-18'650	11
Zurich	171	1'661	1'187'609	715	70'594	58'770	25	8'235'356	8'276'586	41'230	12
Basle-Town	3	37	190'505	5'149	14'852	76'235	43	3'559'379	3'561'351	1'972	24
Genève	45	246	398'910	1'622	21'710	54'189	13	5'861'562	5'429'981	-431'581	27
subtotal I		2'151	1'873'541	871	113'835			18'395'796	17'988'767	-407'029	16
Basle-Land	86	428	256'761	600	12'346	48'632	24	2'053'672	2'056'673	3'001	17
Nidwald	11	242	37'320	154	1'989	54'789	42	244'640	239'538	-5'102	12
Schaffhous e	34	298	73'725	247	3'421	46'708	24	503'538	502'732	-806	15
Argovie	232	1'395	536'462	385	23'667	44'386	16	3'065'561	2'998'193	-67'368	13
Vaud	384	2'822	611'613	217	28'315	45'677	20	5'424'143	5'283'219	-140'924	19
Thurgovie	81	863	226'479	262	8'893	39'399	17	1'378'070	1'342'460	-35'610	15
Schwyz	30	852	126'479	148	6'227	49'768	48	634'509	707'761	73'252	10
St-Gall	90	1'951	444'891	228	17'364	39'123	16	2'926'347	2'893'062	-33'285	17
Soleure	126	791	243'450	308	9'977	41'458	16	1'630'262	1'392'585	-237'677	16
Tessin	245	2'738	306'179	112	12'280	40'691	28	2'389'324	2'278'845	-110'479	19
Lucerne	107	1'429	343'254	240	13'450	39'341	22	2'337'106	2'339'803	2'697	17
Glaris	29	681	38'698	57	1'999	52'222	20	335'298	327'942	-7'356	17
Grisons	212	7'105	186'118	26	7'894	42'151	15	1'774'890	1'718'438	-56'452	22
Berne	400	5'932	941'144	159	36'105	38'111	8	6'830'312	7'043'650	213'338	19
Uri	20	1'058	35'612	34	1'462	42'108	39	405'429	366'883	-38'546	28
Appenzell Rh. Ext.	20	243	53'816	221	2'118	39'592	20	355'100	354'715	-385	17
subtotal II		28'828	4'462'001	155	187'507			32'288'201	31'846'499	-441'702	17
Neuchâtel	62	717	165'594	231	6'501	39'173	12	1'488'392	1'424'204	-64'188	23
Fribourg	245	1'591	232'086	146	8'456	36'302	15	1'958'526	1'921'668	-36'858	23
Appenzell Rh. Int.	6	173	14'873	86	574	39'608	29	101'474	105'477	4'003	18
Obwald	7	481	31'989	67	1'088	34'251	9	230'404	232'254	1'850	21
Valais	163	5'213	274'458	53	9'515	35'197	13	1'972'079	1'924'706	-47'373	21
Jura	83	837	68'995	82	2'277	33'804	10	734'801	713'939	-20'862	32
subtotal III		9'012	787'995	87	28'411			6'485'676	6'322'248	-163'428	23
Total	2903	39'991	7'123'537	178	329'753	46'236	19	57'169'673	56'157'514	-1'012'159	17

Source: Annuaire statistique de la Suisse, 1995, p. 30; R. Steiner, Kooperationen und Fusionen der Gemeinden in der Schweiz, 1999, Institut für Organisations- und Personal der Universität Bern; NIC: National Income in the Cantons: amounts given by the federal Department of Finance; "Finances publiques en Suisse 1998", A.F.F., 18/2000, Berne, p. 59. Column 1: ranking of the Cantons according to their indices of financial capacity 1998-1999; column 3: without lakes and glaciers; column 8: rate of growth of per capita NIC between 1980 and 1997 in real values (current NIC values have been deflated by the indices of consumption prices); column 9: total current (49'015 millions Sfr) and capital (8'154 millions Sfr) expenditures; column 11 = columns (10-9): the total deficit is lower than total capital expenditures; column 12 = columns (9:6).

TABLE 2

GROWTH OF THE PUBLIC SECTOR 1970-1998<sup>1</sup>

1	1970 Sfr. 2	P <sup>3</sup> 3	1980 Sfr. 4	P 5	G <sup>4</sup> 6	1990 Sfr. 7	P 8	G <sup>5</sup> 9	1998 Sfr. 10	P 11	G <sup>6</sup> 12	G <sup>7</sup> 13
Confederation	7'834	32	17'532	32	1.24	31'616	31	0.80	46'962	33	0.49	4.99
Cantons	9'533	39	21'926	39	1.30	41'116	40	0.88	57'170	40	0.39	5.00
Communes	6'840	29	16'476	29	1.41	30'245	29	0.84	39'327	27	0.30	4.75
Total <sup>2</sup>	24'207	100	55'934	100	1.31	102'977	100	0.84	143'459	100	0.39	4.93
% GNP	22		26.2			27.3			31.7			

Source: "Finances publiques en Suisse 1998", A.F.F., 18/2000, Berne, pp. 2-3.

1. Public expenditures, in millions Swiss francs (Sfr); 2 with double imputation and without social security; 3 per cent share of each level of government in total public expenditures; 4 growth rate over the period 1970-1980; 5 growth rate over the period 1980 -1990; 6 growth rate over the period 1990 - 1998, current values; 7 growth rate over the period 1970-1998.

TABLE 3

PUBLIC EXPENDITURES 1998			
(in 1 000 Sfr)			
Function	Confederation	Cantons	Communes
<b>Administration</b>	<b>1'425'530</b>	<b>2'926'084</b>	<b>3'395'280</b>
<b>Public order</b>	<b>484'041</b>	<b>4'612'253</b>	<b>1'808'953</b>
. police	83'258	2'135'453	767'507
. justice	96'880	1'010'771	39'855
. fire defense	0	65'007	480'527
. other	303'903	1'401'022	521'064
<b>National defense</b>	<b>5'352'217</b>	<b>306'531</b>	<b>280'773</b>
. army	5'235'654	176'689	47'013
. civil defense	116'563	129'842	233'760
<b>Foreign Affairs</b>	<b>2'043'198</b>	<b>0</b>	<b>0</b>
<b>Education</b>	<b>3'131'112</b>	<b>13'914'687</b>	<b>9'043'484</b>
. Kindergarten	0	351'403	605'636
. public schools	21'765	5'462'221	7'016'353
. special schools	0	488'905	477'085
. professional teaching centers	450'370	2'428'916	761'530
. colleges	12'850	1'748'467	63'401
. higher technical schools	161'551	778'686	54'279
. universities, research	1'803'002	2'290'306	8'157
. others	681'574	365'783	57'043
<b>Culture, leisure and sports</b>	<b>465'586</b>	<b>1'150'686</b>	<b>2'093'792</b>
. culture	194'304	559'795	767'445
. sports	110'077	126'275	757'401
. leisure	161'205	464'616	568'946
<b>Health</b>	<b>184'357</b>	<b>9'253'832</b>	<b>7'035'062</b>
. hospital	7'686	6'940'121	5'009'906
. others	176'671	2'313'711	2'025'156
<b>Social Affairs, solidarity</b>	<b>12'909'673</b>	<b>10'987'438</b>	<b>5'592'103</b>
. old-age pensions	4'576'091	814'167	190'075
. invalidity insurance	3'061'166	1'019'573	214'234
. illness insurance	1'470'117	2'360'731	299'518
. Other social insurance	2'450'607	3'307'684	778'112
. social houses	203'406	223'504	61'570
. homes for old age pensioners	0	97'338	887'970
. individual social aid	1'148'286	2'489'068	2'570'499
. others	0	675'373	590'125
<b>Transportation and roads</b>	<b>8'686'152</b>	<b>5'407'911</b>	<b>2'787'269</b>
. roads	2'717'590	4'113'692	2'212'810
. railways	4'635'010	49'313	666
. regional public transportation	1'059'219	1'163'296	559'273
. others	274'333	81'610	14'520
<b>Environment</b>	<b>694'897</b>	<b>1'353'371</b>	<b>3'529'124</b>
. water	0	39'573	223'581
. sewage and water purification plants	191'143	537'127	1'698'698
. garbage collection and disposal	39'514	137'756	846'028
. land planning, zoning	295'090	444'727	244'458
. others	169'150	194'188	516'359
<b>Economy</b>	<b>4'596'240</b>	<b>3'487'854</b>	<b>699'723</b>
. agriculture	3'925'524	2'643'347	96'301
. forests	180'088	366'332	357'535
. others	490'628	478'175	245'887
<b>Finance</b>	<b>6'989'180</b>	<b>3'769'023</b>	<b>3'061'795</b>
. equalization	0	594'285	314'740
. revenue-sharing	3'485'238	579'357	0
. public debt interest and management	3'503'653	2'472'637	2'723'277
. others	289	122'744	23'778
<b>Total</b>	<b>46'962'183</b>	<b>57'169'670</b>	<b>39'327'358</b>

Source: "Finances publiques en Suisse 1998", A.F.F., 18/2000, Berne, pp. 24, 44 and 76



TABLE 4

## RESPECTIVE SHARES OF PUBLIC EXPENDITURES 1998

(in per cent)

Function	Within			Between		
	Confederation	Cantons	communes	Confederation	Cantons	Communes
administration	3	5	9	18	38	44
public order	1	8	5	7	67	26
national defense	11	1	1	90	5	5
foreign affairs	4	0	0	100	0	0
education	7	24	23	12	53	35
culture, sports	1	2	5	13	31	56
health	0	16	18	1	56	43
social affairs	27	19	14	44	37	19
transportation	18	9	7	51	32	17
environment	1	2	9	12	24	63
economy	10	6	2	52	40	8
finance	15	7	8	51	27	22
Total	100	100	100	33	40	27

Source: own computation from table 3

within = proportion of the function in the budget for a government layer (vertical).

between = proportion of each of the three layers for a single function (horizontal).

TABLE 5

## EDUCATION EXPENDITURES 1998

(in 1 000 Sfr)

Education function	Confederation		Cantons		Communes	
	1 000 Sfr	%	1 000 Sfr	%	1 000 Sfr	%
kindergarten	0	0	351'403	37	605'636	63
public school	21'765	0	5'462'221	44	7'016'353	56
special school	0	0	488'905	51	477'085	49
professional school	450'370	12	2'428'916	67	761'530	21
college	12'850	1	1'748'467	96	63'401	3
technical school	161'551	16	778'686	78	54'279	5
university	1'803'002	44	2'290'306	56	8'157	0
other	681'574	62	365'783	33	57'043	5
Total	3'131'112	12	13'914'687	53	9'043'484	35

Source: "Finances publiques en Suisse 1998", A.F.F., 18/2000, Berne, pp. 24, 44 and 76

TABLE 6

## ECONOMIC CLASSIFICATION OF PUBLIC EXPENDITURES 1998

(in 1 000 Sfr)

Nature of public expenditures	Confederation	Cantons	communes
<b>Current Account</b>			
Personnel	4'784'833	20'810'803	15'057'613
Consumption	5'049'478	6'309'274	7'880'622
Interest	3'343'509	2'367'494	2'274'168
Other	3'485'238	1'173'642	314'740
Grants-in-aid and reimbursements			
- public sector			
- Confederation	0	15'922	0
- Cantons	7'121'091	*415'088	3'732'216
- communes	0	3'924'557	*1'443'222
- semi-public sector	12'740'245	3'319'819	587'399
- foreign countries	1'590'824	0	0
- private sector	2'557'513	11'093'715	3'846'676
<b>Capital Account</b>			
Own investments	724'525	4'776'748	5'178'244
Loans and contributions	1'995'599	1'468'778	120'265
Grants-in-aid and reimbursements			
- public sector			
- Confederation	0	5'022	0
- Cantons	2'662'872	*12'994	64'848
- communes	0	906'929	*76'558
- semi-public sector	785'699	369'679	65'595
- private sector	120'757	618'874	195'634
Other	0	8'413	9'335
<b>Total</b>	<b>46'962'183</b>	<b>57'169'669</b>	<b>39'327'355</b>

Source: "Finances publiques en Suisse 1998", A.F.F., 18/2000, Berne, pp. 20, 40, 72 and 74.

\*without double imputation; this amount is not included in the total.

TABLE 7

PUBLIC REVENUES 1998 (in 1 000 Sfr)			
Sources	Confederation	Cantons	communes
<b>Taxes on income and wealth</b>	<b>18'330'763</b>	<b>24'031'534</b>	<b>18'354'852</b>
Income of individuals	5'996'891	16'174'257	13'392'283
Wealth of individuals	0	1'891'712	1'514'768
Corporate profits	3'163'331	2'685'681	1'595'420
Corporate capital	481'382	842'557	532'632
Immovable property	0	178'384	504'237
Capital gains	45'285	434'333	458'424
Inheritance and gifts	0	1'214'762	112'857
Transfer of immovable property	0	609'848	244'231
Withholding tax	5'387'568	0	0
Stamp tax	3'256'306	0	0
<b>Consumption or expenditure taxes</b>	<b>21'522'185</b>	<b>1'639'396</b>	<b>60'300</b>
Turnover	13'286'502	0	0
Tobacco	1'459'316	0	0
Customs and imports duties	1'027'461	0	0
Motor fuel and petrol	4'712'250	0	0
Motorways voucher	458'776	0	0
Motor vehicles	0	1'564'530	0
Entertainment	0	27'618	25'652
Dogs	0	9'364	19'227
Others	577'880	37'884	15'421
<b>fiscal monopolies, licences</b>	<b>249'526</b>	<b>625'271</b>	<b>121'637</b>
<b>Revenues from public property</b>	<b>4'461'049</b>	<b>2'340'154</b>	<b>2'609'090</b>
Interests, dividends	1'064'148	836'827	598'411
Rents	47'153	332'746	1'208'239
Others	3'349'748	1'170'581	802'440
<b>Revenue-sharing</b>	<b>5'389</b>	<b>3'705'379</b>	<b>1'168'251</b>
Federal Direct Tax	0	2'918'544	1) -
Withholding tax	0	535'407	-
Military tax	0	31'288	-
Others	5'389	220'140	-
<b>Grants-in-aid</b>	<b>20'944</b>	<b>14'042'003</b>	<b>5'393'466</b>
Federal grants-in-aid	0	9'575'653	20'256
Cantonal	20'944	*428'082	4'884'207
Communal	0	3'797'064	*1'519'780
Others	0	669'286	489'003
<b>Indemnities and sales</b>	<b>2'482'987</b>	<b>9'773'772</b>	<b>11'062'267</b>
Administrative fees	277'838	1'315'013	382'803
Sales of products and services	56'820	4'722'002	7'444'449
Sales of property	46'170	21'218	56'806
Reimbursements	1'413'644	1'392'163	572'044
Others	688'515	2'323'376	2'606'165
<b>Total</b>	<b>47'072'843</b>	<b>56'157'509</b>	<b>38'769'863</b>

\*without double imputation; this amount is not included in the total; 1) subtotals are not given.

Source: "Finances publiques en Suisse 1998", 18/2000, Berne, pp. 22, 26, 42, 74, 137, 139, 141.

**TABLE 8****REVENUE SOURCES 1998***(in pre cent)*

	<b>Confederation</b>	<b>Cantons</b>	<b>communes</b>	<b>total</b>
Direct taxation	39	43	47	43
Consumption and expenditure taxes	46	3	-	16
Fiscal monopolies, licence	1	1	-	1
Public property	9	4	7	7
Revenue sharing	-	7	3	3
Grants-in-aid and reimbursements	-	25	14	14
- from the Confederation	-	17	-	-
- from the Cantons	-	-	13	-
- from the Communes	-	7	-	-
Indemnities and user charges	5	17	29	16
Total	100	100	100	100

Source: own computation from table 7.

TABLE 9

## INDICES OF TAX BURDEN IN THE CANTONS AND COMMUNES, 1998

Cantons 1	Individual		Legal entities		Motor vehicle 6	Global index 7
	income 2	Wealth 3	profit 4	Capital 5		
Zurich	77.2	51.0	108.9	86.1	97.1	80.0
Berne	122.8	103.5	91.2	107.6	139.6	120.3
Lucerne	115.6	170.8	90.2	97.7	97.6	116.8
Uri	90.7	61.5	105.3	98.4	81.6	88.5
Schwyz	80.8	73.3	81.7	85.3	96.9	81.3
Obwald	120.3	121.4	97.1	74.7	90.6	116.9
Nidwald	70.6	43.2	87.5	40.6	82.6	70.3
Glaris	102.6	106.5	107.9	179.9	106.8	108.1
Zoug	54.1	62.5	57.9	59.4	83.9	57.3
Fribourg	122.1	197.8	100.0	103.2	104.0	124.8
Soleure	102.0	81.1	98.5	100.9	89.2	100.3
Bâle-Ville	112.5	115.6	105.8	122.9	95.0	112.1
Bâle-Campagne	90.9	85.4	99.4	175.3	110.6	93.0
Schaffhouse	101.2	82.3	106.0	77.6	65.0	99.0
Appenzell Rh.-E	108.5	84.5	110.4	123.7	113.4	106.1
Appenzell Rh.-I	97.3	78.4	86.4	86.6	99.3	94.3
St. Gall	101.5	90.2	95.7	96.1	105.3	100.0
Grisons	80.0	89.9	103.5	145.8	138.0	90.6
Argovie	96.3	97.3	101.7	109.2	75.4	96.6
Thurgovie	99.6	136.3	95.0	112.3	71.3	101.5
Tessin	92.5	75.1	128.1	111.8	94.0	97.6
Vaud	103.6	157.3	105.3	103.9	126.0	109.3
Valais	122.4	284.8	103.2	139.5	54.3	130.0
Neuchâtel	123.9	129.4	150.7	114.9	101.8	126.4
Genève	113.2	116.7	121.5	103.9	67.7	113.5
Jura	135.0	142.1	100.2	112.7	120.0	131.8
Average	100.0	100.0	100.0	100.0	100.0	100.0
max / min ratio	2.50	6.59	2.60	4.43	2.57	2.30

Source : "Charge fiscale en Suisse 1998", AFF, Berne, 1999, pp. 62, 76 and 89.

The indices of tax burden are computed in the following way. For each tax, several standard specifications are assessed. For example, for personal income taxation, four categories with various income are considered : single person, married person without children, married persons with two children, old-age pensioners. For each category, the amount of cantonal, communal and church taxes paid in the capital town are computed. Each category is weighted in the global index according to the importance of this source in the total revenue in each canton. The average is given the value of 100 points; all indices are proportionally calculated.

TABLE 10

## FINANCIAL CAPACITIES OF THE CANTONS 2000/2001

Cantons	NIC per capita 1996/97 (x 1.5)	Inverse of tax burden 1995-1998 (x 1)	Tax revenues 1996/1997 (x 1.5)	Expenditure requirements (x 1)	Weighted average	Total index
1	2	3	4	5	6	7
Zoug	158.32	142.23	161.02	96.63	143.57	218
Bâle-Ville	141.00	89.93	129.60	111.10	121.39	158
Zurich	125.15	118.22	126.56	108.95	120.95	157
Genève	112.65	85.49	126.35	111.10	111.02	130
Nidwald	115.81	128.85	105.77	83.38	108.92	124
Bâle-Campagne	107.22	107.21	109.39	105.52	107.53	120
Schaffhouse	102.29	102.93	95.53	111.06	102.14	106
Argovie	98.80	105.99	90.33	110.46	100.03	100
Schwyz	97.49	118.71	94.20	85.49	98.35	96
Vaud	98.77	87.80	98.47	106.17	97.96	95
Thurgovie	86.31	102.42	89.40	110.44	95.28	87
Soleure	91.51	102.51	88.46	103.52	95.20	87
Saint-Gall	86.48	101.13	91.74	98.58	93.41	82
Tessin	84.06	96.67	100.53	85.96	91.90	78
Glaris	113.65	90.98	80.86	77.30	92.01	78
Grisons	87.12	100.89	101.52	70.00	90.77	75
Lucerne	88.82	87.75	83.36	102.09	89.62	72
Uri	86.81	113.89	81.17	73.61	87.89	67
Berne	88.50	83.25	84.99	94.18	87.53	66
Appenzell Rh.-Ext.	80.79	95.45	83.43	82.25	84.81	59
Appenzell Rh.-Int.	83.36	105.49	82.49	71.39	85.13	60
Neuchâtel	87.53	76.48	84.35	88.65	84.59	58
Fribourg	84.63	70.00	78.09	97.00	82.21	52
Obwald	77.47	89.06	70.99	76.76	77.70	40
Jura	70.00	73.41	72.27	84.98	74.36	31
Valais	74.23	71.99	70.00	81.19	73.90	30
Switzerland	100	100	100	100	100	100
max/min ratio	2.26	1.98	2.30	1.35	1.94	7.27

Source : ordonnance fixant la capacité financière des cantons pour les années 2000 et 2001 du 17 novembre 1999, RS 613.11

The computed indices are not directly comparable with the corresponding figures in table 1 (per capita NIC) and table 9 (indices of tax burden) because for each series, the lowest result is given the value of 70 points and all the other numbers are proportionally computed through a specific formula. One cannot say a priori whether this adjustment reinforces or reduces equalizing effects. It depends on whether, in the first calculation, the original min/max ratio, i.e. the original differences in the relative position of the cantons, was higher or lower.

TABLE 11

## TRANSFER PAYMENTS IN 1998

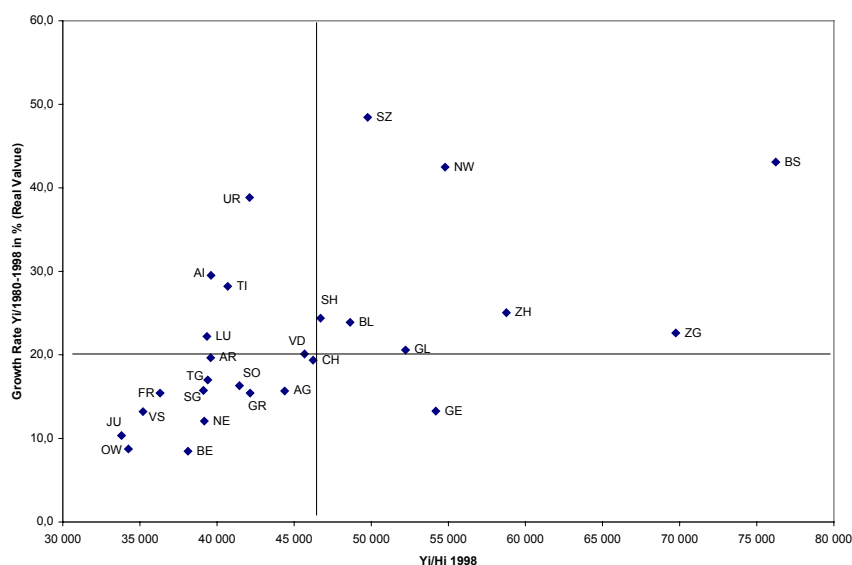
		equalizing proportion	
		% <sup>1)</sup>	SFr
1. Federal specific grants <sup>2)</sup>	3'597'586	24	850'855
2. Revenue-sharing	4'993'249	42	2'086'796
FDT	2'918'544	43	1'254'974
WT	535'407	50	267'704
DC	480'212	40	192'085
BNS	1'005'498	37	372'034
Military tax	31'288	0	0
Tax on alcohol	22'300	0	0
Confederation cantons (1+2)	8'590'835		2'937'651
3. Cantonal contributions (3)	1'841'191	8	147'295
AVS	801'447	8	64'116
AI	995'630	8	79'650
AFA	44'114	4.5	1'985
Total (1 + 2 - 3)	6'749'644		

Source: Federal specific grants: amounts delivered by the Federal Department of Finance; FDT, WT, Military tax: "Finances publiques en Suisse 1998", A.F.F., Berne, 18/2000, pp. 26-27; DC: Office fédéral des routes; BNS: Rapport de gestion 1998; Tax on alcohol: Régie des alcools, Rapport de gestion et comptes 1997/1998; AVS, AI: amounts delivered by the Federal Department of Social Insurance; AFA: amounts delivered by the Federal Department of social insurance.

- Equalizing proportions are evaluated on the basis of the 1991 estimated results (DAFFLON, 1995, p. 198) since the revenue sharing formulas have not changed.
- Only federal specific grants paid to the cantons which contain an equalization supplement have been taken into consideration. The equalization proportion has been given by the Federal Finance Administration from its own calculations. It corresponds to the results that the author has obtained for 1991 from its own estimation (DAFFLON, 1995, pp. 299).

CHART 1

## Cantonal Revenue per capita: Growth Rate 1980-1998 and Disparities 1998







## Balance and imbalance in the Swiss federal system

*By Sonja Wälti*

### 1. WHAT PURPOSE DOES COMPARISON SERVE?

It may seem daring to study Swiss federalism in order to put into perspective the Canadian federal system, given the enormous difference in size between the two countries. Switzerland has barely 7 million inhabitants, while Canada has over 30 million. Switzerland has an area of just over 40,000 km<sup>2</sup>, while Canada has an area of nearly 10 million km<sup>2</sup>. A Swiss person living at the edge of the country can reach the capital city, Bern, 250 km away by train in just over four hours, while a Canadian in the same situation must travel nearly 4,000 km to reach Ottawa.

What, one might ask, is the use of drawing parallels between two such different situations? In my opinion, there are two reasons why such an undertaking is far from futile, not necessarily to copy the systems but to better understand them. First, federalism in the two countries displays important similarities, which bode well for a fruitful comparison. Second, institutions are, so to speak, indifferent to size. The executive and legislative branches and the administrative system resemble each other regardless of the number of inhabitants to be served, the land area to be administered and the distances to be travelled, all the more so as these data are less and less important in a world that is at once 'local' and 'global' in nature. Solutions adopted in one country can therefore, bearing in mind the specific traits of each country, be contemplated in the other.

This paper seeks to put into perspective fiscal federalism in Switzerland, in particular facets pertaining to fiscal balance and imbalance. It is intended to present a "political portrait" of fiscal federalism in Switzerland and provide details that make it possible to better understand interactions resulting from fiscal institutions. Following an introduction to the Swiss political system, I will emphasize the allocation of responsibilities and resources between levels of government. Next, I will discuss how these institutional configurations affect intergovernmental relations in Switzerland, before offering some concluding remarks on the feasibility and plausibility of reforms of the system.

### 2. FEDERAL COMPONENTS OF THE SWISS POLITICAL SYSTEM

The Swiss federal government comprises a cabinet made up of seven ministers designated by parliament, who exercise power in a collegial manner, i.e. by sharing responsibility for decision-making. The composition of the cabinet follows a "magic formula" whereby the federal government more or less reflects partisan politics in the country: two Social-Democrats, two Christian-Democrats, two Radicals and one member of the Democratic Union of the Centre. Essentially, it is as if Switzerland is permanently managed by a great coalition. During a given year, one of the ministers acts as President of the Confederation, a largely representative function. Under Switzerland's consociational tradition, parliament also ensures that the government represents linguistic, regional and religious ratios. Until very recently, it was impossible to elect two ministers from the same canton.

The National Council, the lower house of parliament in Switzerland, comparable to the House of Commons in Canada. It is made up of 200 representatives elected by proportional representation in their electoral ridings, i.e. the 26 cantons, for four years. Each canton is entitled to a certain number of seats, based on population. The National Council's decisions reflect partisan political lines. However, depending on the issues at hand, partisan logic gives way to the formation of regional or even linguistic coalitions.

The Council of States is in some ways comparable to the Canadian Senate, although it functions on a very different footing. Two deputies elected by a majority of cantonal voters represent each of the 26 cantons.<sup>1</sup> In the past, when the cantonal governments appointed the senators, the Council of States operated somewhat like a cabinet of cantonal ministers. Today, the upper house is simply a second chamber in a perfect bicameral system. If the deputies continue to pay special attention to the interests of their canton, many decisions are reached, as on the National Council, along partisan lines. In Switzerland, perfect bicameralism means that the two houses may make proposals and decide on current issues. Unlike the Canadian Senate, however, the Council of States, along with the National Council, may decide on budgetary and financial measures. The budget is evaluated jointly and must obtain the approval of both houses.

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<sup>1</sup> The six half-cantons are entitled to only one deputy each.

Should differences arise, the budget shuttles back and forth between the two houses until agreement is reached.<sup>2</sup> The same process applies to any other decision, i.e. regulatory acts, expenditures or taxes.

One particularity of the Swiss system is that certain legislation is also subject to a public referendum. When the federal Constitution is amended, the referendum is compulsory. In the case of legislation, it is optional and may be demanded through the collection of signatures. Some observers deem direct democracy procedures to have a restrictive effect. Although little comparative evidence is available in that respect, this hypothesis seems plausible, since votes often revolve around new programs, and hence new expenditures.

Intergovernmental coordination between the Confederation and the cantons also relies on numerous task forces, commissions, and conferences of cantonal directors of finance, education, the economy, and so on. Especially fiscal policy is subject to ongoing negotiation within such coordination structures.

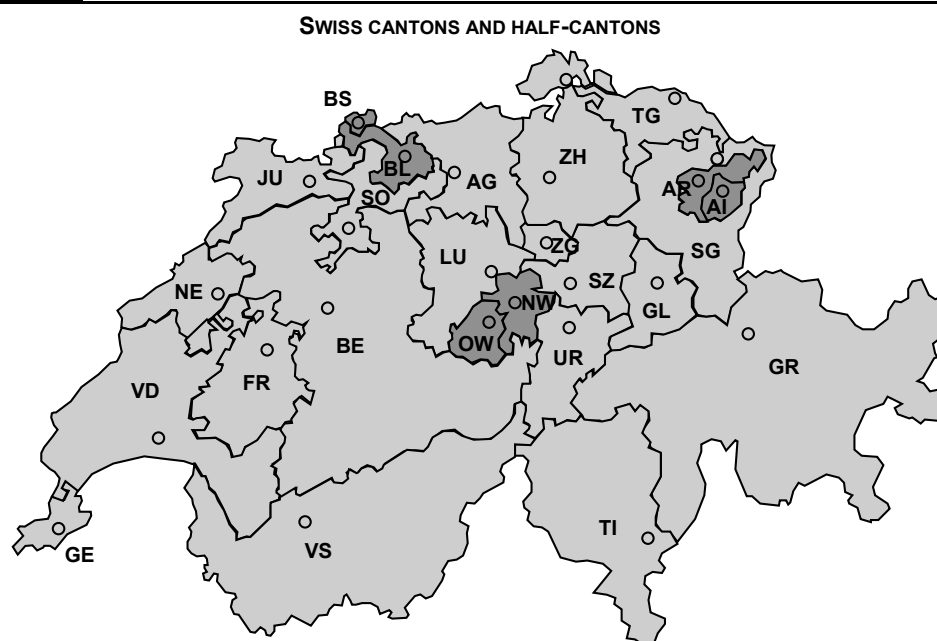
### 3. IS SWISS FEDERALISM SUBJECT TO IMBALANCE?

Swiss and Canadian federalism have important points in common. Not only are the systems in both countries established federations but also their federalism is rooted in comparable principles. Both systems seek to reconcile needs for unity and cohabitation with cultural and linguistic diversity and regional and local autonomy. Both systems have found in federalism a means of pursuing the common good while attributing to regional entities some degree of autonomy that should enable them to display and develop their unique situations. Both federal systems continue to engage in self-reflection, in order to call into question established institutions or with a view to perfecting them.

#### 3.1. Horizontal imbalance

Switzerland is made up of 26 cantons, six of which are called half-cantons (they are darker on the map below).

MAP 1



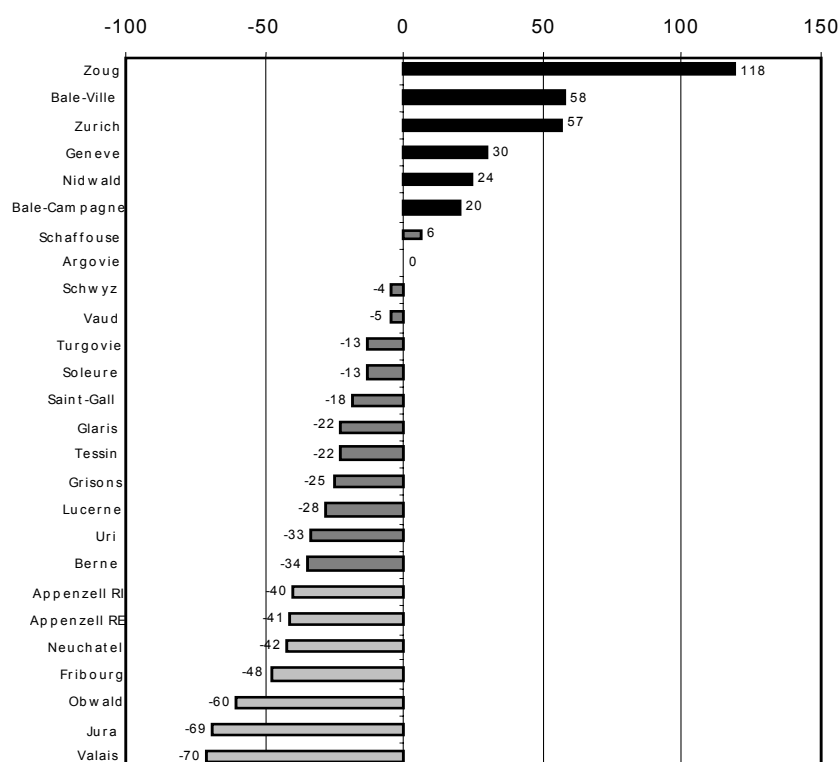
The cantons vary markedly in terms of their socio-economic dimensions (see also Dafflon 2001a, 2001b, 1995). The two most populous cantons, Zurich and Bern, are 70 times bigger than the smallest entity, the canton of Appenzell Inner-Rhodes. From the standpoint of economic disparities, although it is hard to establish a clear distinction between “rich” and “poor” cantons (Gaudard 1989), a similar observation can be made. Over 20% of GDP is generated by the Zurich

<sup>2</sup> Failing agreement, the lowest figure takes precedence.

canton alone, where 16% of the population lives. In 1998, the gross domestic product of cantons such as Basel-City (BS) was double that of Jura (JU). The growth rate in the most successful canton (Schwyz, SZ) was six times greater than in the least successful canton (Bern, BE). The same applies to disparities in income: per capita income in the wealthiest cantons (Zurich, Zug and Basel-City) is almost double the income in the poorest cantons (Uri, Obwalden, Thurgau and Jura). The financial capacity index of the cantons varies between 30 and 218 in relation to the Swiss mean (100).<sup>3</sup> Chart 1 presents the cantons according to their financial capacity in relation to the mean (set here at zero), ranging from the most privileged to the least privileged.

CHART 1

## DISPARITIES IN THE FINANCIAL CAPACITY OF THE CANTONS



Financial capacity reflects, by and large, a canton's tax revenues. The tax revenues of Jura canton are less than half those of Zug canton. While these differences are somewhat mitigated by the cost of living, which is lower in underprivileged regions, they are considerable. Equalization is intended to remedy this situation (see also Dafflon 2001a, 2001b). One-third of direct federal tax, i.e. income tax levied by the Confederation, is redistributed among the cantons according to their financial capacity. However, federal government investment and jobs tend to overwhelm the effect of equalization by favouring the economically strong cantons (Grosclaude and Schwab 1991). The same may be said of conditional transfers, which are common in Switzerland and which, by subsidizing expenditures, essentially favour those cantons that are able to allocate substantial own-source revenues. For this reason, equalization is under review, primarily with a view to eliminating the subsidization of expenses to achieve genuine equalization of revenues (see also Bullinger 2001).

Moreover, there are significant structural (and by extension, political) disparities between the cantons: the share of the primary sector ranges from 16% (Geneva) to 48% (Glarus) and the share of services between 46% (Glarus, Appenzell Inner-Rhodes) and 75% (Geneva).<sup>4</sup> While an urban centre dominates a number of cantons (Geneva, Basel-City and Zurich), others are mainly rural (Appenzell and Grisons). These structural differences also reflect the historic

<sup>3</sup> For more details on the calculation of this index, see Dafflon (2001a, 2001b).

<sup>4</sup> These figures are based on the number of employees in the production and service sectors and are drawn from the 1991 federal business census.

development of the cantons and are expressed through politics and political parties. Indeed, each canton is a full-fledged mini political system with its own political and partisan elite. Numerous political parties are organized solely at the cantonal level. The cantonal and communal sections of national political parties have their own history and pursue their own agendas. However, compared with the Canadian political system, the Swiss partisan system is more homogeneous. The four governmental parties mentioned earlier are established in all of the cantons and contribute to national cohesiveness.

Important differences are also apparent from an administrative viewpoint. Administrative structures vary even more strikingly than political institutions (Germann 1986: 356). Those of the big cantons are characterized by a high degree of professionalization and differentiation (Urio 1986). The small rural cantons have more traditional administrative models. They maintain a strong participatory cultural and assign numerous duties to non-professional volunteers in conjunction with commissions and corporations (Linder 1983: 340-341; Urio 1986: 109-111). These differences do not stem solely from disparities in resources but also from the cantons' organizational autonomy. The federal Constitution empowers the cantons to organize their administration, including its municipalities, as they see fit. The same autonomy prevails with respect to political structures, which, however, have been subject over time to much broader convergence.

### **3.2. Vertical imbalance**

The two variables of vertical imbalance in any federal system are the division of jurisdictions and the distribution of resources. As for the division of jurisdictions, the Swiss federal Constitution stipulates a strict concept of subsidiarity, i.e. unless the Constitution attributes a jurisdiction explicitly to the Confederation, it is within the competence of the cantons. Moreover, the power of the cantons stems from the delegation to them, either by the Constitution, through legislation or even by means of statutory instrument, of numerous federal responsibilities (see Faganini 1991: 51ss; Delley 1984: 343; Klöti 1988). In Switzerland, this delegation of implementation to the cantons is referred to as "executive federalism," which results from the principle of cooperation that characterizes the Swiss federal system (contrary to the principle of separation or competition that prevails in more dual federal systems such as Canada). Executive federalism can be perceived as a vertical imbalance to the extent that the Confederation now is given important decision-making powers, while the cantons are responsible for executing these responsibilities.

The Confederation has to fight, often unsuccessfully, to obtain new jurisdictions. It achieves this end often by promising the cantons additional financial resources but leaving them full leeway to implement the responsibilities. Because of this imbalance, the Swiss federal system has, in the post-war era, simultaneously undergone centralization in respect of decision-making and decentralization from the standpoint of financial and organizational resources. While growing numbers of responsibilities have been transferred to the federal government in recent decades, especially in such areas as land use planning and development, environmental protection and energy policy, the cantons have maintained considerable power with regard to implementation (Germann 1986: 348; Kriesi 1995; Linder 1983: 335-339; Nüssli 1985: 258-260). This shift has been accompanied by an increase in conditional transfers to the cantons.

Even fields that are formally fairly centralized, such as transportation policy and social security, are in fact administered by the cantons. Only the public economy (in particular, agriculture) is largely funded by the Confederation despite the formal sharing of jurisdictions by the two levels (Nüssli 1985: 353).

**TABLE 1****BREAKDOWN OF EXPENDITURES BY FUNCTION***(in %, 1998)*

	<b>Confederation*</b>	<b>Cantons*</b>	<b>Communes*</b>	<b>Share of total federal expenditures</b>
Foreign affairs	<b>100</b>	0	0	2
National defence	<b>93</b>	5	5	5
Finance and taxation	<b>78</b>	42	34	7
Public economy	<b>74</b>	56	11	5
Transportation	<b>64</b>	40	21	11
Social security	<b>52</b>	44	23	21
Justice and police	7	<b>70</b>	27	5
Education	14	<b>64</b>	42	18
Health	1	<b>63</b>	48	12
General administration	19	39	<b>45</b>	6
Culture and recreation	13	32	<b>58</b>	3
Environment and land use planning and development	15	29	<b>75</b>	4
<b>Total expenditures</b>	<b>39</b>	<b>48</b>	<b>33</b>	<b>100</b>

Source: adapted from Eidgenössische Finanzverwaltung (2000).

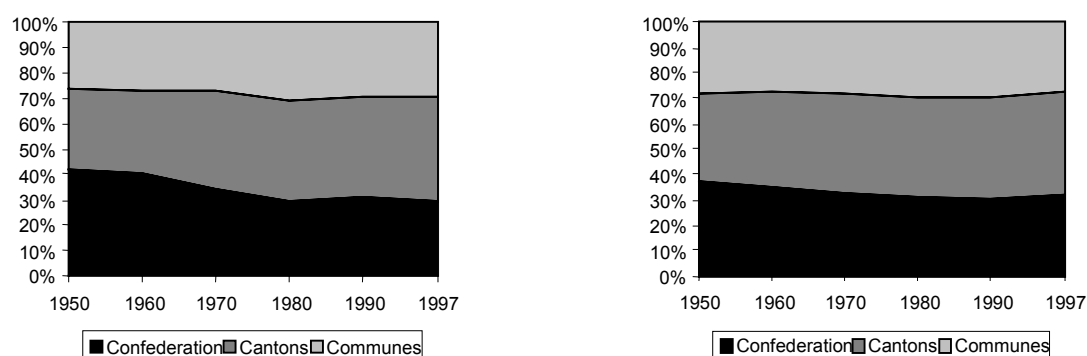
\*Certain expenditures appear more than once, which explains why the totals exceed 100%.

The Confederation and the cantons both deplore this entanglement of responsibilities. The cantons are deprived of decision-making power that would allow them to fully enjoy their autonomy, while the Confederation complains that it lacks the power to ensure that its responsibilities are executed as prescribed. For this reason, current reforms of the Swiss federal system are aimed at untangling responsibilities. Such untangling is geared to re-establishing decision-making and fiscal responsibilities with a view to enhancing the efficacy of the Swiss federal system. Such efforts, if they succeed, will inevitably lead to some degree of withdrawal by the Confederation from cantonal affairs, which must be offset by the strengthening of financial equalization, mentioned earlier.

The second variable in vertical imbalance concerns resources. A comparison of changes in the revenues and expenditures of the three levels of government suggests that the Swiss federal system has avoided fiscal imbalance.

## CHART 2

## EVOLUTION OF REVENUES AND EXPENDITURES



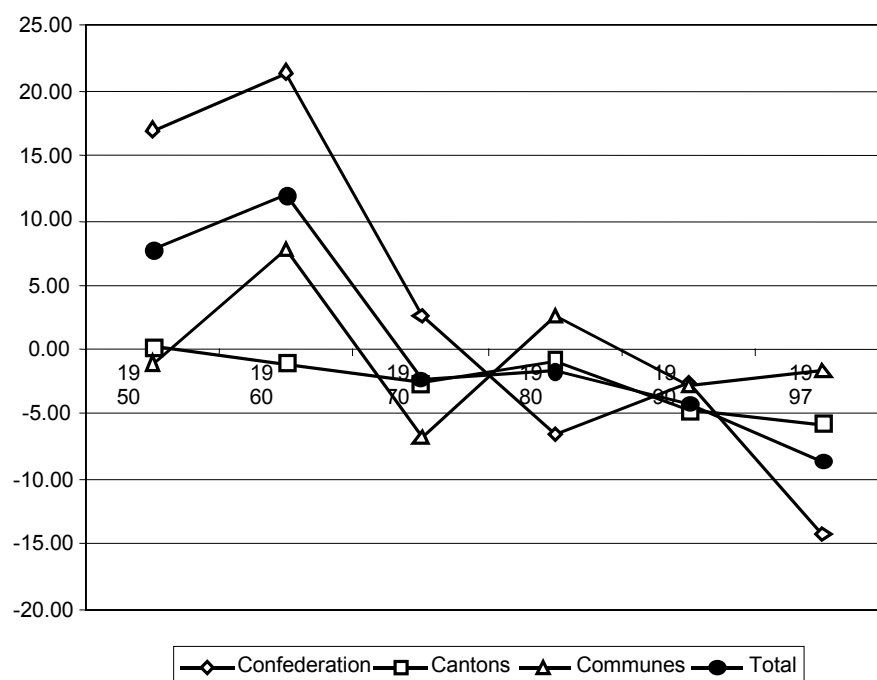
However, it has to be kept in mind that the flow of funds between the three levels is considerable. The cantons' share of federal revenues stands at 8.3% (Office fédéral de la statistique 1999: 462, 473). Some 26.8% of cantonal revenues come from federal funds, only 6.4% of which are unconditional (*ibid.*: 472). Most federal contributions to the cantons are in the form of conditional transfers (matching grants). The latter enable the Confederation, which is largely lacking in power to guide the cantons, to prompt the cantons to act, e.g. to build roads, cover the needs of the poor in the realm of health insurance, or to foster scientific research in the cantonal universities.

The well-known problem stemming from this configuration is that, first of all, it is difficult to direct resources where they are the most needed. Second, the resources steer the cantonal budgets toward "paying" activities. Third, different levels of government can avoid blame for the financial situation. As for the first criticism, research is unanimous in showing that the financially strongest cantons also benefit from the biggest conditional transfers simply because they have the means to raise sufficient revenues in order to obtain a big share. Moreover, the less financially advantaged cantons often take time to embark upon a program and leave empty-handed when subsidies dry up. The second criticism concerning the poor allocation of the cantons' budgetary resources also seems justified, at least in the realm of investment.

The typical example of this phenomenon is the construction of bomb shelters: in order to take the fullest possible advantage of federal subsidies put in place during the cold war to increase the availability of such shelters, the communes have eagerly equipped each school, local home and sports centre with shelters, to the extent that some communes have created considerable overcapacity (Kissling-Näf and Wälti 1999). To the contrary, subsidies intended to make health insurance affordable for low-income earners are underutilized, especially in those cantons that need the subsidies the most. Unlike the first two criticisms, the third criticism concerning the avoidance of blame seems to be unfounded. In comparison with the Confederation, the cantons and communes are now less threatened by deficits. As Chart 3 shows, the situation was reversed toward the end of the 1970s, in light of the observation that the cantons and communes became indebted following the oil crisis, while the Confederation continued to record surpluses. The Confederation now shoulders over half of the public debt (53.4% of GDP in 1998).

CHART 3

## CHANGE IN BUDGET SURPLUSES AS A PERCENTAGE OF REVENUES



Source: Office fédéral de la statistique (1999: 462).

Given the overlapping in federal and cantonal finances, it is hard to ascertain the extent of fiscal imbalance in Switzerland. What is important from the standpoint of autonomy is the freedom the cantons enjoy to make independent budget choices. This freedom is not entirely the same as regards expenditures and revenues. In terms of expenditures, the cantons are closely tied to federal budget choices (Braun *et al.* 2000). A large part of their revenues come from transfers, which, contrary to those in Germany, for example, are for the most part tied to the accomplishment of certain responsibilities. Having said that, the Confederation has fairly limited means of controlling the allocation by the cantons of these resources and often confines itself to a political denunciation in the event of overly free implementation (Linder 1987; Wälti 1996). As for revenues, the link is not as strong.<sup>5</sup>

The only truly “shared” tax is direct federal tax, which is levied by the Confederation on income and of which the cantons receive one-third.<sup>6</sup> Roughly one-fifth of federal revenues are derived from this tax, whose legal basis must be renegotiated every four years. The Confederation relies, by and large, on its exclusive right to levy the value-added tax, now set at 7.5%, and various consumption taxes (tobacco, alcohol, mineral oils, duty on heavy vehicles). The cantons enjoy considerable fiscal autonomy and are free to determine the taxation base and tax rates. Generally speaking, most cantonal revenues come from personal and corporate income tax. Most of the cantons also levy taxes on property, gifts and inheritances, property sales, automobiles, games and entertainment and the production of hydroelectric power.

#### 4. INTERPLAY

The horizontal and vertical imbalances in the Swiss federal system, as described in the preceding sections, are at the heart of the federal dynamics in Switzerland. This dynamics, of which incrementalism and the balance of powers are the hallmarks, gives rise to interplay that I would like to briefly describe below.

<sup>5</sup> See also Dafflon (2001a, 2001b) and the Commission intercantonale d'information fiscale 1998.

<sup>6</sup> The cantons are also entitled to a portion of other, less important taxes, i.e. the withholding tax, federal stamp duties, the tax on the exemption from military service, and road duties.

#### 4.1. Interplay with regard to the execution of responsibilities

Studies of the political process in Switzerland have highlighted the problems stemming from the vertical imbalance in the division of responsibilities, especially shortcomings in implementation (Linder 1987: 188ss). The Confederation's lack of monitoring instruments (or rather, its failure to use them), gives the cantons considerable leeway with respect to implementation. Such leeway is all the broader since the opening up of the legislative process in Switzerland to interest groups with the power to organize referenda makes the legal bases vague and subject to interpretation (Knoepfel 1996; Kriesi 1995: 314ss). The cantons use, or indeed abuse, such leeway in order to pursue their own objectives.

This dynamics is not contested, but its interpretation is subject to debate. Some observers emphasize that, as a result, Swiss federalism has been emptied of its content and that the cantons have become simple executive entities (Knapp 1986: 50). Others regret that the central government is not sufficiently strong to face issues such as environmental protection, the completion of major infrastructure projects or foreign policy (Germann 1994: 57). One intermediate viewpoint consists in focusing on the functional nature of a certain balance of power between the Confederation and the cantons, especially as regards the resolution of conflicts (e.g., Linder 1987: 194; Wälti 1996). The federal authorities may obtain new powers in exchange for financial transfers and the delegation of implementation to the cantons (Faganini 1991: 54; Kriesi 1995: 76). As a result, despite the absence of a genuine joint decision-making power such as it exists in Germany, the cantons carry weight in the federal decision-making process.

Along those same lines, the vertical imbalance that characterizes Swiss "executive federalism" is part of the Swiss consociational model in which the cantons, like interest groups and political parties, appear as players with interests, resources and strategies (Lehmbruch 1993: 51; Duchacek 1986: 99). The ability to play both the centralization (of jurisdiction) card and the decentralization (of implementation) card makes it possible to achieve compromises and attain solutions involving mutual gains that would be otherwise unattainable.

#### 4.2. Interplay with regard to the distribution of financial resources

As is true of responsibilities, neither the Confederation nor the cantons may unilaterally reduce, increase or reallocate resources. If the Confederation seeks to increase or decrease its resources, the cantons will very likely intervene in parliament. As for the first possibility, the cantons would hesitate to agree because they would be deprived of a portion of the tax base. The Confederation has a somewhat simpler task in the realm of shared taxes since the cantons also benefit from such taxes. If the Confederation wishes to increase its own resources, e.g. the value-added tax, the cantons may intervene through their representatives on the National Council and the Council of States. However, their veto power in this instance is more limited than that of the German *Länder*, for example. Why would the Confederation hesitate to unilaterally increase its own revenues? First of all, because it always needs to rally a partisan majority behind its proposals (it should be remembered that the parties have strong regional loyalties) and second, because such a decision is subject to a referendum. The cantons have considerable weight in the referendum process.<sup>7</sup>

If the Confederation intends to reduce its own revenues, the cantons would, *a priori*, have fewer objections. To the contrary, one might even wonder why the cantons do not exercise pressure more often in this respect. There are two reasons: first, the cantons are hardly inclined to relinquish the numerous transfers (often equalizing) financed by these resources, and second, in the case of shared taxes, they actually benefit from them. However, the cantons could step into the breach and collect their own resources instead, one might be tempted to say. In reality, fiscal competition between the cantons poses limits on such unilateral logic. Most of the cantons, even the wealthiest ones,<sup>8</sup> accept the existence of a certain pooled tax harvest, instead of exposing themselves to growing fiscal competition. (At this stage, federalism is functioning like a club in which the members have understood that they are facing the prisoner's dilemma and that cooperation is more profitable than competition.)

Since few tax revenues are genuinely shared between the Confederation and the cantons, a vertical reallocation of such revenues, as regularly occurs in Germany, in particular, is not possible. At best, reallocation occurs indirectly if one level of government modifies its tax base. As Chart 2 indicates, the distribution key remains relatively stable.

A reduction or increase in or the reallocation of expenditures is subject to similar constraints but gives rise to different types of interaction since, in the realm of expenditure, the levels of government depend more heavily on each other. It is

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<sup>7</sup> In the case of the compulsory referendum, voters in the majority of cantons must approve the measure. In the case of the optional referendum, this requirement is eliminated but the cantonal political elites always play an important role in the electoral campaign.

<sup>8</sup> The wealthiest cantons benefit most from the direct federal tax. It is true that the cantons' share is redistributed in the manner of equalization payments, which means that the wealthy cantons transfer part of their revenues to the less privileged ones. At the same time, the wealthiest taxpayers live in the resource-rich cantons and have the greatest exposure to direct federal tax because it is more progressive than cantonal taxes. Despite equalization, the most privileged cantons ultimately receive a larger share of the direct federal tax.



in the intrinsic interests of the cantons with more limited resources and which are more strongly dependent on the Confederation to broaden the resources at their disposal. For this reason, new expenditures are adopted quite readily. However, this dynamics is curbed insofar as the cantons must, so to speak, “buy” the new resources, which they usually receive in the form of conditional transfers. The reduction in or the reallocation of such transfers is hard to achieve but feasible since new expenditures are often adopted for a limited time. Moreover, the budget process in Switzerland deals with revenues and expenditures on the same footing and through the same commissions. Consequently, each new expenditure calls for an increase in or the reallocation of resources and will thus be of limited scope.

## **5. CONCLUSION: FEASIBILITY AND PLAUSIBILITY OF REFORMS**

The history of the reform of horizontal and vertical imbalances in Switzerland is lengthy and fraught with failure and incrementalism. During the 1960s and 1970s, coordination and intergovernmental collaboration were the watchwords. In the 1980s and 1990s, the paradigm shifted to competition, fiscal equivalence and untangling. The change, which is characteristic of all federal systems, also obtains in Switzerland where pressure for reform is now pointing in the direction of broader fiscal responsibility for the cantons. By reducing and untangling vertical financial flows, officials hope to avoid problems of free-riding jumping and fiscal irresponsibility, i.e. the so-called moral hazard. What chance of success do these efforts have?

During the 1980s, the reforms were perceived, first and foremost, as being motivated by the desire of the Confederation and the wealthy cantons to reduce expenditures in order to limit deficits: to untangle is to make accountable, and to make accountable is to discipline. While this causality is certainly plausible on paper, all the more so as most of the cantons have adopted automatic controls that demand a balanced budget, the distribution of interests among the cantons made almost illusory the attainment of these objectives. Decision-making processes, described in the preceding sections, prevent a minority of wealthy cantons from imposing a reform, regardless of how reasonable and economically sound it may be, on a majority of less privileged cantons. The constellation of interests does not favour such a reform.

Budgetary détente in recent years has somewhat altered the situation and the reforms seem more likely to succeed. Through the untangling of responsibilities, combined with the strengthening of equalization (in respect of revenues, but no longer as regards expenditures), all of the cantons could gain broader autonomy. However, the reduction in vast conditional transfers will be hard to achieve. Why? It might be thought that it is in the interests of all of the cantons to undo the “golden chains” of conditional subsidies. In actual fact, the reduction of conditional subsidies will make the cantonal budgetary process more antagonistic. If various departments now have highly predictable budgets, they will, in the future, have to negotiate the allocation with the cantonal finance minister (Bullinger 2001). Broadly speaking, the cantonal budgetary process would clearly become more political.

Aside from the question of feasibility, we must pose the question of plausibility. As I have noted, horizontal and vertical imbalances are real in Switzerland and criticisms of the system are founded. However, such criticism often centres on economic efficiency reasoning and tends to neglect “political efficiency.” The interaction resulting from these imbalances is itself in balance. In other words, the resulting constraints and limitations serve a function in the Swiss political system, that of the integration and balancing of power.

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# **THE 2000 REFORM OF INTERGOVERNMENTAL FISCAL ARRANGEMENTS IN AUSTRALIA**

*By David J. Collins*

## **1. INTRODUCTION**

In July 2000 the Australian Commonwealth (i.e. Federal) Government implemented a package of economic reforms of which the major one was the introduction of a goods and services tax (GST), in reality a VAT, with the revenue from that tax being earmarked for the States. This change resulted in a major reform in the financial relations between the Commonwealth Government and the States. This paper provides a review and analysis of the federal fiscal impacts of the new GST arrangements. It is a briefer and updated version of Collins (2000).

In analysing the probable impact of the introduction of a GST, Australia was able in the planning stages to draw upon the experience of many countries who have gone through this process. In particular, Australia benefited greatly by drawing lessons from New Zealand's experience. However, in this regard the reform of Federal-State financial relations within a GST implementation package is quite different since there is little available international experience of the introduction of a GST concurrent with thoroughgoing reform of federal financial relations. The particular implications which the GST arrangements have for the structure of Commonwealth-State financial relations in Australia have no real counterpart in the experience of other federal systems.

The Australian federal system has a much higher level of vertical fiscal imbalance than has any other similar country. At the same time, it has developed its own system of fiscal equalisation to correct for horizontal fiscal imbalance. Both the level of vertical imbalance and the scope of fiscal equalisation are substantially increased by the GST-associated changes. From the point of view of federal fiscal relations, the GST changes are close to being revolutionary.

Since so much of the subsequent discussion relates to reform of the Australian Federal-State financial arrangements existing immediately prior to the introduction of the GST on July 1, 2000, a brief explanation of the relevant components of these arrangements follows (for a comprehensive exposition and analysis of these arrangements see James, 1992).

The Australian Constitution sets out the expenditure responsibilities and taxation powers of the Commonwealth and the States, although these have in practice been modified to some extent as a result of the exercise of political and economic power by the Commonwealth. The overall outcome has been the existence of a high degree of vertical fiscal imbalance. The States' own source revenues have proved quite inadequate to fund their own purpose expenditures, while the Commonwealth is in the opposite position. In practice, the Commonwealth has a monopoly of income tax and general consumption tax powers. The States are left with a range of relatively unsatisfactory taxes such as financial taxes, stamp duties, payroll tax, gambling taxes, land taxes and motor vehicle taxes. As a result, the Commonwealth has made very substantial grants to the States to make up their revenue shortfall.

These Commonwealth grants to the States take two forms:

- ◆ General revenue assistance (untied grants); and
- ◆ Specific purpose payments (tied grants).

General revenue assistance was distributed to the States on fiscal equalisation principles. Some States experience expenditure disabilities as a result of relatively high per capita costs for the provision of public services. They may also experience revenue-raising disabilities as a result of their having relatively small per capita tax bases. The objective of fiscal equalisation is to compensate the poorer States for these expenditure and revenue disabilities (but not for the results of any inefficiencies arising from their own discretionary policies). The process attempts to achieve capacity equalisation not performance equalisation. The relativities upon which the distribution of general revenue assistance is based are recommended by the Commonwealth Grants Commission (CGC). In the determination of its relativities recommendations, the Grants Commission takes some account of Commonwealth specific purpose payments to the States, even though these are funds in the use of which the States have no discretion.

There remained scope for negotiation between the two levels of government on funds allocation and these were conducted in Financial Premiers Conferences and in the Council of Australian Government. This latter body has a remit much broader than simply financial matters, dealing with such issues as the reforms designed to achieve a single, harmonised national market.

The process by which the arrangements existing at June 2000 were reached was a complex one. There could be said to have been two major themes to Commonwealth-State financial relations over the life of the Australian federation:

1. The battle between the two levels of government over the allocation of taxing powers. This battle has been decisively won by the Commonwealth, as a result of the “temporary” coercive acquisition of sole income taxing powers (relating to both personal income and company profits) by the Commonwealth in the wartime conditions of 1942, and the interpretations of Section 90 of the Constitution by the High Court which have removed from the States the power to impose broad-based consumption taxes.
2. The ebb and flow of the allocation of relative expenditure powers between Commonwealth and State Governments, with some Commonwealth governments pursuing centralist agenda while others have been more willing to yield independent power to the States.

For detailed information on the history of federal financial relations in Australia see James (1992), Collins (1993), and Warren (1997 and 1999).

To put the ensuing discussion in context, Table 1 presents a summary of Australian tax revenues classified by level of Government in the last year before the operation of the IGA.

TABLE 1

## AUSTRALIAN TAX REVENUES, 1999-2000

	\$M	\$M	% of total Aust. taxation
<b>COMMONWEALTH</b>			
<b>Taxes on income</b>			
Individual income tax	83,710		42.6
Company income tax	29,516		15.0
Non-residents tax	1,276		0.6
<b>Total taxes on income</b>		114,502	58.3
<b>Employers' payroll taxes</b>		3,434	1.7
<b>TAXES ON PROVISION OF GOODS AND SERVICES</b>			
Sales tax	15,644		8.0
Excises and levies	14,658		7.5
Taxes on international trade	3,799		1.9
<b>Total taxes on provision of goods and services</b>		34,101	17.4
<b>Other</b>		538	0.3
<b>Total Commonwealth</b>		<b>152,575</b>	<b>77.7</b>
<b>STATE</b>			
<b>Employers payroll taxes</b>		8,942	4.6
<b>Taxes on immovable property</b>		2,427	1.2
<b>Taxes on financial and capital transactions</b>			
Financial institutions taxes	2,237		1.1
Govt. guarantee levies	138		0.1
Stamp duties on conveyances	5,540		2.8
Other stamp duties	1,742		0.9
<b>Total taxes on fin. and cap. transactions</b>		9,657	4.3
<b>Taxes on provision of goods and services</b>			
Excises and levies	17		..
Gambling	4,421		2.3
Insurance	2,138		1.1
<b>Total taxes on provision of goods and services</b>		6,576	3.3
<b>Taxes on goods use and performance of activities</b>			
Motor vehicle taxes	3,900		2.0
Franchise taxes	5,922		3.0
Other	396		0.2
<b>Total taxes on goods use and perf. of activities</b>		10,218	5.2
<b>Total State</b>		<b>37,820</b>	<b>19.3</b>
<b>Total Local</b>		<b>6,002</b>	<b>3.1</b>
<b>Total Australia</b>		<b>196,397</b>	<b>100.0</b>

Source: Australian Bureau of Statistics, Taxation Revenue Australia 1999-00, catalogue no. 5506.0

Throughout this paper the term "States" will, for the purposes of clarity of exposition, be used to signify the six States and two Territories. All values are expressed in Australian dollars. At end July 2001 the Australian dollar was worth approximately \$CAN 0.77, Euro 0.57, £Stg 0.35 and \$US 0.51.

## 2. THE INTERGOVERNMENTAL AGREEMENT REFORM PACKAGE

On 9 April 1999, the Prime Minister, State Premiers and Territorial Chief Ministers signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA), which dealt with the financial implications for the States and Territories of the GST-based reforms in the tax reform package *A New Tax System* (ANTS) (see Costello, 1998). This Agreement was revised as a result of negotiations in May 1999 between the Federal Government and the Australian Democrats, a minor party holding the balance of power in the Senate. These changes had the effect of:

- ◆ Narrowing the GST base;
- ◆ Reducing personal income tax cuts for upper income earners;
- ◆ Reducing the scope of the diesel fuel tax concession;
- ◆ Increasing social welfare compensation; and
- ◆ Increasing environmental expenditures.

The net effect of these changes was to reduce the GST revenue available for distribution to the States. The revised Agreement, which is described in considerable detail in Appendix A, was signed on 20 June 1999.

The broad bones of the revised Agreement are as follows:

- ◆ Implementation of a broad-based GST at a rate of 10%;
- ◆ No variation of the GST rate or base without the unanimous agreement of the States, the Commonwealth Government and both Houses of the Commonwealth Parliament;
- ◆ Abolition of Financial Assistance Grants (FAGs) and Revenue Replacement Payments (RRPs) to the States;
- ◆ Use of the GST revenue to fund the abolition of the Federal wholesale sales tax (WST) and the abolition or reduction of various State taxes;
- ◆ Distribution of the GST revenue to the States according to horizontal fiscal equalization (HFE) principles;
- ◆ Transfer to the States of responsibility for funding a new First Home Owner Scheme (FHOS);
- ◆ Compensation of the Commonwealth by the States for Australian Taxation Office (ATO) costs incurred in administering the GST; and
- ◆ Provisions to ensure that no State budgetary position would deteriorate during the transitional period of implementation of the IGA package.

As a result of what might be called the “Democrat Amendments” the range of State taxes originally proposed to be abolished was substantially reduced.

Table 2 presents a summary of agreed Commonwealth-State financial reform measures arising from the final Agreement.



TABLE 2

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**AGREED COMMONWEALTH-STATE FINANCIAL REFORM MEASURES**


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Measure	Impact of Changes on States' Budgets	Date
<b>NEW COMMONWEALTH TAX</b>		
GST levied by Commonwealth	Replacement of FAGs by GST revenue grants	1 July 2000
<b>COMMONWEALTH TAXES TO BE ABOLISHED</b>		
Wholesale sales tax	Loss of WST Tax equivalent payments	1 July 2000
Revenue Replacement Payments	from PTEs Loss of RRP	1 July 2000
<b>STATES TAXES TO BE ABOLISHED</b>		
Bed Taxes (NSW and NT)	Loss of own-source revenues	1 July 2000
Financial institutions duty	Loss of own-source revenues	1 July 2001
Stamp duty on quoted marketable securities	Loss of own-source revenues	1 July 2001
Debits tax	Loss of own-source revenues	1 July 2005
<b>REDUCTION OF STATES REVENUE</b>		
Gambling tax arrangements (partial reduction)	Reduction of own-source revenues as a result of reduction in tax rate	1 July 2000
<b>NEW STATE EXPENDITURE RESPONSIBILITIES</b>		
First Home Owners Scheme	Increase in expenditure	1 July 2000
Contribution to Commonwealth for ATO costs of collection of GST	Increase in expenditure	1 July 2000
<b>STATES TAXES TO BE REVIEWED FOR NEED FOR RETENTION BY 2005</b>		
Stamp duty on non-quoted marketable securities		
Stamp duty on non-residential conveyances		
Stamp duty on credit arrangements, instalment purchase arrangements and rental (hiring) agreements		
Stamp duty on leases		
Stamp duties on mortgages, bonds, debentures and other loan securities		
Stamp duties on cheques, bills of exchange and promissory notes		

Source: Commonwealth Grants Commission (1999:1), p. 16

The financial implications of the IGA package are examined in considerable detail in the next section.

### 3. THE REVENUE AND EXPENDITURE IMPLICATIONS OF THE INTERGOVERNMENTAL AGREEMENT

The latest published estimates of the financial outcomes resulting from the IGA are presented below. Table 3 presents estimates of GST revenue for the years to 2003-04.

**TABLE 3**

**GST REVENUE, ACTUAL OR FORECAST, 2000-01 TO 2003-04**

	2000-01 \$M	2001-02 \$M	2001-02 % increase	2002-03 \$M	2002-03 % increase	2003-04 \$M	2003-04 % increase
GST revenue	24,180	27,480	13.6	29,170	6.1	30,830	5.7

Source: Budget Paper No. 3, 2001-02, Table A1.

The IGA provides that the States' budgets will be no worse off after the implementation of the GST until such time as GST revenue exceeds the funding which would have been available to the States under current, pre-GST arrangements. Calculations are made of what the "current funding" would have been and this figure constitutes the Guaranteed Minimum Amount (GMA). States receive budget balancing, in the form of untied grants, representing the difference between GST revenue and the GMA. From 2001-2 onwards all budget balancing assistance is provided by way of grants.

Table 4 presents the latest estimates available at the time of writing of GMAs, GST revenue and budget balancing assistance.

**TABLE 4**

**ESTIMATES OF THE GUARANTEED MINIMUM AMOUNT, GST REVENUE AND BUDGET BALANCING ASSISTANCE, 2001-02**

(in million of dollars)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Guaranteed Minimum Amount	9,401.1	6,394.2	5,411.3	2,823.6	2,766.8	1,163.1	583.7	1,379.8	29,923.6
GST revenue	8,317.0	5,813.7	5,198.3	2,642.6	2,541.1	1,087.4	544.3	1,335.6	27,480.0
Budget balancing assistance	1084.1	580.6	213.0	181.0	225.7	75.7	39.4	44.2	2,443.6

Source: Budget Paper No. 3, 2001-02, Table 6.

GST revenue in 2001-02 is predicted to fall short of the Guaranteed Minimum Amount by \$2.444b.

Table 5 presents details of the calculation of the Guaranteed Minimum Amount for the financial year 2001-02. The calculation of GMAs is fully explained in Appendix B.

TABLE 5

## CALCULATION OF THE GUARANTEED MINIMUM AMOUNT, 2001-02

(in million of dollars)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
<b>STATE REVENUES FORGONE</b>									
FAGs	5,286.4	3,718.4	3,629.3	1,673.3	1,927.8	884.5	400.6	1,211.3	18,731.5
RRPs	2,338.0	1,565.0	1,420.3	982.9	609.5	207.3	103.8	132.5	7,359.5
Accomm. Taxes	72.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8.1	80.1
Financial Institutions Duty	587.6	342.2	n.a.	129.3	85.5	21.1	17.4	12.9	1,195.9
Marketable Securities Duty	375.3	205.0	34.5	24.0	14.7	2.4	17.6	1.6	675.1
<b>plus Reduced Revenues</b>									
Gambling Taxes	573.9	389.8	211.4	58.0	79.3	22.5	20.5	13.7	1369.1
<b>plus Interest Costs</b>									
Interest Costs	2.9	3.4	4.3	0.9	1.1	0.5	0.4	0.7	14.2
<b>plus Additional Expenditures</b>									
FHOS	300.0	236.6	222.0	118.1	80.0	16.8	21.9	9.1	1004.5
GST Admin. costs	174.2	128.8	97.0	51.1	40.0	12.5	8.3	5.3	517.2
<b>plus Other Items</b>									
WST Payments	38.0	5.0	18.0	19.0	12.7	13.0	4.0	3.0	112.7
<b>minus Reduced Expenditures</b>									
Off-road Diesel Subsidies	133.2	55.8	117.2	168.1	35.9	2.1	0.0	3.9	516.2
Savings from Tax Reform	157.1	107.4	89.2	53.4	38.8	13.0	9.0	13.2	481.0
<b>minus Growth Dividend</b>									
Remaining State Taxes	56.9	36.7	19.2	11.5	9.2	2.3	1.8	1.3	139.0
<b>TOTAL GMA</b>	<b>9,401.1</b>	<b>6,394.2</b>	<b>5,411.3</b>	<b>2,823.6</b>	<b>2,766.8</b>	<b>1,163.1</b>	<b>583.7</b>	<b>1,379.8</b>	<b>29,923.6</b>

Source: Budget Paper No. 3, 2001-02, Table 6.

**Notes (related to table 5):**

*Revenue Replacement Payments (RRP)* were implemented as a result of 1997 High Court decisions in the *Ha and Lim v N.S.W.* and *Walter Hammond and Associates Pty. Ltd. v N.S.W.* cases, which effectively declared unconstitutional all State business franchise fees. These taxes, on alcohol, tobacco and petroleum, raised revenue of \$5.221b. in 1996-97, their last full year of operation. As a result of the potential disruptive effects on State finances of such a revenue loss, the Commonwealth implemented "safety net" arrangements. These consisted mainly of an increase in Federal customs and excise duties on tobacco and alcohol, and an increase in the WST rate on alcoholic beverages. All revenue (less administrative costs) was returned to the States as RRP.

*Interest Costs* relate to the interest costs incurred by States as a result of the change from weekly payments of FAGs, RRP and State taxes to monthly payments of GST revenue grants.

*WST Payments* relate to payments totalling \$338m., starting in 2000-01 and spread evenly over three years, in respect of revenue forgone from the abolition of the WST Tax Equivalent Regimes.

*Savings from Tax Reform* refer to the reduced costs resulting from the removal of embedded WST and excises on purchases by State Governments.

The *Growth Dividend* is claimed to accrue as a result of the impact upon State revenues of the increased growth attributable to the introduction of the GST package. It is the opinion of this author that calculations of this type are fraught with methodological

difficulty, and estimates of this type should accordingly be treated with the greatest caution. Was it a coincidence that in Federal Treasury calculations of the effects of the first full year of operation of the original package the State growth dividend exactly matched what would otherwise have been a net revenue loss for the States?

Since the original IGA the Federal Government has introduced additional first home owners assistance, fully funded by a Commonwealth Specific Purpose Payment to the States.

Table 6 presents estimates of the distribution to the States of the GST revenue, together with Health Care Grants (HCGs).

**TABLE 6****ESTIMATED DISTRIBUTION OF GST REVENUE, 2001-02**

	Projected population as at 31/12/2000  '000 (1)	Per capita relativities  (2)	Weighted populations (1)*(2)  '000 (3)	Share of weighted population  % (4)	GST revenue/ HCGs pool distribution  \$M (5)	Unquar-antined Health Care Grants  \$M (6)	Total (5)-(6)  \$M (7)
NSW	6,562,944	0.92032	6,040,009	31.0	10,555.5	2,238.5	8,317.0
Victoria	4,851,865	0.87539	4,247,274	21.8	7,422.5	1,608.9	5,813.7
Queensland	3,656,130	1.00269	3,665,965	18.8	6,406.6	1,208.4	5,198.3
W. Australia	1,924,075	0.97516	1,876,281	9.6	3,279.0	636.4	2,642.6
S. Australia	1,505,083	1.17941	1,775,110	9.1	3,102.2	561.1	2,541.1
Tasmania	469,468	1.50095	704,648	3.6	1,231.4	144.0	1,087.4
ACT	313,325	1.14633	359,174	1.8	627.7	83.4	544.3
NT	200,360	4.02166	805,780	4.1	1,408.2	72.5	1,335.6
Total	19,483,250	n.a.	19,474,240	100.0	34,033.1	6,553.1	27,480.0

Source: Budget Paper No. 3, 2001-02, Table 4.

The *per capita* relativities of column (2) are derived from the Grants Commission's relativities recommended in the 2001 update of the 1999 review (see Commonwealth Grants Commission, 1999:2 and 2001). These *per capita* relativities are applied to the population projections to yield the weighted populations of Column (3). The weighted populations are converted into percentage shares in Column (4). These percentages are applied to the total GST revenue plus Health Care Grants pool distribution to yield the figures in Column (5). From these are deducted the unquarantined HCGs of Column (6) to yield the estimates for the distribution of the GST revenue to the States.

Table 7 provides details of total payments to the States and Local Government. A high proportion of Specific Purpose Payments are paid "To" the States, that is, they are provided to finance State expenditures on specific goods and services. Other specific purpose payments are channelled "Through" the States to Local Government or are paid directly to Local Government.

**TABLE 7**

**ESTIMATED GST REVENUE PROVISION AND COMMONWEALTH PAYMENTS TO THE STATE/LOCAL SECTOR, 2001-02**  
(in million of dollars)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
<b>GST Revenue to the States</b>	8,317.0	5,813.7	5,198.3	2,642.6	2,541.1	1,087.4	544.3	1,335.6	27,480.0
<b>General Revenue Assistance</b>									
Budget Balancing Assistance	1,084.1	580.6	213.0	181.0	225.7	75.7	39.4	44.2	2,443.6
National Competition Policy Payments	241.0	178.5	134.6	70.7	55.4	17.3	11.5	7.4	716.3
Special Revenue Assistance	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	14.2	n.a.	14.2
<b>Total General Revenue Assistance</b>	1,325.1	759.1	347.7	251.7	281.1	93.0	65.0	51.5	3,174.1
<b>SPECIFIC PURPOSE PAYMENTS</b>									
"To" the States	4,917.0	3,472.3	2,762.9	1,694.1	1,225.0	391.4	242.0	369.0	15,154.8
"Through" the States	1,689.0	1,463.3	790.1	521.5	339.8	106.2	101.4	56.2	5,067.5
Direct to Local Government	123.0	115.2	77.4	58.6	30.8	14.4	5.0	5.3	492.8
<b>TOTAL SPP</b>	6,729.0	5,050.8	3,630.4	2,274.3	1,595.6	512.0	348.3	430.5	20,652.0
<b>Total Cwlt. Payments</b>	16,371.1	11,623.6	9,176.3	5,168.6	4,417.7	1,692.4	957.8	1,817.7	51,306.2

Source: Budget Paper No. 3, 2001-02, Table 2

All of the above tables provide estimates for the financial year 2001-02 but not for later years. Thus they provide no data for the years in which the GST is fully operational and the associated abolition of certain State taxes has been fully implemented. Table 8 provides the only estimates currently available of the longer term impact of the IGA on the States.

TABLE 8

ESTIMATED NET IMPACT OF THE INTERGOVERNMENTAL AGREEMENT ON THE REFORM OF  
COMMONWEALTH-STATE FINANCIAL RELATIONS

(in million of dollars)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
<b>GST REVENUE LESS GUARANTEED MINIMUM AMOUNT</b>									
2000-01	-1,051.0	-700.7	-489.1	-227.0	-280.2	-104.0	-47.9	-57.6	-2,957.5
2001-02	-1,084.1	-580.6	-213.0	-181.0	-225.7	-75.7	-39.4	-44.2	-2,443.6
2002-03	-807.8	-400.9	85.4	-111.7	-163.2	-68.0	-21.6	-59.6	-1,547.4
2003-04	-593.5	-269.5	239.3	-11.1	-98.9	-33.9	-2.4	-34.4	-804.4
2004-05	-350.4	-97.7	433.9	95.2	-22.8	-6.8	14.2	1.1	66.7
2005-06	-382.6	-174.9	302.2	81.7	-31.3	-12.1	13.3	29.3	-174.4
2006-07	-161.7	-5.9	456.7	185.0	43.3	15.5	29.2	71.4	633.5
2007-08	114.0	195.2	655.1	309.2	130.3	47.2	49.0	122.6	1,622.6
<b>IMPACT POST GUARANTEE</b>									
2000-01	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2001-02 (after loan repayment)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2002-03	0.0	0.0	85.4	0.0	0.0	0.0	0.0	0.0	85.4
2003-04	0.0	0.0	239.3	0.0	0.0	0.0	0.0	0.0	239.3
2004-05	0.0	0.0	433.9	95.2	0.0	0.0	14.2	1.1	544.4
2005-06	0.0	0.0	302.2	81.7	0.0	0.0	13.3	29.3	426.5
2006-07	0.0	0.0	456.7	185.0	43.3	15.5	29.2	71.4	801.1
2007-08	114.0	195.2	655.1	309.2	130.3	47.2	49.0	122.6	1,622.6

Source: Costello (2000), page 9; Budget Paper No. 3, 2000-01, Table 5; and Budget Paper No.3, 2001-02, Tables 5 and 6.

The original agreement specified that it would be necessary for the Commonwealth to top up funds to the States' Guaranteed Minimum Amounts for a relatively short period of time, up to June 2003. However, the Democrat Amendments now mean that budget balancing assistance is predicted to be necessary up to June 2007, although not for all States. For Queensland, the GST revenue is predicted to exceed the GMA from 2002-3. For Western Australia, the ACT and the Northern Territory GMAs will be exceeded in 2004-5. For South Australia and Tasmania GMAs are exceeded in 2006-7, while in NSW and Victoria they are not exceeded until 2007-8.

Forecasts of GST revenue and of the level of GMAs for the period up to and including 2003-04 are published in the 2000-01 Budget Papers, but no breakdown is available for the post 2003-04 estimates contained in Costello (2000) and reproduced in Table 8. Nor has any information been published concerning the composition, in years after 2000-01, of GMAs (particularly forgone State revenues, RRP's and FAGs). Thus it is not possible to comment on the estimated size of these GMAs, even though their levels are crucial to the financial outcomes of the States.

The original document *A New Tax System* (ANTS, Costello 1998) did provide some longer term forward estimates but the Democrat Amendments rendered these forward estimates largely invalid. However, it is possible to use these original estimates as a basis for the production of some more up-to-date forecasts.

Costello (1998, page 103) presented a summary of the revenue and outlay impacts of the IGA on the States and Territories for the year 2000-01 to 2002-03 inclusive. The March 2000 press release, however, did not produce such forward estimates. Table 9 presents this author's own attempt to provide revised estimates in the light of the information provided in Costello (2000) and subsequent budget documents.

TABLE 9

## ESTIMATED IMPACT OF THE IGA ON THE STATES AND TERRITORIES

(in billion of dollars)

	2000-01	2001-02	2002-03
<b>Increases in Revenue</b>			
GST revenue	24.18	27.48	28.87
Growth dividend - States' share	0.10	0.14	0.21
Total	24.28	27.62	29.08
<b>Reductions in Revenues</b>			
Reduced gambling taxes	-1.21	-1.37	-1.43
Abolition of FID/debits tax	0.00	-1.20	-1.46
Abolition of business stamp duties	0.00	-0.68	-0.75
Abolition of accommodation taxes	-0.08	-0.08	-0.05
Abolition of business franchise fee replacement taxes	-6.63	-7.36	-7.54
Total	-7.92	-10.69	-11.24
<b>Changes in Other Payments to the States</b>			
Abolition of FAGs	-18.02	-18.73	-19.23
Commonwealth grants to balance State budgets	3.00	2.44	1.63
Total	-15.02	-16.29	-17.60
<b>Changes in Outlays</b>			
First Home Owners' Scheme	-1.00	-1.00	-0.80
Reduced costs to government from indirect tax reform	0.45	0.48	0.50
State rebates for off-road diesel	0.45	0.52	0.59
Payments to Commonwealth for GST collection	-1.00	-0.52	-0.34
Total	-1.10	-0.52	-0.05
<b>Total Impact on State and Territory Budgets</b>	<b>0.24</b>	<b>0.12</b>	<b>0.20</b>

Note: positive numbers represent budgetary gains, negative numbers represent budgetary losses.

Sources: Costello (2000); IGA Appendix C; Budget Paper No. 3, 2001-02, Tables 5 and 6; and author's calculations.

Table 9 includes payments to the Commonwealth for ATO costs incurred in collecting the tax. The States have agreed to the inclusion of this provision in the Agreement presumably because they reap the benefits of not having to administer the abolished taxes. No estimates are presented of these latter benefits. Nor are any estimates presented of the benefits accruing to the Commonwealth in the form of ATO administrative cost savings resulting from the abolition of the wholesale sales tax.

Costello (1998, p.25) states that the new arrangement will enhance the budgetary position of the States "by giving them all the revenue from the GST". This is, in fact, a less than adequate representation of the impact of the Agreement, as can be seen from inspection of Table 10. This Table, which relates to the year 2002-3, the first year of virtually full operation of the IGA package, examines its revenue and expenditure impacts upon both the Commonwealth Government and sub-national governments.

**TABLE 10****SUMMARY OF GAINS AND LOSSES AS A RESULT OF THE IGA, 2002-03***(billion of dollars)*

<b>Budgetary Gains</b>		<b>Budgetary Losses</b>	
<b>Commonwealth</b>			
Abolition of FAGs	19.23	Commonwealth grants to balance State budgets	1.63
Transfer of FHOS responsibility	0.80	Abolition of WST	18.75
Total	20.03	Total	20.38
<b>NET GAIN TO COMMONWEALTH</b>	<b>-0.35</b>		
<b>States and Territories</b>			
GST revenue	28.87	Reduced gambling taxes	1.43
Commonwealth grants to balance State budgets	1.63	Abolition of FID	1.46
Reduced govt. tax costs	0.50	Abolition of business stamp duties	0.75
Growth dividend - States' share	0.21	Abolition of bed taxes	0.05
State rebates for off-road diesel	0.59	Abolition of franchise fee replacements	7.54
		Abolition of FAGs	19.23
		Transfer of FHOS responsibility	0.80
		Payments to Commonwealth for GST collection	0.34
Total	31.80	Total	31.60
<b>NET LOSS TO STATES AND TERRITORIES</b>	<b>0.20</b>		

Sources: Costello (2000), IGA Appendix C and author's calculations.

Given the stress which the Treasurer has placed on his claim that the States receive all the GST revenue, it is important to identify the crucial aspects of the IGA package.

These are:

- ◆ Introduction of a GST with all revenues hypothecated to the States as untied grants;
- ◆ Simultaneous abolition of untied Financial Assistance Grants to the States;
- ◆ Abolition or reduction of certain State taxes; and
- ◆ Abolition of the Federal wholesale sales tax.

In a complicated package the essential elements are that the GST revenue (\$28.87b. in 2002-03) will fund:

- ◆ Abolition of the Federal wholesale sales tax (\$18.75b. in 2002-03);
- ◆ Abolition of State FID, bed taxes and stamp duties on quoted marketable securities (\$3.26b.);
- ◆ Abolition of Revenue Replacement Payments (\$7.54b.); and
- ◆ Reduction of State gambling taxes (\$1.43b.)

In summary, about 60% of GST revenue will fund the abolition of the Federal WST and only about 40% will fund the abolition or reduction of State taxes.

It has been a normal process in the past for the Australian Federal Government to pick up the blame for Federal taxes being raised to finance State expenditures. The spin presented for the IGA by the Federal Government represents an interesting reversal of the process, whereby the States shoulder the blame for a tax raised largely to benefit the Federal Government.



## 4. REVENUE AND EFFICIENCY ASPECTS OF THE IGA

### 4.1. State Revenues

A core effect of the IGA is to hypothecate all GST revenue to the States in order “to reform antiquated Commonwealth-State financial relations and get rid of some of the State indirect taxes that are the most inefficient of all” (Costello, 1998, p.9). This would provide the States “with access to a secure and growing source of revenue and the capacity in the medium to long term to allocate additional funding for services, such as health and education” (ibid. p.16). This is a worthy objective given that the States’ deficiency in broad-based tax revenue sources has led them to the use of taxes which are narrow-based, inefficient and highly costly in terms of administration and compliance. The implications of the above quotation are that the shift from the nominated State taxes to the GST would provide a revenue source that had the following characteristics:

- ◆ Security. A secure tax base is one which is not liable to decline or disappear. The most likely reason for insecurity in a tax base is tax competition, leading to a base moving partially or totally to other Australian State jurisdictions or out of Australia completely. Two examples will serve to illustrate this potential difficulty. The unwillingness of Queensland to implement a FID implied a substantial loss of revenue by other States, as financial transactions were shifted into the Queensland jurisdiction. The development of internet gambling on an international scale threatens a serious erosion of State gambling tax bases as Australians gamble outside any Australian jurisdiction.
- ◆ Growth. The statement that the GST revenue will give the States “the capacity in the medium to long term to allocate additional funding for services...” clearly implies a prediction that GST revenue will eventually exceed the revenue which would have been yielded by the replaced sources.

A further characteristic which might have been added is “stability”. A characteristic of some State taxes, particularly stamp duties, is that their revenues, while trending upwards over time, tend to fluctuate wildly. Australian State Governments have generally been unable to resist the temptation to spend up in periods of high revenues, rather than build up reserves as provision for the inevitable subsequent revenue downturns.

The really crucial question here is whether GST revenues will eventually exceed the revenue sources which the GST replaces –FID, stamp duties on marketable securities, bed taxes, debits tax (from 2005), gambling taxes, FAGs and RRP. The available published forward GST revenue estimates are presented in Table 2 above. Table 11 summarises the overall impact of the IGA, including the transitional arrangements, on the States.

**TABLE 11**
**GST REVENUES AND GUARANTEED MINIMUM AMOUNTS**
*(in million of dollars)*

	<b>GST revenue less Guaranteed Minimum Amount All States (1)</b>	<b>Total impact on the States post-guarantee All States (2)</b>
2000-01	-2957.5	0.0
2001-02	-2443.6	0.0
2002-03	-1547.4	85.4
2003-04	-804.4	239.3
2004-05	66.7	544.4
2005-06	-174.4	426.5
2006-07	633.5	801.1
2007-08	1622.6	1622.6

Source: Table 8.

Column (1) indicates that GST revenues accruing to the States as a whole are not forecast to exceed total Guaranteed Minimum Amounts until the financial year 2006-07. While the net figure is forecast to be briefly positive in 2004-05 it slides back into deficit in the following year as a result of the abolition in that year of the debits tax.

Column (2) shows that, as a result of budget balancing assistance payments, the States are fully compensated up to 2001-02 and, in total, move into increasing surplus from 2002-03.

Table 12 presents details of the distribution of the All State surplus between the individual States.

**TABLE 12**

THE DISTRIBUTION OF GST REVENUE BENEFITS DURING THE TRANSITION PERIOD									
	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	All States
First year of excess GST revenue	2007-08	2007-08	2002-03	2004-05	2006-07	2006-07	2004-05	2004-05	n.a.
Total undiscounted benefit to 2007-08 (\$m)	114.0	195.2	2172.6	671.1	173.6	62.7	105.7	224.4	3719.3
Percentage of total undiscounted benefit	3.1	5.2	58.4	18.0	4.7	1.7	2.8	6.0	100.0
Present value (2000-01) of future benefits (\$m)	71.5	122.5	1513.3	445.8	110.5	39.9	70.1	145.9	2519.5
Percentage of total present value	2.8	4.9	60.1	17.7	4.4	1.6	2.8	5.8	100.0
Present value per capita (\$)	10.9	25.5	421.5	233.6	72.7	83.7	222.2	737.1	130.1

Sources: Table 3.8 and Budget Paper No. 3 1999-2000, Table 1.

Notes: n.a. denotes not applicable. Present values calculated using a discount rate of 6%.

It is clear from Table 12 that the period of time during which States need to wait before experiencing GST net revenue benefits varies substantially between States. NSW and Victoria experience revenue gains for the first time in 2007-08, but Queensland needs only to wait until 2002-03. This arises from the combined effects of three influences:

- ◆ GST revenue is from the start to be distributed on fiscal equalisation principles;
- ◆ If a State's GST revenue assessment exceeds its GMA, the State keeps the excess, even if other States are still in deficit; and
- ◆ Some States apply much lower tax rates than others to State tax bases which are affected by the IGA. Thus, even in *per capita* terms, they are forgoing less revenue from the reduced or abolished taxes.

It is not possible to present a simple inter-State comparison of taxes, as a result of the wide diversity of tax bases and scales (for a comprehensive comparison see NSW Treasury, 1996 and 2000). However the following points illustrate major differences between taxes affected either directly or indirectly (through RRP) by the IGA arrangements:

- ◆ All States except Queensland imposed business franchise fees on petrol;
- ◆ All States except Queensland imposed business franchise fees on tobacco;
- ◆ Tasmania and the Northern Territory imposed lower rates of debits tax than the other States;
- ◆ All States except Queensland imposed FID;
- ◆ Only NSW and the Northern Territory imposed accommodation levies (bed taxes).

The differences in State tax rates and bases ultimately result in differences in taxation per mean head of population, which are presented in Table 13.

**TABLE 13****STATE AND LOCAL TAXES PER HEAD OF MEAN POPULATION***(in dollars)*

	1992-93	99-2000
NSW	1,740	2,671
Victoria	1,717	2,337
Queensland	1,243	1,742
W. Australia	1,414	2,150
S. Australia	1,399	2,149
Tasmania	1,346	1,803
ACT	1,529	2,005
NT	1,207	2,220

Source: Australian Bureau of Statistics, catalogue number 5506.0, Table 2.

Table 14 compares the 1999-2000 ranking of per capita taxation (1=highest) with the ranking of the length of the transitional periods before GST revenue break-even occurs (1=longest period).

**TABLE 14****STATE PER CAPITA TAX AND BREAK-EVEN PERIOD RANKINGS**

	Per capita tax ranking (1999-2000) (1=high)	Break-even period ranking (1=long)
NSW	1	1 (equal)
Victoria	2	1 (equal)
Queensland	8	8
W. Australia	4 (equal)	5 (equal)
S. Australia	4 (equal)	3 (equal)
Tasmania	7	3 (equal)
ACT	6	5 (equal)
NT	3	5 (equal)

Sources: Tables 12 and 13.

The above Table clearly illustrates the strong association between high *per capita* taxes and long break-even periods.

Returning to Table 12, the final five rows indicate how, during the transitional period, the distribution of excess GST revenue is biased in favour of low tax jurisdictions. Whether measured in undiscounted or present value terms, Queensland accounts for about 60% of all-States excess revenue. The 2000-01 present value of excess revenue represents \$422 *per capita* in Queensland and only \$11 *per capita* in NSW.

In all, the transitional process involves very significant redistributive benefits to some States. It is not clear whether this is a deliberate effect or an unintended consequence. Certainly it would have been possible to design a policy under which the benefits were more equitably distributed between the States. If the States believe that further taxes will be abolished in 2005, as foreshadowed in the IGA, they would be well advised to design their tax strategy to minimise the break-even period in the new transitional period. This could be achieved by the prior abolition of taxes slated for possible abolition in 2005. Victoria already appears to be heading down this path with the announcement in its 2001-02 budget of the abolition in the next three years of some further business stamp duties.

One of the major benefits claimed for the IGA arrangements is that the revenues accruing to the States are a function of objective measures of national consumption rather than resulting from the political process, as expressed in the Premier's Conferences. It is true that the total GST revenue accruing to all States is objectively determined. However, the distribution of that revenue total between the States is undertaken on the basis of Commonwealth Grants Commission fiscal equalisation recommendations. The principles underlying the calculation of these relativities are suspect (as is discussed in Chapter 6) and, in any case, the Federal Government is not bound to accept these recommendations. Thus, while the total GST payments to the States as a whole are guaranteed, the payments to any

individual State are not. Furthermore, there still remains the possibility for Federal Governments to influence overall State receipts by varying Special Purpose Payments and, during the transitional period, the Guaranteed Minimum Amounts.

If the Treasurer's forward revenue estimates are taken at face value it does appear that the States as a whole will, after a significant period of time, have access to a revenue source yielding higher revenues than the replaced sources. Given the paucity of published information on forward estimates of revenue from the GST and the abolished State taxes (as well from FAGs and RRP), it is virtually impossible with any confidence to check Federal Treasury's overall revenue estimates.

There is no doubt that the States have enthusiastically accepted the hypothecation to them of GST revenue, even though reservations on their part may exist about other aspects of the IGA package. There can be little doubt that State Treasuries have been undertaking their own forward revenue estimates, and so the States' relatively compliant attitudes can reasonably be interpreted to mean that they also believe that GST revenue will ultimately rise faster than the revenue from the abolished taxes.

The calculation of the GMA during the transitional period involves considerable uncertainty. As an example, since the latest calculation of the GMA there has been a significant increase in the price of petroleum. As the business franchise fees on petroleum were largely an *ad valorem* tax, a price increase should lead to an increase in the RRP for the petroleum franchise fee above that incorporated in the current estimates. The estimation of forgone FAGs is another area of uncertainty. In summary, the ability to control the calculation of GMAs would imply the ability to determine overall payments to the States during the transitional period.

An interesting issue arises in the calculation of the RRP for business franchise fees on tobacco. As part of the ANTS package the Commonwealth is changing the basis of tobacco taxation to a "per stick" basis, with an expected consequent price increase of 6.5%, and presumably a revenue increase of at least the same order (since the demand for tobacco is price inelastic). The States do not appear to be receiving any share of this increased revenue. Thus the tobacco tax has now become a totally Federal tax.

Had the States retained tobacco taxes, they would over the transitional period probably have increased the tobacco tax rate. The ability to raise the rate exists because the price elasticity of demand for tobacco is low, so that tax increases will not produce a decline in revenue. The motive to raise the rate exists because of the need to reduce the social costs of smoking (see Collins and Lapsley, 1996). It does not appear that calculation of GMAs takes into account these types of tax policy options which the States would have had under the pre-IGA arrangements. This is an illustration of the effects of the increase in vertical fiscal imbalance, which is the subject of Chapter 5.

Similar issues arise in relation to alcohol taxation which was significantly increased in the 2000-01 Federal Budget. Should the States notionally receive some of this revenue increase through an upward adjustment of their GMAs?

It should be noted that if, as a result of a 2005 Ministerial Council review, other taxes are abolished, a further transitional period, with its attendant implications, would be established. It is not, however, clear how the abolition of further State taxes could be funded unless there was an increase in the GST rate. Since at least one, and probably several, States could be expected to veto such an increase, the abolition of further State taxes would be unlikely to proceed unless the Federal Government broke the Intergovernmental Agreement. This is, of course, not impossible.

#### 4.2. Tax Efficiency

The concept of tax efficiency relates to the requirement that the tax system should not distort more than absolutely necessary what would otherwise be efficient business decisions. To quote the Asprey Committee (Taxation Review Committee, 1975.p.16), the tax system "should not alter the relative returns from different modes of investment; it should not alter the relative attractiveness of different types of business organisations, or the relative prices of productive resources; and it should not discriminate between different types of production".

A major objective of the ANTS package was the replacement of various inefficient taxes with a broad-based, single rate consumption tax – an admirable objective. At the State level the taxes to be abolished were, in the main, a broad range of financial taxes which were seen as being discriminatory; vulnerable to avoidance, evasion and inter-State tax competition; and having high administrative and compliance costs.

Under the original ANTS proposal the following State taxes were to be abolished:

- ◆ Financial Institutions Duty;
- ◆ Debits tax;
- ◆ Stamp duties on marketable securities;
- ◆ Conveyancing duties on business property;
- ◆ Stamp duties on credit arrangements, instalment purchase arrangements and rental (hiring) agreements;
- ◆ Stamp duties on leases;
- ◆ Stamp duties on mortgages, bonds, debentures and other loan securities;
- ◆ Stamp duties on cheques, bills of exchange and promissory notes; and
- ◆ Bed taxes.

As a result of the GST revenue loss arising from the Democrat Amendments, the range of financial taxes to be abolished has been much reduced. The amendments appear to have reduced the revenue available to fund the abolition of financial taxes and stamp duties by about 35%. As a result, only FID, stamp duties on marketable securities and debits tax (from 2005, probably) remained on the schedule of financial taxes to be abolished, with the remaining stamp duties on the above list to be reviewed by 2005. Given the inability of the States to increase the rate or extend the base of the GST it is difficult to see where the extra revenue would come from to fund the abolition of these remaining stamp duties.

At the same time, the Democrat Amendments have rendered the GST less efficient by narrowing its base to exclude basic foods, prescription medicines and some health and education services. The objective of the base-narrowing, to mitigate the regressive impact of the tax change, could have been achieved more efficiently by higher targeted social welfare payments.

In terms of efficiency, the reduced tax substitution enforced by the Democrat Amendments is still a worthy exercise, in the sense that it is better than nothing, since the State financial taxes to be abolished perform poorly. FID and debits tax are imposed upon a relatively narrow range of financial transactions. Variations between States in rates and bases raise compliance costs for businesses operating in more than one State and encourage inefficiencies through avoidance activities. The absence of a FID in Queensland had been particularly damaging in this regard. Stamp duties on marketable securities increased Australian share trading costs and reduced the competitive positions of Australian stock exchanges compared with competitors overseas who do not bear these types of stamp duties.

The abolition of bed taxes was a useful reform, though their low revenue yield meant that they were little more than an irritant. NSW bed tax revenue was forecast to be \$72.4m. in 2000-01, while the NT forecast revenue for that year was \$7.0m. Many foreign jurisdictions levy accommodation taxes as a benefits tax, with revenue hypothecated to fund tourist facilities and services. The NT tax was of this type and was reasonably broad-based. The NSW tax, purely on accommodation in central Sydney, was a discriminatory tax whose only purpose appeared to be revenue-raising.

The narrowing of the range of State taxes to be abolished is regrettable, although blame can hardly be placed at the feet of the present Federal Government. A great opportunity for an improvement in the efficiency of State taxes has been partially lost.

Nevertheless, the overall efficiency of the Australian tax system has undoubtedly been improved by the tax changes implemented in the IGA. With the Australian States having such inadequate taxing powers the search was always on for new revenue sources, with consequent deterioration in tax efficiency.

### 4.3. Implications for Stabilisation Policy

Fiscal policy, together with macroeconomic policy generally, is a Federal Government responsibility and so should perhaps, be considered to be outside the scope of this paper. However, as a result of the mechanisms implemented in the IGA for approval of changes in the GST tax rate and base definition, the States now have some influence, albeit negative, over the conduct of fiscal policy.

The IGA mechanism which grants each State the power of veto over rate or base changes effectively means that, unless the Federal Government is willing to break the Agreement, it will not be possible to change the GST rate and changes in the base may also prove difficult. This aspect of the IGA seems to have met with almost universal approval, as a result of a generally expressed fear that GST rates almost inevitably rise beyond their initial level at implementation. There seems ample evidence to confirm the validity of these fears (see, for example, Tait, 1972).

This does, however, seem a poor basis upon which to sacrifice a major tool of macroeconomic policy. Furthermore, it now appears impossible to implement any further tax mix change towards increased reliance on consumption taxes. It is likely to be very difficult to expand GST revenue to fund further reductions in the scope of discriminatory State taxes.

The GST rate change mechanism has been set up for political reasons. It would be difficult to justify it on the basis of efficient macroeconomic policy-making or rational tax policies. Given that Australian governments appear to have philosophical objections to raising personal income tax rates, taxation as a tool of Australian fiscal policy appears now to have been largely compromised.

## 5. VERTICAL FISCAL IMBALANCE ISSUES

The term *vertical fiscal imbalance* (VFI) relates to a mismatch for an individual level of government (federal, state or local) between its revenue-raising powers and expenditure responsibilities. To be more specific, VFI implies a mismatch between a particular level of government's own-source revenues (not including grants from other levels of government) and own-purpose expenditures (not including grants to other levels of government). This concept is very clearly illustrated for the case of Australia in Table 15 below.

TABLE 15

### VERTICAL FISCAL IMBALANCE, AUSTRALIA, 1993/94 TO 1998/99

	1993/4	1994/5	1995/6	1996/7	1997/8	1998/9
<b>Proportion of Total-Own Source Revenues</b>						
	%	%	%	%	%	%
Commonwealth	72.6	73.5	73.6	73.1	73.1	74.0
States	23.4	22.7	22.6	23.3	23.3	22.5
Local Governments	4.0	3.8	3.7	3.6	3.5	3.5
Total	100.0	100.0	100.0	100.0	100.0	100.0
<b>Proportion of Total Own-Purpose Expenditures</b>						
	%	%	%	%	%	%
Commonwealth	56.4	57.1	57.8	57.1	55.6	56.0
States	39.3	38.6	37.6	38.2	39.8	39.3
Local Governments	4.3	4.3	4.6	4.7	4.6	4.6
Total	100.0	100.0	100.0	100.0	100.0	100.0
<b>VFI Ratio (Revenues/Expenditures)</b>						
Commonwealth	1.13	1.18	1.21	1.26	1.32	1.33
States	0.52	0.54	0.57	0.60	0.59	0.58
Local Governments	0.81	0.80	0.77	0.75	0.76	0.77
Total	0.88	0.91	0.95	0.98	1.00	1.01

Source: Collins (2000).

This table shows that:

- ◆ The Commonwealth consistently raises over 70% of total own-source revenues raised by all levels of government in Australia, but accounts for less than 60% of total own-purpose expenditures. "Own-source revenues" includes tax revenues, and interest receipts from public trading enterprises, public financial enterprises and other sectors;
- ◆ The States raise less than 25% of total own-source revenues but account for almost 40% of total own-purpose expenditures;
- ◆ Local governments raise less than 4% of total revenue but spend over 4% of total expenditure.

Taken together these data imply that the Commonwealth VFI ratio (the ratio of own-source revenues to own-purpose expenditures) has risen over the period 1992/3 to 1997/8 from 1.13 to 1.30. Over the same period the States' VFI ratio has ranged between 0.52 and 0.60 while the Local Government ratio has ranged between 0.75 and 0.81.

Thus the Commonwealth Government consistently has an excess of own-source revenue over own-purpose expenditure while both State and Local Governments experienced revenue shortfalls. The final row of the table indicates that only in the last two years of the period under review did the government sector as a whole not have to resort to borrowing to make up a revenue shortfall.

In analysing the impact of the IGA arrangements upon VFI, the first issue to arise is the impact of the changes upon the revenue-raising capacities of the three levels of government. Since the IGA does not directly affect local government revenue-raising powers, the issue here is the impact upon Federal and State revenue powers.

It was shown earlier that, in spite of Federal Government claims that all GST revenue will be received by the States, the concurrent abolition of FAGS implies that the States will, in fact, have available only about 40% of GST revenue to fund the abolition of selected State taxes. The rest of the GST revenue will be used to fund the abolition of the WST.

The CGC summarises the impact of the GST arrangements on the States in the following way:

*The GST arrangements mean that*

- ◆ *The sum of total payments to the States of general revenue grants, unquarantined health care grants, and special purpose payments treated by absorption will be considerably larger than it was under previous arrangements;*
- ◆ *The States' total own-source revenues will substantially reduce;*
- ◆ *The States' total expenditures will increase slightly; and*
- ◆ *The total budget results of the States will remain largely unchanged.*

(Commonwealth Grants Commission, 1999:1, page19)

It might be argued, therefore, that effectively the revenue-raising capacities of the two levels of government are largely unchanged. However, the problem here is the IGA arrangements change the process by which decisions about the level of tax rates and the composition of tax bases are made.

As explained earlier, the *A New Tax System (Commonwealth State Financial Arrangements) Act 1999* lays down the process by which the 10% GST rate or the GST base can be changed. In summary, rate or base changes (except those of an administrative nature) will require:

- ◆ The unanimous support of State and Territory Governments;
- ◆ Endorsement by the Commonwealth Government of the day; and
- ◆ Passage of relevant legislation by both Houses of Commonwealth Parliament.

It is extremely unlikely that these requirements could ever be simultaneously satisfied. Even if they were, it would only be as a result of the Commonwealth's approval of State recommendations. Thus the IGA arrangements completely remove from the States the power to control this revenue-raising source, which will have replaced taxes whose bases and rates were exclusively under the control of the States.

But is not the same also true of the impact of the IGA arrangements on the discretionary tax powers of the Commonwealth? The Federal Government had full control over the rate structure and base of the WST but the States and Territories will have the power of veto over rate and base changes of its substitute tax, the GST. In a sense then, it

could be argued that the GST will be a non-discretionary tax instrument, with neither the Commonwealth nor the States having effective control over the structure of the tax or its revenue.

However, the significant difference between the situations of the Commonwealth and the States is that the IGA arrangements are enshrined in Commonwealth legislation. Since these are not constitutional provisions, they can also be changed or repealed by Commonwealth legislation. It will always be possible for the Commonwealth Government to change the IGA legislation, assuming that it can obtain the agreement of the Senate. The Commonwealth's Agreement with the States does not contain, nor could contain, provisions for sanctions to be imposed in the event of the Agreement being broken. This the Commonwealth has the power to change GST provisions while the States and Territories have no such powers.

The Australian Bureau of Statistics, approaching the same issue from a different perspective, has reached the same conclusion. It faced the question of whether, in presenting Australian taxation statistics, it should treat the GST as a Commonwealth or a State tax. In addressing this problem it applied the International Monetary Fund (IMF's) five specific rules for attribution of taxes to the appropriate level of government. It concluded

*that the Commonwealth exercises considerable influence and discretion over the setting of the GST and the distribution of its proceeds. [...] individually, the States and Territories do not have sufficient influence or discretion over the setting of the GST and the distribution of its proceeds. GST revenues will be distributed in accordance with the Commonwealth Grants Commission fiscal equalisation principles in a similar manner to that already applied in the distribution of income taxes. This situation does not fit the IMF guidelines relating to the attribution of tax revenues to beneficiary governments, which means that GST revenues should not be treated as individual State or Territory tax revenue. Thus, the GST should be treated as a Commonwealth tax for government finance statistics purposes. (Australian Bureau of Statistics, Information Paper. Accruals-based Government Finance Statistics. 2000, catalogue number 5517.0).*

With the States having lost direct control over approximately \$3.5 billion of revenue in financial year 2001-2, without losing any expenditure responsibilities, the degree of VFI has been increased.

The absence of forecasts beyond 1999-2000 for both revenues and expenditures for the three levels of government make the estimation of the impact of the ANTS Agreement changes upon VFI a somewhat hazardous process. Table 16, therefore, represents an attempt to estimate the impact on VFI of the ANTS changes had they been fully operational in the fiscal year 1997/8. While it is not possible to claim complete accuracy for this calculation there appears no reason to doubt the general conclusion to be drawn from this Table.



TABLE 16

**ESTIMATED IMPACT OF THE INTERGOVERNMENTAL AGREEMENT  
ON VERTICAL FISCAL IMBALANCE, 1997/98**

*(as a percentage)*

	1997/98 Actual	1997/98 After implementation of IGA
<b>Proportion of Total Own-Source Revenues</b>		
Commonwealth	73	78
States	23	18
Local Governments	4	4
Total	100	100
<b>Proportion of Total Own-Purpose Expenditures</b>		
Commonwealth	56	56
States	40	40
Local Governments	4	4
Total	100.00	100.00
<b>VFI Ratio (Revenues/Expenditures)</b>		
Commonwealth	1.32	1.42
States	0.59	0.46
Local Governments	0.76	0.76
Total	100.00	100.00

Source: as for Table 15, and author's calculations.

It has been demonstrated that the Agreement will involve a substantial increase in the degree of vertical fiscal imbalance in the Australian Federation. What are the implications of such a change in VFI?

The significance of VFI goes to the heart of the justification for the federal system. The basis for the belief in federalism is the existence of different preferences, for types and levels of public services and taxes, in different areas of the nation. The communities of predominantly rural States, such as Queensland, will have different preferences from those in more urbanised States, such as Victoria or New South Wales. A unitary nation, with a single central government (which has local government directly under its constitutional control) will be largely constrained to provide common levels of service at common tax levels.

The implementation of uniform policies across areas of disparate preferences will, it is asserted, have substantial efficiency implications. This arises from the fact that the provision of a common level of services funded by common taxes will lead to underprovision of services in some areas compared with what those communities would prefer, and overprovision in others.

Thus, in areas of underprovision, a certain level of services is not provided in spite of the community's being willing to pay (in terms of taxes) the costs of provision. In areas of overprovision, on the other hand, services are being provided at a level above that for which the community would be willing to bear the full costs.

In a federal system, on the other hand, the individual States can provide service levels according to that community's preferences. Some States will choose to have high expenditure/high tax policies. Others will choose policy mixes of low expenditures and low taxes.

The above analysis relies on the implicit assumption that the State jurisdictional boundaries reflect the different patterns of community preferences. Sufficient differences exist between say, New South Wales and Victoria, on the one hand, and Queensland and Western Australia on the other, to suggest that this assumption is not totally unrealistic.

There are various reasons why provision of some types of public service by sub-national jurisdictions will better match consumer preferences than provision by the national government:

- ◆ With a multi-level system of government, politicians may have a better knowledge of voters' preferences;

- ◆ Decentralisation of government may lead to better control of public officials, because the ratio of elected representatives to public officials is higher;
- ◆ Electors in sub-national jurisdictions are more likely to be aware of the costs of the provision of public services and so are more likely to make rational decisions about appropriate levels of public service provision. These decisions are not obscured by cross-subsidies to or from other jurisdictions.

This analysis is embodied in the concept of subsidiarity – that public activities should be carried out at the lowest government level consistent with efficiency considerations.

In summary, the conclusion of this evaluation is that the IGA arrangements, by significantly increasing VFI to levels way beyond those existing in any comparable country, will lead to a deterioration in the efficiency of resource allocation in Australia. Federal Governments of both political persuasions have been willing in the past to defend current levels of VFI, although the relevant academic literature in both Australia and elsewhere has been virtually unanimously critical of current levels. There has, however, been no justification advanced by the Federal Government for the increase in VFI implied by the IGA arrangements.

## 6. FISCAL EQUALISATION ISSUES

An important implication of the Intergovernmental Agreement is that a significantly greater proportion of State receipts will be the subject of distribution according to horizontal fiscal equalisation (HFE) principles, as recommended by the Commonwealth Grants Commission. According to Federal Treasury estimates, FAGs of \$18.7b. would be distributed according to HFE principles in 2001-02 whereas under the IGA, GST revenue of approximately \$27.5b. would be subject to HFE distribution, an increase of almost 47%. Effectively, the FAGs fiscal equalisation system has been extended to apply to all GST revenue. This difference amounts to a little about \$8.7 billion in the financial year 2001-02. The extent of the difference will rise since, the Federal Treasurer has forecast, GST revenues will rise faster than FAGs would have done (Costello, 1998).

The potential implications of this change are indicated in Table 17. This Table shows:

- ◆ In Column 1 the distribution of the overall GST revenue, as indicated by the Treasurer in 2001-02 Budget Paper No. 3, Table 2;
- ◆ In Column 2 the estimated distribution of funds which would have occurred had the States received FAGs, with the balance of the \$27.5 billion funding being raised through the abolished State taxes (assuming that the tax provisions of the Intergovernmental Agreement had been fully implemented but that there was no transitional assistance); and
- ◆ In Columns 3 and 4, the difference between the two distributions.

**TABLE 17**

### COMPARISON OF THE EFFECTS OF DIFFERENT BASES FOR THE DISTRIBUTION OF GST REVENUE, 2001-02

(in million of dollars)

	GST Revenue Distribution (1)	State Revenue Distribution (2)	Difference (3)	Difference (%) (4)
New South Wales	8,317	8,520	-203	-2.4
Victoria	5,814	5,768	46	0.8
Queensland	5,198	4,994	204	3.9
Western Australia	2,643	2,652	-9	-0.3
South Australia	2,541	2,574	-33	-1.3
Tasmania	1,087	1,092	-5	-0.4
ACT	544	531	13	2.4
NT	1,336	1,350	-14	-1.0
Total	27,480	27,480	0	0.0

Source: author's calculations.

The Table indicates that the application of HFE principles to the distribution among the States of the total GST revenue will (after the end of the transitional period) result in a significant redistribution of funds compared with the outcome which would have resulted had the States raised the \$8.7 billion excess from their abolished revenue sources. According to these calculations, the major redistribution occurs from NSW to Queensland.

However, care should be taken with the interpretation of this Table since it relates to the funds available to State governments. It may also be that NSW taxpayers paid less tax under the GST than they would have paid under the abolished State taxes, and Queensland taxpayers paid more. Thus the redistribution *between governments* is likely to be more than *between taxpayers*.

The principles and processes of Australian fiscal equalisation are complex and not widely understood in the Australian community. Given that the increased importance of the HFE funds distribution process under the IGA appears to entail some funds redistribution, a broad explanation of the HFE process follows.

Fiscal equalisation is designed to correct the problem of horizontal fiscal imbalance (HFI). HFI in the federal system results from a combination of cost disabilities in public service provision and of revenue-raising disabilities in the funding of those public services.

Expenditure cost disabilities in a particular State can arise from a number of sources, including:

- ◆ Geographic size, leading to high *per capita* costs for the provision of infrastructure such as roads and railways;
- ◆ Small population size and low population density, leading to inability to exploit scale economies in the provision of such public services as education and health; and
- ◆ Population age structure which, with a relatively high proportion of school age children, could lead to above average *per capita* expenditures on education, or, with a relatively high proportion of the population being above retirement age, would be likely to lead to above average health and welfare expenditures.

In summary, some States suffer cost disabilities in that their *per capita* costs of provision of a given level of public services are higher than in other States.

Revenue disabilities arise from inter-State differences in *per capita* taxable capacities. Essentially a State's taxable capacity is determined by its level and distribution of income and by its resource endowments. The higher are average incomes, the greater will be the State's capacity to raise revenue from taxes on payrolls, financial transactions, property, gambling, motor vehicle ownership and operation, and insurance. Thus States with lower *per capita* incomes will almost certainly have lower taxable capacities (although the Commonwealth Grants Commission does not calculate taxable capacities in this way).

A disadvantaged State is likely to face a combination of relatively high *per capita* costs for the provision of a given level of public services and a relatively low ability to raise the tax revenue necessary to finance these services. The function of the Commonwealth Grants Commission (CGC) is to recommend the process by which such horizontal fiscal imbalance can be corrected.

The terms of reference of the CGC's most recent report on general grant relativities were as follows:

*The Commission's assessment should:*

- a) *be based on the application of the principle that the respective general revenue grants and hospital funding grants to which the States are entitled should enable each State to provide the average standard of State-type public services assuming it does so at an average level of operational efficiency and makes the average effort to raise revenue from its own sources;*
- b) *take account of:*
  - i) *differences in the capacities of the States to raise revenues; and*
  - ii) *differences in the amounts required to be spent by the States in providing an average standard of government services.*

(Commonwealth Grants Commission, 1999:2)

The Commission interprets its terms of reference in the following way:

*To enable a claimant State to function at a standard not appreciably below that of other States without having to levy taxation and other charges of greater severity than those in other States, its revenue needs to be supplemented because of:*

- a) *its lower capacity to raise taxes and other revenues; and*
- b) *its need to incur higher costs in order to provide comparable government services.*

(Ibid.).

It is important to note that the CGC operates on the principle of equalisation of *fiscal capacity*. States are to be put into the position of *having the ability* to provide average levels of public services while imposing taxes of only average severity. There is no requirement for any individual State actually to provide average levels of public service while imposing average tax burdens. Such a system would be one of *fiscal performance* equalisation and would imply that Federal grants became tied grants, with the Commonwealth Government determining how those grants were to be spent. Performance equalisation would imply that the claimed major advantage of federal systems – the ability to cater for inter-State differences in tastes and preferences – would be lost. Capacity equalisation means that States can choose whether to adopt high spending/high taxing policies or low spending/low taxing policies.

There are essentially two sets of calculations in the CGC model – cost disabilities and taxable capacities. Full details of the calculations, which are extremely complex, are presented in Attachment A of Volume II of Commonwealth Grants Commission (1999:2).

*Per capita* relativities for each assessment year are calculated by:

- ♦ calculating each State's *per capita* standardised expenditure (the amount which it would need to spend in order to provide the average level of public services, given its demand and cost structure disabilities);
- ♦ calculating each State's *per capita* standardised revenue (the amount it could raise if it made an average effort to raise revenues from its own sources);
- ♦ using standardised *per capita* expenditure and revenue adjusted by State population data to produce each State's total financial assistance requirement (TFAR) (the total assistance which the State would require to enable it to provide the average standard of State-type services, assuming that it produced these services at an average level of efficiency and made the average effort to raise revenues from its own sources);
- ♦ deducting from each State's TFAR its receipts of relevant Commonwealth specific purpose payments (SPPs) to produce the State's standard deficit;
- ♦ expressing a State's standardised deficit *per capita* as a ratio of the total *per capita* pool of untied Commonwealth funds, including relevant SPPs.

A State's *per capita* requirement for revenue assistance consists of an equal *per capita* share of general revenue *plus* an adjustment for the costs of service provision *plus* a further adjustment to take account of revenue capacities (Commonwealth Grants Commission, 2000)

In its most recent relativities review the CGC examined 41 expenditure categories for its standardised expenditure calculations and 18 revenue categories for its standardised revenue calculations.

The above description represents a simplified explanation of the CGC methodology and aims to give no more than a general understanding of the approach adopted. The outcome of this methodology in terms of the recommended relativities is presented in Table 18. If a State has a relativity greater than 1 it is a claimant (i.e. subsidised) State while States with relativities less than unity are subsidisers.

**TABLE 18****GST AND FAG RELATIVITIES, 2001-02**

	<b>GST Relativities</b>	<b>FAGs Relativities</b>
New South Wales	0.92032	0.88284
Victoria	0.87539	0.84543
Queensland	1.00269	1.01882
Western Australia	0.97516	0.92429
South Australia	1.17941	1.27328
Tasmania	1.50095	1.68695
ACT	1.14633	1.18924
NT	4.02166	4.93364

Source: Budget Paper No. 3, 2001-02, Table 11.

The GST relativities are all closer to 1 than the FAGs relativities. This arises from the fact that fiscal equalisation requires redistribution of a fixed dollar amount of funding (approximately \$2.1 billion). Since the GST pool is greater than the FAGs pool a smaller proportion of GST funding is redistributed among the States (Budget Paper No. 3, 2001-02, page 19). The implications of the IGA package for the Grants Commission's calculation of relativities are discussed in Searle (1998) and Commonwealth Grants Commission (1999:1).

The results, in terms of the translation of these relativities into actual Federal untied grants distribution is presented in Table 19. This Table also presents, for the purposes of comparison, data on what the distribution would have been had it been undertaken purely on the basis of State populations. This table provides a broad indication of the redistributive impact of fiscal equalisation in Australia.

**TABLE 19****EFFECT OF HORIZONTAL FISCAL EQUALISATION, 2001-02***(in million of dollars)*

	<b>GMA distributed under HFE</b>	<b>Equal per capita distribution</b>	<b>Difference (1)-(2)</b>	<b>Population (million)</b>	<b>Per capita redistribution (3)/(4)(\$)</b>
	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>	<b>(5)</b>
NSW	9,401.1	10,425.7	-1,024.6	6.6	-156.1
Victoria	6,394.2	7,340.9	-946.7	4.9	-195.1
Queensland	5,411.3	5,297.0	114.3	3.7	31.3
W Australia	2,823.6	3,000.2	-176.6	1.9	-91.8
S Australia	2,766.8	2,285.8	480.9	1.5	319.5
Tasmania	1,163.1	729.0	434.1	0.5	924.7
ACT	583.7	484.4	99.3	0.3	316.8
NT	1,379.8	360.6	1,019.2	0.2	5,086.9
<b>Total</b>	<b>29,923.6</b>	<b>29,923.6</b>	<b>0.0</b>	<b>19.5</b>	<b>n.a.</b>

Source: Budget Paper No 3, 2001-02, Table 12.

**7. RECENT DEVELOPMENTS**

As is to be expected after such a major reform, the year since the implementation of the IGA has seen stability in Australian federal fiscal arrangements. My perception is that, as the States come to fully understand the implications of the IGA there is increasing unease in some States and increasing satisfaction in others. With understanding of the redistributive implications of the transitional arrangements has come a realisation that, if the States are to abolish or reduce taxes prior to 2005 they would be wise to act on those taxes slated under the IGA for possible abolition in that year (business stamp duties and the debits tax). Victoria has already moved in this direction and NSW has recently announced that it will abolish the debits tax from January 2002.

What has been surprising has been the apparent lack of appreciation by federal politicians on both sides of the House of the fundamental nature of the IGA – that, once the transitional period is over, all increases in GST revenue benefit the States not the Commonwealth. The most recent example of this was a speech in July 2001 by the Federal Treasurer in which he said.

*Obviously if a country wants a competitive taxation regime and a decent level of social services then it needs a taxation base to sustain it. To stay competitive the weight must be kept off direct tax – income tax and company tax- and the indirect tax base must carry the burden of funding social services (Costello, 2001).*

The difficulty with this statement is that, under the IGA, GST revenue is hypothecated to the States but the funding of social services is largely a federal responsibility. How can State revenues fund federal expenditure responsibilities unless other federal fiscal arrangements change?

In a similar vein, the Federal Opposition has as a main plank in its policy platform for the next federal election, due late this year, some “rollback” of the GST so that certain “necessities” become, in the Australian terminology, GST-free, that is zero-rated. The revenue cost of this reform would, without compensation arrangements, be borne by the States but the policy proposals so far have not discussed compensation. Under the IGA, any proposal to change the GST base would need the unanimous support of, *inter alia*, all States and Territories and should be consistent with maintenance of the integrity of the tax base. It would appear that the Federal Opposition would be willing, if necessary, to break the IGA.

I believe that, in the long run, Federal Governments on either side of politics will find it difficult to resist the temptation to appropriate, either directly or indirectly, some of the GST revenue. Australian Federal Governments have consistently exercised financial domination over the States and I would expect this tradition to continue.

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## **APPENDIX A: SUMMARY OF THE INTERGOVERNMENTAL AGREEMENT ON THE REFORM OF COMMONWEALTH-STATE FINANCIAL RELATIONS**

The Agreement relates to the reform of Commonwealth-State financial relations consequent upon the introduction of the Commonwealth Government's *A New Tax System* (ANTS) package and, in particular, of the GST. The original agreement between the Commonwealth and the States and Territories was signed on 9 April 1999. It was revised in the light of the changes to the ANTS package (particularly to narrowing of the GST base) announced by the Prime Minister, Mr Howard on 28 May 1999, and signed on 20 June 1999. It is reproduced as Schedule 2 of *A New Tax System (Commonwealth State Financial Arrangements) Act 1999*.

### ***Objectives***

The objectives of the reforms contained in the Agreement are:

- ◆ achievement of a new national tax system, including the elimination of a number of existing inefficient taxes;
- ◆ provision to State Governments of a more robust tax base, that can be expected to grow over time; and
- ◆ an improvement, once the transitional changes have been completed, in the financial position of all State Governments.

### ***Reform measures***

The following reform measures are incorporated in the Agreement:

- ◆ the Commonwealth to provide all GST revenue to the States;
- ◆ the wholesale sales tax to cease to apply from 1/7/2000 and neither it nor any similar tax to be reintroduced in the future;
- ◆ the temporary safety net arrangements for the taxation of petrol, liquor and tobacco to cease on 1/7/2000;
- ◆ The payment of Financial Assistance Grants to cease on 1/7/2000;
- ◆ Specific Purpose Payments to the States to continue, with the Commonwealth having no intention of cutting aggregate SPPs. The Agreement does not state whether this intention applies to SPPs expressed in nominal or real terms although it does refer to the objective of State governments being financially better off under the new arrangements;
- ◆ States to cease to apply the following taxes:
  - Bed taxes, from 1/7/2000;
  - Financial Institutions Duty (FID), from 1/7/2001;
  - Stamp duties on quoted marketable securities, from 1/7/2001; and
  - Debits tax, by 1/7/2005, subject to review by the Ministerial Council (see below for details of the Council).
- ◆ The Ministerial Council will, by 2005, review the need for retention of stamp duties on:
  - non-residential conveyances;
  - leases;
  - mortgages;
  - debentures, bonds and other loan securities;
  - cheques, bills of exchange and promissory notes; and
  - unquoted marketable securities.
- ◆ States to adjust their gambling tax arrangements to take account of the impact of the GST on gambling operators;
- ◆ States to ensure that ANTS increases in pensions and allowances do not flow through to increased public housing rents;
- ◆ All parties to the Agreement to retain the right to introduce anti-avoidance (and presumably anti-evasion) measures to protect remaining bases or liabilities accrued prior to the date at which the tax ceases to apply.

### ***Distribution of GST revenue***

GST revenue will be distributed according to the following principles:

- ◆ The Commonwealth to make revenue grants to the States equivalent to the total revenue from the GST, subject to the arrangements in the Agreement;
- ◆ GST revenue grants to be freely available to the States to be used for any purpose;



- ◆ GST revenue grants to be distributed among the States in accordance with horizontal fiscal equalisation principles, subject to transitional arrangements.

Details of the payment arrangements are set out in Appendix B of the Agreement.

### ***Transitional arrangements***

The Commonwealth guarantees that, in each of the transitional years following introduction of the GST, the budgetary position of each State and Territory will be no worse off than it would have been had the Agreement not been implemented.

The transitional period will extend from 1/7/2000 to 30/6/2003 but may be extended if transitional assistance is needed by any State or Territory after June 2003. In practice this period has already been extended to the end of 2006-07.

To meet the transitional guarantee the Commonwealth will make transitional assistance payments to all States, as necessary, over the period. The assistance will take the form of interest-free loans and grants in 2000-01 and of grants in subsequent years. These payments, or repayments, will be excluded from Commonwealth Grants Commission per capita relativities assessment and will be freely available for use for any purpose.

After the second year after GST introduction, the GST revenue grants will be made on an HFE basis and any State or Territory receiving more than would have been received under the previous arrangements will retain the excess.

Full details of the transitional arrangements are presented in Appendix B.

### ***Application of the GST to Government***

All levels of Government and their statutory corporations and authorities are to operate as if they were subject to GST legislation. All GST payments from these sources will be included in GST revenue.

### ***Government taxes and charges***

The GST will not apply to the payment of some taxes and compulsory charges, the list of which is to be agreed between the State Governments and the Commonwealth Government.

### ***Management of the GST rate and base***

Any proposal to vary the 10% GST rate or the GST base will require:

- ◆ the unanimous support of State Governments;
- ◆ endorsement by the Commonwealth Government of the day; and
- ◆ passage of relevant legislation by both Houses of Commonwealth Parliament.

All future changes to the base should be consistent with:

- ◆ maintenance of the integrity of the tax base;
- ◆ simplicity of administration; and
- ◆ minimisation of taxpayer compliance costs.

For the first 12 months following implementation of the GST the Commonwealth Government retains the discretion to make unilateral changes to the GST base where the changes:

- ◆ are of an administrative nature (that is, are necessary to protect the integrity of the base or to prevent tax avoidance);
- ◆ are necessary to facilitate the implementation of the new tax; and
- ◆ have regard to the need to protect the revenue of the States.

From July 2001, changes to the GST base of an administrative nature (as defined above ) will require the majority support of the Commonwealth, States and Territories.

### *Australian Taxation Office*

The States will compensate the Commonwealth for agreed costs incurred by the ATO in administering the GST.

### *First Home Owners Scheme*

The States will take on the responsibility for funding a new First Home Owners Scheme (FHOS). This funding may not be drawn from Home Purchase Assistance funds provided through the Commonwealth State Housing Agreement (CSHA). States will not introduce or vary any taxes or charges associated with home purchase with the intention of offsetting FHOS benefits for recipients.

## **APPENDIX B TRANSITIONAL ARRANGEMENTS IN THE INTERGOVERNMENTAL AGREEMENT**

The following description (Appendix C of *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*) sets out the IGA transitional arrangements and the method of calculation of Guaranteed Minimum Amounts.

### *Guarantee in Legislation*

- 1) Commonwealth legislation will provide a State or Territory with an entitlement to an additional amount of funding from the Commonwealth to offset any shortfall between its entitlement to GST revenue grants and the total amount of funding which would ensure that the budgetary position of a State or Territory is not worse off during the transition period.
  - In 2000-01, transitional assistance will be provided to a State or Territory as a grant or an interest free loan to be repaid to the Commonwealth in full in 2001-02.
  - In subsequent transitional years, transitional assistance will be provided to a State or Territory as a grant.

### *Guaranteed Minimum Amount*

- 2) The amount of a State or Territory's entitlement to transitional assistance in a financial year will be calculated by subtracting its entitlement to GST revenue grants from a "Guaranteed Minimum Amount" constructed in the following way:

State revenues forgone: financial assistance grants, revenue replacement payments and State and Territory taxes as defined in Appendix A of this Agreement with the exception of stamp duties on marketable securities which will be the amount as if fully abolished.

**plus**

Reduced revenues: the amount by which States and Territories adjust gambling taxation arrangements to take account of the impact of the GST on gambling operators.

**plus**

Interest costs on cash flow shortfalls: the interest cost incurred by States and Territories as a result of the change to cash flows arising from the replacement of weekly financial assistance grants, revenue replacements and State and Territory taxes with monthly GST revenue grants.

**plus**

Loan Repayments: in 2001-02 only, the repayment of a guarantee loan by a State or Territory.

**plus**

Additional expenditures: payments to first home owners in accordance with Appendix D of this Agreement and the amount of the agreed GST administration costs payable to the ATO by a State or Territory.

**plus**

Other items: \$338 million spread evenly over three years starting in 2000-01 in respect of the claim by States and Territories in relation to revenue forgone from the abolition of the Wholesale Sales Tax (WST) Tax Equivalent Regimes (with the distribution to be agreed among the States and Territories).

**minus**

Reduced expenditures: off-road diesel subsidies and reduced costs from the removal of embedded WST and excises on purchases by a State or Territory government.

**minus**

Growth dividend: the increase in revenue to a State or Territory (not including GST revenue payments) that is attributable to the impact of the Commonwealth's taxation reform measures on economic growth.

**plus**

Adjustments: from 2001-02, the net difference between preliminary estimates and outcomes or final estimates for items that were taken into account in the previous year's Guaranteed Minimum Amount.

In addition, \$269 million in total, spread evenly over three years, will be included in the new Commonwealth State Housing Agreement starting in 2000-01 in respect of the net increased public housing costs as a result of tax reform (with the distribution to be agreed among the States and Territories).

Heads of Treasuries' Advice to Ministerial Council

- 3) The Guaranteed Minimum Amount for a State or Territory will be determined by the Commonwealth Treasurer by 10 June of each year of the transition period. The Ministerial Council will make recommendations to the Treasurer on the Guaranteed Minimum Amount for each State and Territory.
- 4) The Heads of Treasuries will provide written advice to the Ministerial Council on the following issues by the indicated dates.
  - By 1 March 2000, advice on the estimated loans and grants to be provided to each State and Territory in 2000-01 and the amounts which the Commonwealth should provide to each State and Territory on Tuesday 4 July 2000.
  - By 1 November 2000 advice on the most recent estimates of transitional assistance for the year and any adjustment that may need to be made to the amount of the loans and grants made to each State and Territory.
  - By 1 September of each subsequent year of the transition period, advice on the most recent estimates of the transitional assistance to be provided to each State and Territory in the financial year and the installment amounts which the Commonwealth should provide to each State and Territory on the first Tuesday of the following October and January. This advice should identify the adjustments for the net difference between preliminary estimates and outcomes or final estimates for items that were taken into account in the previous year's Guaranteed Minimum Amount for a State or Territory.
  - By 1 March of each subsequent year of the transition period, advice on the most recent estimates of the transitional assistance to be provided to each State and Territory in both the current financial year and the next financial year, and the installment amounts which the Commonwealth should provide to each State and Territory on the first Tuesday of the following April and July.
  - By 1 June of each year of the transition period, advice on the Guaranteed Minimum Amount for each State and Territory in the current financial year.

*Frequency and Amounts of Payments and Repayments*

- 5) In each year of the transitional period after 2000-01, the Commonwealth will provide an installment of the guarantee payment to a State or Territory on the first Tuesday (or the first business day thereafter) of January, April, July and October. The installment amounts will reflect the advice to be provided to the Ministerial Council by the Heads of Treasuries under paragraph C4.
- 6) Adjustments to the total amount of additional assistance to a State or Territory in light of actual GST collections and the Treasurer's determination of the Guaranteed Minimum Amount will be made in conjunction with the payments of GST revenue grants after 10 June in each year.
- 7) A State or Territory will repay a loan which it receives from the Commonwealth in 2000-01 in quarterly installments in 2001-02. These installments will be paid to the Commonwealth on the same day on which a State or Territory receives an amount of GST revenue grants in the months of July, October, January and April.
- 8) The methodology for calculating the amounts of particular components of the Guaranteed Minimum Amount for a State or Territory has been agreed by the Heads of Treasuries and is set out in the document titled *Methodology for Estimation of Components of the Guaranteed Minimum Amount*.



# CONCEPT OF FISCAL DECENTRALISATION AND WORLDWIDE OVERVIEW

By Robert D. Ebel and Serdar Yilmaz

## 1. INTRODUCTION

In the last two decades there has been a worldwide interest in decentralization of government in all parts of the world. The pursuit of decentralization is widespread, as both developed and developing countries attempt to challenge central governments' monopoly of decision-making power. In the western world, decentralization is an effective tool for reorganization of the government in order to provide public services cost effectively in the "post-welfare state" era (Bennett, 1990; Wildasin, 1997). Developing countries are turning to decentralization to escape from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth (Bird and Vaillancourt, 1999). Throughout post-communist Central and Eastern Europe, decentralization of the state is the direct result of the transition from socialist system to market economy and democracy (Bird, Ebel, and Wallich, 1995). In Latin America, the origin of decentralization is the political pressure from the people for democratization (Rojas, 1999). In Africa, decentralization has served as a path to national unity (World Bank, 1999).

This diversity in the list of factors that have contributed the interest in decentralization reflects institutional differences across countries. Institutional factors, such as political, social, legal, and economic conditions, are generally important for the analysis of public finance issues, but they are especially important for the analysis of fiscal decentralization. The institutional context of fiscal decentralization entails the overall economic development, the nature of the legal system, ongoing process of economic and political reform, the organization of monetary and financial institutions, and tensions arising from ethnic, religious, or economic differences (Wildasin, 1997). This institutional background determines the design of intergovernmental financial system and ultimately affects the outcome of fiscal decentralization reform process.

During the last two decades, the economic reforms in different parts of the world largely focused on the role of markets and understated the importance of the organization of the public sector in achieving broader objectives such as economic stability, sustainable growth, and provision of basic public services equitably across people and jurisdictions (World Bank, 1999). The key element underlying the interest in fiscal decentralization is to achieve these objectives by increasing efficiency, transparency, and accountability in the public sector.

In a fiscally decentralized system, the policies of subnational branches of governments are permitted to differ in order to reflect the preferences of their residents. Furthermore, fiscal decentralization brings government closer to the people and a representative government works best when it is closer to the people (Stigler, 1957). The theoretical argument for fiscal decentralization is formulated as "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision."<sup>1</sup> However, much of the established theoretical literature of fiscal federalism has been based on issues that arose within developed countries, particularly the US and Canada and the definition and implementation of fiscal decentralization differ greatly across developing countries due to differences in economic and political structures. This diversity creates challenges to measure and compare the degree of decentralization across countries and to make generalizations about it.

### 1.1. Existing Decentralization Indicators

Figure 1 shows the population weighted average shares of subnational expenditure and revenue in total public sector for those 28 countries reported in the Government Finance Statistics of the International Monetary Fund (IMF) between 1980 and 1998<sup>2</sup>. The average expenditure and revenue shares of subnational governments in this group of countries has been increasing steadily over time since 1980.<sup>3</sup>

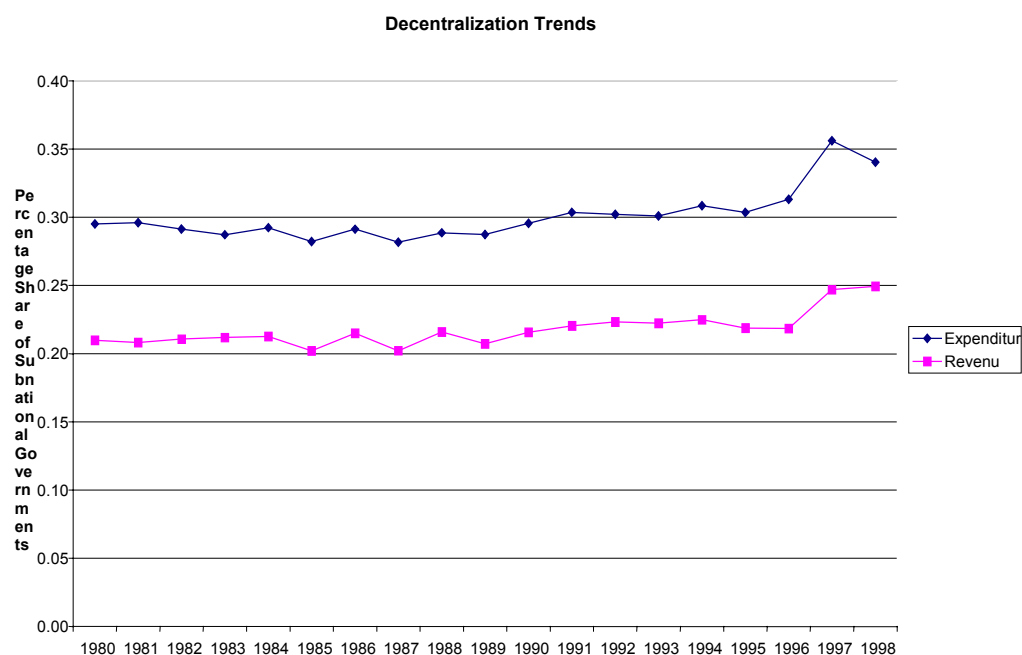
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<sup>1</sup> Oates, 1972.

<sup>2</sup> Argentina, Austria, Bahrain, Belgium, Bolivia, Brazil, Canada, Costa Rica, Denmark, Dominican Republic, Finland, Hungary, Iceland, India, Indonesia, Ireland, Israel, Luxembourg, Mauritius, Mexico, Netherlands, Norway, Romania, South Africa, Spain, Sweden, Thailand, and United States.

<sup>3</sup> Revenue figures are for all revenues other than intergovernmental grants.

FIGURE 1

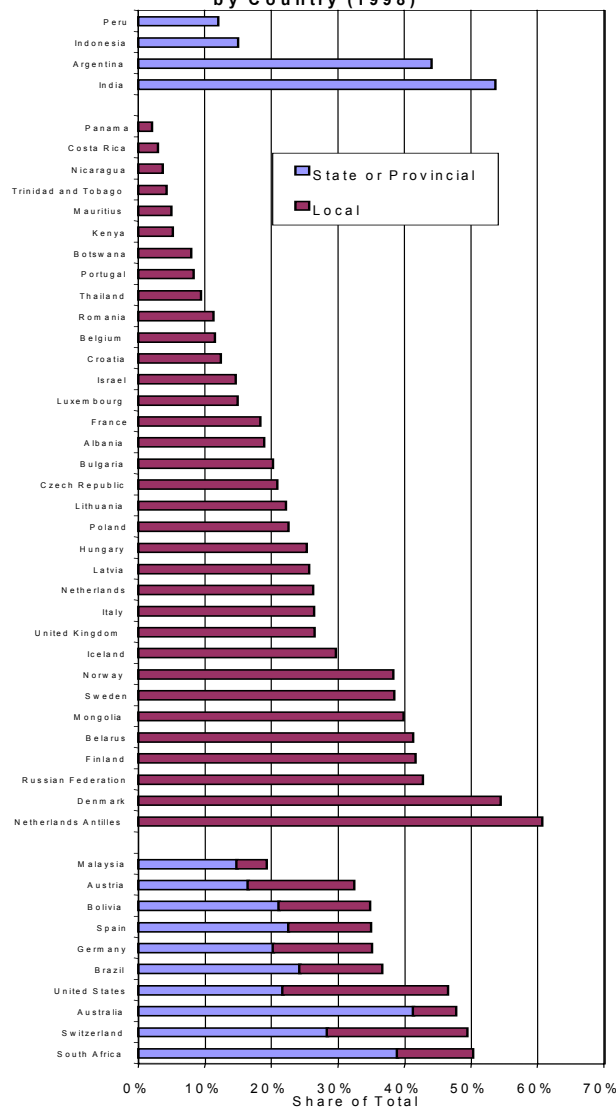


Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

Although, the share of subnational governments in total government spending or revenue gives us an idea about the relative importance of subnational governments in total public sector and its change over time, neither of them is a perfect measure of fiscal decentralization.

FIGURE 2

Figure-2: Subnational Share of Expenditures by Country (1998)



Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

Fiscal decentralization is about empowering people to participate in and influence the decisions made within their close community (Inter-American development Bank, 1997). In a fiscally decentralized system, where citizens' participation in decision-making is encouraged, locally elected governments have the power to pursue the agenda mandated by voters.

Thus, a measure of fiscal decentralization should reflect the key characteristics of a fiscally decentralized system, such as the existence of elected local council, locally approved budget, local governments' borrowing power, capacity of local governments to collect taxes (Bahl, 1999). In most countries, intergovernmental relations system does not have these characteristics.

Comparing the degree of fiscal decentralization across countries is a complex and multifaceted task that requires identification of subnational autonomy and discretion on expenditure and revenue affairs. Although there has been an

effort by both multinational (OECD, 1999) and bilateral (Bird and Banta, 1999) organizations to develop a methodology for a comparable statistics on fiscal decentralization across countries, there is yet no standardized data set.<sup>4</sup>

The Government Finance Statistics (GFS), which has consistent definitions across some countries over time, is the only existing source of data for worldwide cross-country analysis of fiscal decentralization and public finance. Although, GFS is the most widely available internationally comparable data source on subnational finances, it is not an ideal data set for measuring fiscal decentralization. The need to standardize fiscal variables in GFS inevitably leads to a loss of details. For example, although GFS provides a breakdown of expenditures by function and economic type, it is silent about expenditure autonomy. Thus, expenditures that are mandated by the central government appear as subnational expenditure in the GFS. Similarly, on revenue side, the GFS contains information about tax and non-tax revenues, intergovernmental transfers, and other grants, but it does not distinguish whether taxes are collected through shared taxes, piggybacked taxes, and locally determined "own-source" taxes, or what proportion of intergovernmental transfers is conditional as opposed to general purpose transfers.

Although the expenditure share of subnational governments in total government spending is an imperfect measure of fiscal decentralization, in the absence of an appropriate indicator, economists commonly use the percentage share of subnational governments expenditure in total government expenditure as a representative of fiscal decentralization. Figure 2 shows the degree of fiscal decentralization, measured as the percentage share of subnational governments expenditure in total government spending, for those countries reported subnational statistics in 1998. In general, subnational governments (intermediate plus local) in federal countries have executed higher portion of total government spending than their counterparts in unitary countries. In 1998, the average subnational share of expenditures is 38% for federal countries and 22% for unitary countries.

### **1.2. Generalizations About Decentralization**

The government structure in any country is unique reflecting the historical, social, and cultural evolution of the society. The differences in the structure of government are a natural consequence of these factors. Despite such differences, the structure of intergovernmental financial system in many countries exhibits certain broad patterns, such as the existence of inadequate "own resources"<sup>5</sup> of subnational governments to finance the expenditure functions, the heterogeneity of subnational governments, and the lack of subnational autonomy to levy taxes that are capable of yielding enough revenue to meet local needs (Bird, 1995).

*First, subnational governments don't have adequate level of "own resources."* The revenues under direct control of local governments invariably less than their expenditures in most countries. Due to lack of data for own source of revenues, Table 1 presents local governments' revenues as a percentage of their expenditures reported in the GFS.<sup>6</sup> The revenues of subnational governments are less than their expenditures in both unitary and federal countries. The vertical imbalance is financed through intergovernmental transfers. However, in many countries, intergovernmental transfer system is not formula based and the central government decide on the amount of transfer on a discretionary basis. Therefore, intergovernmental transfer system in many countries is not transparent and subject to political manipulation, which lead to uncertainties on the part of subnational governments. Such uncertainties discourage fiscal planning and effective budgeting.

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<sup>4</sup> There are data sets available about subnational finances only for selected countries, such as Indian Subnational Database of the World Bank.

<sup>5</sup> Bird (2000) defines own revenues as taxes (i) that are assessed by subnational governments, (ii) for which subnational governments set the rate, and (iii) the revenues accrue to the local government. A revenue may be "own source" even if the tax base is centrally defined and the proceeds are centrally collected.

<sup>6</sup> Since these figures are from the GFS, they are subject to constraints discussed above. For example, the revenue figures include shared taxes and other taxes which their rate and base are determined by central government. However, regardless of local governments' control over revenue resources, Table 1 shows that subnational revenues are less than their expenditures.



TABLE 1

## LOCAL GOVERNMENT REVENUES AS PERCENT OF TOTAL SUBNATIONAL EXPENDITURES

<i>Unitary Countries</i>	1995	1996	1997	1998
Albania	5.64%	6.85%	3.69%	4.05%
Azerbaijan	73.97%	68.65%	66.78%	58.30%
Belarus	73.18%	70.63%	77.73%	81.69%
Bulgaria	57.27%	66.19%	65.35%	61.08%
Croatia	98.11%	93.62%	93.83%	89.18%
Czech Republic	72.26%	60.28%	72.74%	75.80%
Denmark	57.10%	57.50%	58.55%	59.25%
Estonia	65.95%	66.97%	73.10%	72.04%
Iceland	87.26%	84.64%	84.29%	85.31%
Kazakhstan	N/A	N/A	78.76%	71.68%
Latvia	75.53%	77.93%	73.82%	72.08%
Lithuania	73.82%	72.22%	71.71%	80.65%
Mauritius	39.51%	39.91%	40.68%	42.52%
Moldova	72.74%	60.50%	58.66%	62.49%
Mongolia	58.46%	56.92%	60.10%	57.32%
Norway	60.96%	62.10%	61.30%	59.71%
Poland	71.52%	66.49%	66.21%	64.83%
Slovak Republic	N/A	89.65%	79.75%	73.69%
Slovenia	77.31%	82.83%	81.88%	80.60%
United Kingdom	27.47%	27.31%	27.91%	29.33%
<i>Federal Countries*</i>				
Australia	85.73%	83.28%	81.92%	81.80%
Austria	82.74%	85.31%	87.28%	83.89%
Bolivia	85.64%	85.93%	85.85%	85.76%
México	97.37%	97.72%	99.98%	N/A
Switzerland	81.35%	81.91%	81.96%	82.02%
United States	62.43%	63.51%	64.32%	64.51%

\*In federal countries local government is the lowest tier of government.

Note: Intergovernmental transfers are not included in local government revenues.

Source: International Monetary Fund. 1998. Government Finance Statistics Year Book 1998, Country Tables.

*Second, striking variations appear in the size and capacity of subnational governments in all countries.* There are big differences in terms of population, expenditure capacity, and revenue sources across subnational units in almost every country. These horizontal imbalances and fiscal disparities present challenges to fiscal decentralization reforms. Table 2 presents these striking variations across subnational governments' expenditure capacity in a selected group of countries. The coefficient of variation in the last row is an indicator of fast growing economic inequalities across subnational governments in these countries.

TABLE 2

## MEASURES OF HORIZONTAL IMBALANCE: PER CAPITA SUBNATIONAL EXPENDITURES

	India (97) (rupee)	Russia (97) (ruble)	China (97) (yuan)	Argentina (94) (pesos)
Mean	1,946	3,762,600	6,857,226	1,410
Minimum	919	1,336,700	3,027,937	616
Maximum	3,407	30,543,500	27,413,257	4,665
Coefficient of Variation	0.39	1.17	0.77	0.62

Source: India: Author's calculations based on data from the Indian Subnational Database, The Statistical Information Management and Analysis System, World Bank; China: Author's calculations based data from Statistical Yearbook of China 1998; Russia: From Martinez-Vazquez and Boex (2001); Argentina: From Rezk (1999).

Third, subnational revenues are not adequately responsive to changing needs and subnational governments lack the legal authority to levy some taxes that yield enough revenue to meet their needs. The size and pattern of subnational government taxation varies greatly from country to country (see Table 3). In many countries, subnational governments are authorized to assess and collect taxes, but determining tax bases and rates is the responsibility of the central government. For example, income and property taxes are intended to be the most important sources of revenue for subnational governments. However, since there is no well developed real estate markets, the collection of property tax is problematic in most of the developing countries. In many countries, property values are not updated regularly and the inflationary environment is an important hindrance on subnational governments' ability to generate a substantial revenue from property tax. On the other hand, taxes that expand with economic activity and expenditure needs is exclusively collected by central governments in many countries. Exceptionally, in a number of Latin American countries and India, industry and commerce tax are important sources of revenues for subnational governments (Bird, 1995).

TABLE 3

## TAX REVENUE ATTRIBUTABLE TO EACH TYPE OF GOVERNMENT

	1997 INCOME TAX		1998 INCOME TAX		1997 PROPERTY TAX		1998 PROPERTY TAX		1997 CORPORATE TAX		1998 CORPORATE TAX	
	C	L	C	L	C	L	C	L	C	L	C	L
Albania	100.00%	0.00%	100.00%	0.00%	99.11%	0.89%	99.66%	0.34%	100.00%	0.00%	100.00%	0.00%
Belarus	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Bulgaria	50.01%	49.99%	50.29%	49.71%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Croatia	61.10%	38.90%	61.05%	38.95%	32.46%	67.54%	33.43%	66.57%	100.00%	0.00%	100.00%	0.00%
Czech Rep.	37.98%	62.02%	38.28%	61.72%	55.68%	44.32%	60.33%	39.67%	100.00%	0.00%	100.00%	0.00%
Denmark	44.88%	55.12%	42.35%	57.65%	39.38%	60.62%	44.53%	55.47%	100.00%	0.00%	100.00%	0.00%
Estonia	44.19%	55.81%	44.26%	55.74%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Hungary	81.27%	18.73%	79.50%	20.50%	49.84%	50.16%	50.00%	50.00%	100.00%	0.00%	100.00%	0.00%
Iceland	46.92%	53.08%	45.63%	54.37%	54.46%	45.54%	54.64%	45.36%	100.00%	0.00%	100.00%	0.00%
Kazakhstan	18.06%	81.94%	15.86%	84.14%	3.30%	96.70%	0.98%	99.02%	100.00%	0.00%	100.00%	0.00%
Latvia	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.23%	99.77%	100.00%	0.00%	100.00%	0.00%
Lithuania	21.79%	78.21%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Mauritius	100.00%	0.00%	100.00%	0.00%	85.10%	14.90%	85.88%	14.12%	100.00%	0.00%	100.00%	0.00%
Moldova	N/A	N/A	0.00%	100.00%	N/A	N/A	1.55%	98.45%	N/A	N/A	100.00%	0.00%
Mongolia	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Norway	40.87%	59.13%	44.10%	55.90%	35.17%	64.83%	40.44%	59.56%	100.00%	0.00%	100.00%	0.00%
Poland	77.17%	22.83%	76.55%	23.45%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Slovak Rep.	82.91%	17.09%	84.33%	15.67%	24.50%	75.50%	28.68%	71.32%	100.00%	0.00%	100.00%	0.00%
Slovenia	100.00%	0.00%	100.00%	0.00%	0.00%	100.00%	15.53%	84.47%	100.00%	0.00%	100.00%	0.00%

Source: International Monetary Fund. 1998. Government Finance Statistics Year Book 1998, Country Tables.

## 2. WHY DECENTRALIZATION?

The best starting-point for a discussion about decentralization-centralization debate is the structural arrangement of government. In the centralist structure decision-making power concentrates in the hands of central government bureaucrats whereas in a decentralized system subnational governments have decision-making power on issues that effect their citizens' life. Although decentralization takes different forms, as discussed in the fourth section, political and economic dimensions of centralization-decentralization debate are inexorably linked to each other. In order to have economic gains to be realized from decentralization, it is necessary to have decentralization of political decision-making authority. This logic suggests that the greater the number of political units to which political authority is decentralized, economic gains are likely to be maximized. This is because large numbers of political units mean more choice to individuals to find a community that provides the level of outputs best suited their tastes (Tiebout, 1956).

Therefore, there are two dimensions of the decentralization of public management system: economic and political. The standard economic dimensions of a public finance policy are macroeconomic stability, equity and efficiency (Musgrave and Musgrave, 1984). The efficiency aspect of the economic dimension is the economists' *raison d'être* for fiscal decentralization. Since individual preferences for public goods differ, in a fiscally decentralized system individuals choose to live in a community that reflect their preference, which in return maximizes social welfare. The economic argument of efficiency stems from the fact that due to closeness to the citizens, local governments are able to meet different views and interests of people and allocate resources more efficiently than a central authority. However, efficiency aspect is not the only one in evaluating economic dimension of fiscal decentralization. Intergovernmental fiscal design has important implications on macroeconomic stability and equity. Before starting discussions on political dimension of fiscal decentralization, we discuss issues related to each aspect of the economic dimension of fiscal decentralization in turn.

### 2.1. Efficiency

The fiscal federalism literature argues that there are efficiency gains from decentralization. According to Stigler (1957) a representative government works best when it is closer to the people. In his seminal work on the theory of public finance, Musgrave (1959) separates the functions of government into three: macroeconomic stabilization, income redistribution, and resource allocation. With respect to resource allocation function, Musgrave (1959) argues that policies of subnational branches of governments should be permitted to differ in order to reflect the preferences of their residents. Carrying Stigler's and Musgrave's arguments further, Oates (1972) formulated the decentralization theorem as "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision."

The decentralization theorem is based on the assumption that central government can only provide goods and services uniformly across jurisdictions. Therefore, according to the argument, there are potential efficiency gains from fiscal decentralization. Efficiency gains from decentralization can be allocative and managerial:

#### (1) Efficient Allocation of Resources

Decentralization will increase efficiency because local governments have better information about their residents' needs than the central government. Decisions about public expenditure that are made by a level of government that is closer and more responsive to a local constituency are more likely to reflect people's choices than decisions made by a remote central government.

#### (2) Competition Among Local Governments

If public goods are financed by local taxes that reflect costs, people will shop around for the community that best fits their preferences (Tiebout, 1956). In doing so, they will "vote with their feet." Therefore fiscal decentralization will increase competition among the local governments for better use of public resources. Thus, by serving as a constraint on the behavior of the revenue-maximizing government, fiscal decentralization promotes interjurisdictional competition that limits excessive taxing power of the governments (Brennan and Buchanan, 1980).

While there are potential gains from decentralization, the primary reasons for decentralization in most countries have been political, not economic. For example, in Latin America, decentralization has been an integral part of programs to restore and deepen democracy (Rojas, 1999). In other countries, the poor performance of the central governments in achieving macroeconomic stability, sustainable growth, and adequate level of public services has fueled the interest in

fiscal decentralization. Countries, such as India,<sup>7</sup> Philippines,<sup>8</sup> Columbia,<sup>9</sup> and Brazil,<sup>10</sup> have started assigning certain functions of public sector to subnational governments in order to offload the burden from central government's shoulder and rely more on lower level governments, which are often underutilized and have untapped revenue potential (Smoke, 1994).

In some developing countries, decentralization reforms are carried out without institutional and legal support mechanisms and appropriate intergovernmental fiscal arrangements to support decentralized system. In these countries, subnational governments fell short of meeting the expectations and decentralization has been blamed for macroeconomic instability, regional inequalities and inefficiencies in the public sector.<sup>11</sup>

Some macroeconomists argue that in a decentralized system, since policymaking becomes a responsibility shared by different levels of government, circumvention of central control over monetary and fiscal policies may have aggravated macroeconomic problems in these countries (Prud'homme, 1995; Tanzi, 1996). According to them, central governments are better equipped in dealing with spillover effects of local spending, inflationary pressures of monetization of local debt and cyclical shocks. To the extent that this line of argument highlights the potential problems arising from decentralization when checks and balances of intergovernmental relations system are not in place, decentralization can make matters worse. A good decentralization policy is not easy to design; clearly, it can be done well or badly (Bird and Vaillancourt, 1999).

## 2.2. Stability

Empirical research on decentralization and macroeconomic governance gives little a priori support to the concerns that decentralization is inherently destabilizing.<sup>12</sup> Recent studies on the relationship between fiscal federalism and macroeconomic governance find that "decentralized fiscal system offers a greater potential for improved macroeconomic governance than centralized fiscal systems."<sup>13</sup> In fact, highly decentralized federal countries, such as Switzerland, Germany, Austria, and USA, have very stable macroeconomic performance and low rates of inflation (Shah, 1997).

The concern over macroeconomic instability in a decentralized system stems from different factors:

- (i) local pursuit of independent demand management policies will be largely ineffective in small, open, local economies;
- (ii) uncoordinated local monetary policies will pose a severe inflation risk;
- (iii) local debt will have national repercussions with an integrated capital market; and
- (iv) economic shocks tend to be correlated across localities (Hemming and Spahn, 1997, p. 112).

In traditional Keynesian theory, fiscal policy is an important tool for manipulation of short-run demand, which affects prices and employment levels. Spahn (1998) argues that Keynesian demand management argument has overemphasized the need for centralized macroeconomic policies. According to him, any national fiscal stimulus would be offset by an exchange-rate change in an open economy. With regard to economic shocks, Gramlich (1977) has argued that may shocks are asymmetric and central policy instruments cannot be customized to address localized effects of economic shocks.

To the extent that local debt has national repercussions suggests time-inconsistency problem. In most countries, due to political concerns central governments cannot credibly commit to enforcing hard-budget constraint. Subnational governments may then overspend, expecting to get more resources from the common pool of national resources, either through additional discretionary transfers or bailouts. These can manifest themselves in the form of higher inflation if bailouts are financed through central bank borrowing.

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<sup>7</sup> Rao, 1999.

<sup>8</sup> Rood, 2000.

<sup>9</sup> Bird and Fiszbein, 1999.

<sup>10</sup> Dillinger and Webb, 1999.

<sup>11</sup> According to Prud'homme (1995), "Argentina provides a good illustration of the 'fiscal perversity' of subnational governments" and constitutional reform of 1988 in Brazil "significantly reduced the central government's ability to conduct macroeconomic policies."

<sup>12</sup> Fiscal decentralization has an impact on different macro indicators, such stability, public sector size, and economic growth. This section discusses the impact of fiscal decentralization on macroeconomic stability, for discussions on public sector size and economic growth see Box 1 & 2.

<sup>13</sup> Huther and Shah (1998) examine statutory aspects of central bank operations, such as the terms of office for chief executive officer, the formal policymaking power, limitations on lending to the government and other 13 criteria and show that there is a positive correlation between central bank independence and decentralization.

Countries like Argentina and Brazil have had macroeconomic problems due to subnational debt reflects the fact that the old institutional arrangements no longer function under the decentralized regime (Spahn, 1998). In countries without institutional structures that support mature and stable decentralized system, subnational governments may use their fiscal power irresponsibly causing macroeconomic problems. Therefore, in countries undergoing decentralization process, institutional reform is required for an effective mechanism of intergovernmental cooperation.

Institutional reforms that minimize adverse incentives and promote transparency, accountability, and predictability should be executed to have an effective fiscal decentralization (Wildasin, 1997; Bird, 2000). In the absence of these characteristics governments would settle their intergovernmental fiscal transactions on ad hoc basis, responding to the fiscal distress of lower-level units with a variety of special loans, grants, negotiated tax-sharing agreements, directed-credit programs, and other emergency bailouts, rather than establishing firm transparent rules which would govern the form and extent of fiscal flows between central and subnational fiscal and financial institutions.<sup>14</sup> Consequently, in order for the decentralization to be effective and successful, the transfer of fiscal power from the center to the localities must be supplemented by institutional arrangements that monitor the system. Such proper arrangements should enforce hard-budget constraints, motivate responsible behavior by the subnational governments, and reduce the possibility of macroeconomic instability.

It is therefore important to recognize that fiscal decentralization does not necessarily lead to macroeconomic instability. In fact, most countries choose to decentralize because of macroeconomic distress—that is in response to large central budget deficits central governments are increasingly relying on local governments for service provision. In some countries, decentralization is part of the fiscal adjustment strategy of the central government—pushing expenditure responsibilities downward without designing an intergovernmental financial system that allocates revenue sources to subnational governments. In the absence of appropriate rules that regulate intergovernmental relations, forcing local governments to provide adequate level of services and maintaining a sustainable decentralized system is a difficult task: when appropriate rules are not in place, the institutions of political control and accountability are not mature, and administrative professionalism and control mechanisms are not developed, fiscal decentralization aggravates macroeconomic problems.

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<sup>14</sup> Op. cit. Wildasin (1998).

Box -1: Empirical Studies on the Impact of Fiscal Decentralization on Public Sector Size

If greater decentralization increases number of alternative fiscal jurisdictions, any attempt to increase tax rates in one jurisdiction would result in migration of its residents to another jurisdiction (Tiebout, 1956). In Tiebout's analysis, taxpayers migrate to alternative jurisdictions in order to avoid higher taxes and interjurisdictional competition limit excessive taxing power of the governments. Along with the lines of Tiebout, Brennan and Buchanan (1980) developed the "Leviathan" hypothesis, which argues that fiscal decentralization serves as a constraint on the behavior of the revenue-maximizing government. The "Leviathan" hypothesis predicts that the overall size of the public sector should vary inversely with fiscal decentralization; fiscal decentralization increases competition among local governments, which ultimately limits the size of the public sector. Empirical studies have tested the relationship between fiscal decentralization and public sector size and reported conflicting results.

Studies Testing "Leviathan" Hypothesis

Study	Unit of Analysis	Findings
Oates (1985)	Cross-country comparison	No significant relationship
Nelson (1986)	United States	No significant relationship
Marlow (1988)	United States	Strong negative correlation
Grossman (1989)	United States	Strong negative correlation
Joulfaian and Marlow (1990)	United States	Strong negative correlation
Grossman and West (1994)	Canada	Strong negative correlation
Ehdaie (1994)	Cross-country comparison	Strong negative correlation

**Box -2: Empirical Studies on the Impact of Fiscal Decentralization on Economic Growth**

Little research has been done on the impact of fiscal decentralization on economic growth. Until recently the debate over the merits of fiscal decentralization had been on theoretical grounds of efficiency gains and the empirical studies that have analyzed the impact of fiscal decentralization on economic growth have only appeared recently. Interestingly, these studies generally find that fiscal decentralization is associated with slower economic growth.

Studies on The Impact of Fiscal Decentralization on Economic Growth

Study	Unit of Analysis	Findings
Davoodi and Zou (1998)	Cross-country comparison	Significant negative relationship
Xie, Zou and Davoodi (1999)	United States	Significant negative relationship
Zhang and Zou (1998)	China	Significant negative relationship

Serious methodological issues confront efforts such empirical studies. First, there is no consensus about specification of an empirical model for growth studies. The literature on economic growth suggests that growth is a complex phenomenon with multi-dimensions (Levine and Renelt, 1992). Growth studies are usually criticized on the grounds of a possible model misspecification (Martinez-Vazquez and McNab, 1997). Second, the fiscal decentralization variable used in these studies does not represent the multidimensionality of the issue. Without controlling for subnational governments' autonomy over expenditure and revenue decisions and whether subnational officials are democratically elected, the expenditure share of subnational governments as a fiscal decentralization variable means very little in representing the level of decentralization. Third, regression coefficients may very well be the product of spurious correlation. In regression analysis models, the cause-and-effect relationship runs directly from explanatory variables to the dependent variable. However, if both dependent and independent variables are determined simultaneously, the distinction between dependent and explanatory variables becomes dubious. If there is no unidirectional cause-and-effect relationship, the dependent variable is determined by explanatory variables, and some of the explanatory variables are, in turn, determined by output. Given that there has been extensive research on the role of economic on growth on fiscal decentralization (Oates, 1985; Pommerehne, 1977; Kee, 1977; Bahl and Nath, 1986) and very little research on the causation line from fiscal decentralization to economic growth, it is highly suspected that the regression coefficients reported on these studies is a mere reflection of spurious correlation. Therefore, the theoretical underpinnings of the relationship between fiscal decentralization and economic growth still need to be further developed.

**2.3. Equity**

Equity aspect of a public finance policy concerns with the redistribution of income to achieve a socially just outcome. In its classical definition, redistribution typically implies a transfer of funds to low-income households to achieve more equal distribution of income. In decentralization context, the issue of redistribution has two dimensions: horizontal and within-locality equity. Horizontal equity refers to the extent which subnational governments have the capacity to deliver an equivalent level of services. There are two major factors contributing horizontal inequalities: taxes bases vary significantly from region to region and regional characteristics affect the cost of service provision. In addressing horizontal inequalities redistribution policies are designed to provide more resources to poorer regions. Equalization grant, discussed in the fifth section, is the commonly used tool to correct for horizontal inequalities in most fiscally decentralized systems.

However, providing more resources to poor regions addresses only one aspect of the equity problem. Success in redistribution policies requires special attention to within-locality equity. In designing redistributive policies subnational governments need to be supported by the central government. Otherwise, subnational governments cannot effectively carry out redistributive policies. The potential mobility of households places real constraints on the capacity of decentralized governments to employ redistributive policies. If a local government were to undertake an aggressive program to redistribute income, it would create compelling incentives for low-income people to immigrate into the jurisdiction and for high-income people to move elsewhere. Nevertheless, there is certainly scope for local governments in engaging fight against poverty. In fact, some even argue that local governments are more concerned with poverty and by the nature of their business their actions have redistributive impacts. For example, Pauly (1973) makes the point about greater concern for poverty in a locality than in other places. Furthermore, Sewell (1996) argues that the regulatory power of subnational governments, such as land use, rent controls, user charges, has profound distributional implications.

#### **2.4. Political Dimension of Fiscal Decentralization**

Institutions of accountability and participation are the key to the success of decentralized decision making. In decentralized systems, local governments' proximity to their constituents will enable them to respond better to local needs and efficiently match public spending to private needs. This entails establishing institutions and mechanisms for citizens voice and exit. Regular elections, local referendums, permanent councils and other institutional structures are some of the easily identifiable and effective tools that may improve the ability of local governments to identify and act on citizen preferences in a decentralized setting.

Issue and project-specific mechanisms for enhancing the flow of information between decision-makers and the public can often be implemented more quickly and easily locally than centrally. It should be recognized that in many countries local governments use a wide variety of techniques in determining people's preferences and having them involved in decision-making and application process. For example, a survey of water supply users in Baku, Azerbaijan revealed that users are willing to pay more for better quality of services (World Bank, 1995). In Bangalore and several other Indian districts, local governments use report cards to evaluate effectiveness of service delivery. In Colombia, municipalities have formed public-private councils to obtain technical assistance from the private sector.

Together with shortening the distance between people and elected representatives and widening the scope for greater transparency about how and where money is spent locally, decentralization makes accountability a more tangible issue. Therefore, the debate about decentralization of government should not be limited only to considerations of economic factors and efficiency. Political accountability of elected officials to voters ensures that government services are responsive to people's needs. If officials are not responsive, the citizen has the choice of either voting out the offending officials and/or migrating to other jurisdictions (to "vote with one's feet").

In democratic societies, public servants are responsible to elected officials and the latter are in turn responsible to the public that elected them in the first place. In this process, political accountability should increase the pressure for more transparent local governance that is more responsive to people's needs. The democratic local governance initiatives currently under way in many countries hold much promise for developing effective systems of public accountability that will ensure that public resources are used efficiently and services are delivered effectively. Studies have shown that citizens' participation and control over government's actions can increase the quality of public management system and that participation of citizens in decision-making process can lead to some identifiable improvements in the allocation of resources (Putnam, 1993; Fiszbein, 1997; Huther and Shah, 1998; Inter-American Development Bank, 1997).

### **3. DIFFERENCES IN THE DEGREE OF DECENTRALIZATION**

It is likely that the average divergence of individual preferences from the tax and service package adopted by the community through its government will be less in small communities of relatively like-minded individuals than it will be in larger, more heterogeneous areas. Therefore, the differences in the degree of decentralization across nations are in part explained by different size variables, such as population (Oates, 1972; Pommerehne, 1977; Bahl and Nath, 1986), land area (Oates, 1972), and GDP (Pommerehne, 1977). Figures 3 and 4 present the variation in expenditure and revenue shares of subnational governments across regions. As presented in figures 3 and 4, high-income countries are relatively more decentralized than others. Subnational governments in sub-Saharan African countries have the lowest level of expenditure and revenue shares compared to other regions of the world. As shown in figures 3 and 4, high income OECD countries have the highest degree of decentralization.



## FIGURES 3 AND 4

FIGURE-3: SUB-NATIONAL SHARE OF EXPENDITURES BY REGION

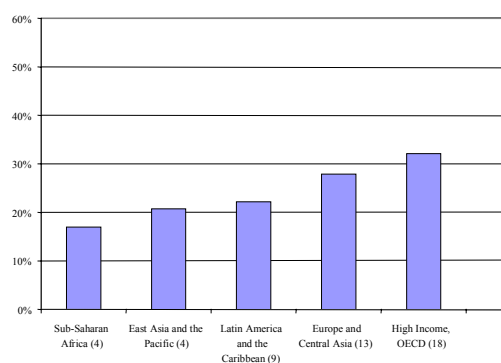
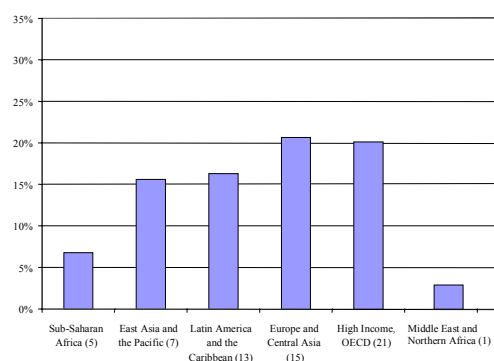


FIGURE-4: SUB-NATIONAL SHARE OF REVENUES BY REGION



Note: Simple average of most recent observations in available countries. Numbers in parenthesis indicate number of countries represented. Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

Figures 5, 6, and 7 present the association between country size and decentralization for federal and unitary countries separately<sup>15</sup>. The regression line in Figure 5 suggests that GDP per capita is positively associated with higher decentralization in both groups. The positive association is stronger for unitary countries. The steeper regression line for unitary countries implies that the increase in income levels has a stronger effect on subnational governments' expenditure levels in unitary countries than it has in federal countries. Also, the higher value of  $R^2$  for this group of countries indicates that regression analysis has a stronger explanatory power than federal countries. Overall, the positive association of decentralization and GDP per capita suggests that an increase in income increases expenditure levels for subnational governments in both groups.

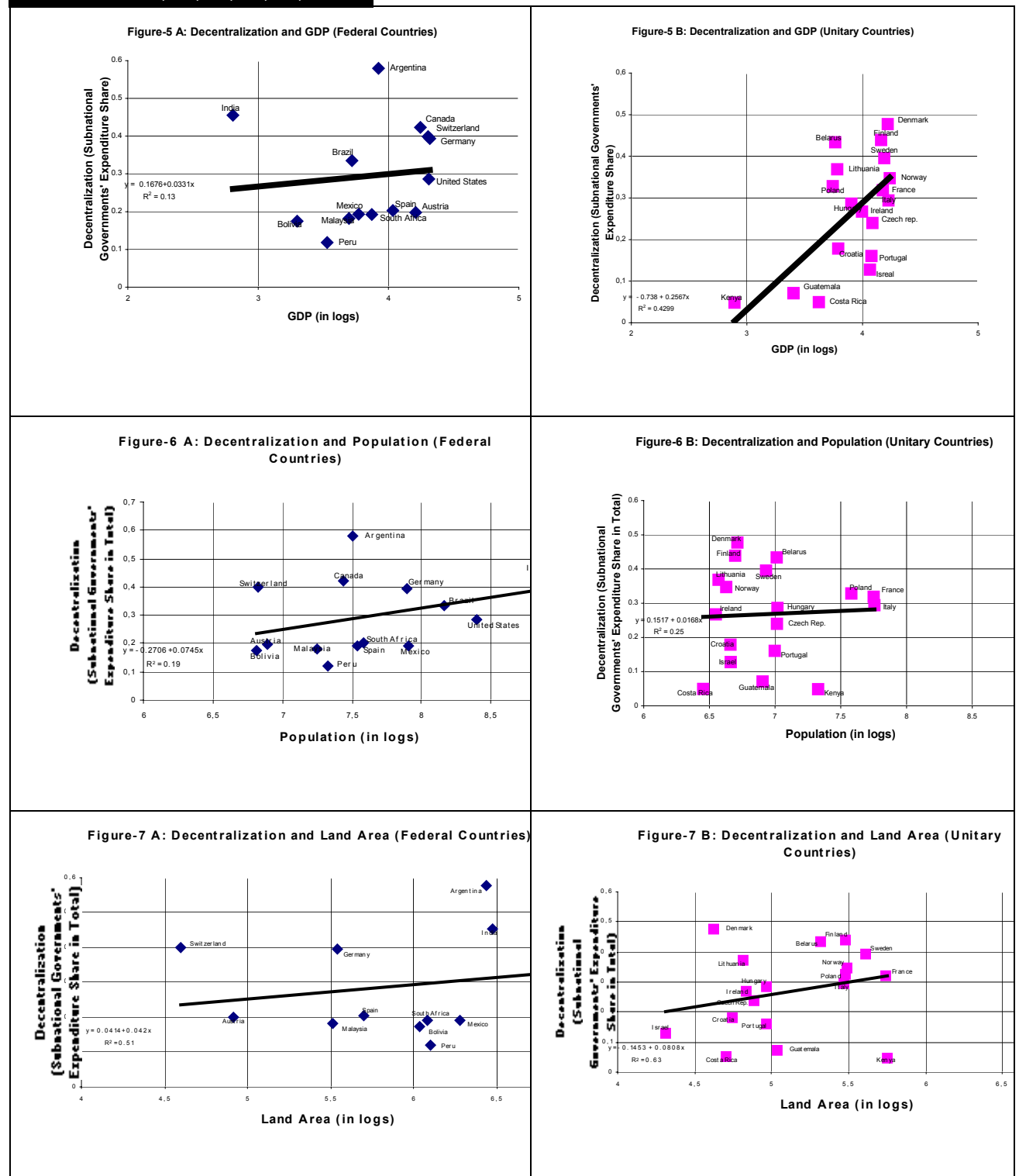
Figure 6 presents the association between population and fiscal decentralization for the same group of countries. It appears that population is positively associated with higher level of subnational governments spending in both groups also. Unlike GDP per capita, the positive association of population and decentralization is stronger for federal countries than unitary countries. The stronger association of population with fiscal decentralization in federal countries is consistent with the argument that as country size gets bigger, subnational governments are expected to play an important role in delivering public services.

Figure 7 shows the relationship between the third size variable and decentralization. The positive slope of regression line suggests that land area is positively associated with higher decentralization. The magnitude of the impact of land area on fiscal decentralization is stronger for unitary countries than federal countries.

The estimation results suggest that size variables have a reasonable level of explanatory power in analyzing the differences in the degree of decentralization across countries. Among the size variables, GDP per capita and population have the strongest effect on the level of decentralization in unitary and federal countries, respectively.

<sup>15</sup> The figures for subnational governments' expenditure share are from GFS used in Figure 1 and the size variables are from World Development Indicators of the World Bank.

FIGURES 5A, 5B, 6A, 6B, 7A, 7B



#### 4. HOW TO DECENTRALIZE?

The transfer of authority and responsibility over public functions from the central government to subordinate or quasi-independent government organizations covers a broad range of topics (World Bank, 1999). There is no prescribed set of rules governing the decentralization process that apply to all countries. Decentralization takes different forms in different countries, depending on the objectives driving the change in structure of government.

In general, decentralization of public policy making power is transfer of legal and political authority for planning projects, making decisions and management of public functions from the central government and its agencies to subnational governments. Taking advantage of their capacity to tailor services to the needs and preferences of communities, subnational governments are in a good position to provide public services whose benefits are localized. Devolution of resources and decision-making power is expected to result in improvement in the life quality of the population. Power can be transferred on three fronts: political, administrative, and fiscal. Although each type of decentralization has different characteristics, system outcomes, and policy implications, the expected impact in each of them is an improvement in the life quality of the population (see Figure 8). Ideally, this is the case for a good decentralization practice that is people oriented.

While distinguishing among different types of decentralization is useful for highlighting its many dimensions, it is impossible to disentangle the inter-linkages between these three concepts. Political decentralization aims to give citizens and their elected representatives more power in public decision-making. The concept implies transfer of policy and legislative power to citizens and their democratically elected representatives at the local level. Political decentralization is often associated with pluralistic politics and representative government. If necessary, it requires constitutional or statutory reforms, development of pluralistic political parties, strengthening of legislatures, and creation of local political units and encouragement of effective public interest groups.<sup>16</sup>

Administrative decentralization seeks to redistribute authority, responsibility, and financial resources among different levels of government (Rondinelli, 1999). Administrative decentralization can be done in two different ways: functional and areal distribution of power (Rondinelli, 1981). Functional distribution is the transfer of authority to specialized organizations that operate across jurisdictions. An example of functional distribution is creation of field offices within national ministries dealing with health care, education, and transportation issues. Areal distribution of power aims to transfer of responsibility for public functions to institutions within specified geographical and political boundaries. Usually, areal distribution of power is to a subnational government - a province, district, or municipality.

In administrative distribution of power, an essential distinction with important implications on intergovernmental relations system is the form of decentralization: deconcentration, delegation, and devolution.

1. Deconcentration involves the shifting of responsibilities from central government agencies located in the capital city to regional offices. Rondinelli (1981) defines deconcentration as local administrations in which all subordinate levels of government within a country are agents of the central authority either appointed by or are responsible directly to central government. This is the least extensive type of administrative decentralization.
2. Delegation refers to the transfer of public policy making and administrative authority and/or responsibility for carefully spelled out tasks to institutions and organizations that are either independent or under central government's indirect control. Typically, delegation of functions is by the central ministries to semi-autonomous organizations not wholly controlled by the central government but legally accountable to it, such as state owned enterprises, public utilities, and regional planning and economic development authorities.
3. Devolution is the most extreme form of decentralization where independently established subnational governments are given the responsibility for delivery of a set of public services along with the authority to impose taxes and fees to finance services. In a devolved system, subnational governments have independent authority to raise their own revenues and to make investment decisions. It is devolution of administrative power that underlies decentralization of power on political fronts.

Devolution is usually synonymous to fiscal decentralization where subnational governments have clear expenditure assignments, substantial budget autonomy, and legally recognized geographical boundaries within which they perform public functions. Although the varieties of fiscal decentralization may exist, corresponding to the degree of independent decision making exercised at the subnational level, the general description of the term fiscal decentralization encompasses the political, economic, and institutional underpinnings of intergovernmental fiscal relations, and ranges

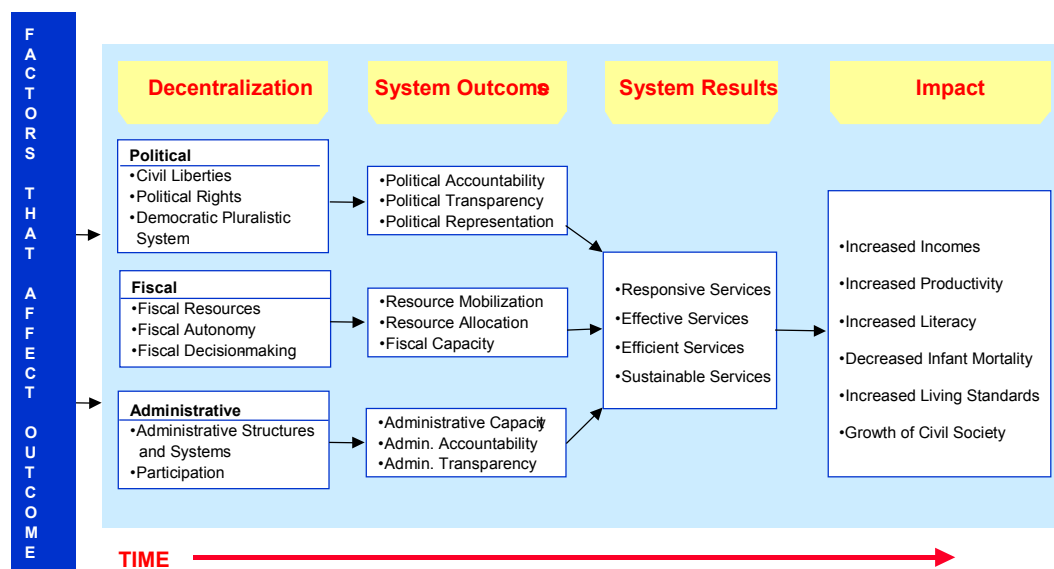
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<sup>16</sup> *Op. cit.* Rondinelli (1999).

from examining the efficiency of public institutions and developing sustainable infrastructure finance, to rationalizing fiscal transfer mechanisms and supporting the social safety net (Ebel and Hotra, 1997). Therefore, a carefully designed fiscal decentralization policy should not only enhance local autonomy where subnational governments are allowed to act independently within their own sphere of competence in designing revenue and expenditure policies but also promote political accountability, economic efficiency and transparency.

FIGURE 8

### -Decentralization on Three Fronts



Source: Adapted from Parker, Andrew N. 1995. *Decentralization: The Wayforward for Rural Development?* Policy Research Working Paper 1475. The World Bank, Washington, D.C.

There is no easy answer to the question of how to design a decentralization strategy to promote transparency, accountability, and efficiency in intergovernmental financial system. Ideally the intergovernmental fiscal system should function leaving little room for ambiguity and negotiations among different levels of government. Therefore, an important component of a decentralization strategy is designing a legal and regulatory framework that would provide guidance to different levels of government in sorting out the roles and responsibilities.

In the process of decentralization, the constitution should enshrine the broad principles on which decentralization is to operate, including rights and responsibilities of all levels of government, the description, and role of key institutions at central and local levels, and the basis on which detailed rules may be established or changed (Ford, 1999). The specific parameters of the intergovernmental fiscal system and the institutional details of the local government structure must be defined in the laws governing relations across governments. Ford (1999) lists the issues that the legal framework of reform efforts should address as:

- ◆ Classification of local governments within tiers established under the constitution;
- ◆ Broad organization structures and their roles and responsibilities;
- ◆ Terms of office, operating powers, procedures, and limitations of the political leadership, as distinct from the civil service;
- ◆ The degree of autonomy of personnel policies and administration of local governments;
- ◆ The taxing and fiscal administration authority of local governments;
- ◆ The borrowing authority and capacities of local governments;
- ◆ The distribution of budgeting, expenditure management, accounting, auditing, and reporting requirements;
- ◆ Service provision and delivery authority;
- ◆ The mechanisms for citizen participation and voice.

## 5. FOUR PILLARS OF INTERGOVERNMENTAL FISCAL SYSTEM

The design of a decentralized system requires "sorting-out" of public sector responsibilities among different types of governments and the process of sorting out entails transfer of some decision-making powers from central to subnational governments (Ebel, Varfalavi and Varga, 2000). Ideally, to achieve the relevant policy objectives, intergovernmental fiscal system should be designed based on each country's specific circumstances. The policy objectives should include not only the public finance goals of efficiency, transparency, and accountability but also should aim at maintaining national integrity and political stability and being equitable to different people and places. Such a design is based on four pillars: expenditure assignment, revenue assignment, intergovernmental transfers/grants, and subnational debt/borrowing (Bird, 2000).

### 5.1. Expenditures

Expenditure assignment is the first step in designing an intergovernmental fiscal system. Designing revenue and transfer components of a decentralized intergovernmental fiscal system in the absence of concrete expenditure responsibilities would weaken decentralization process (Martinez-Vazquez, 1998). In Latin America and Eastern Europe, many countries have focused only on the revenue side of decentralization and neglected a clear assignment of expenditure responsibilities, which led to weak decentralized systems and fiscally overburdened central governments.

The lack of clarity in the definition of subnational responsibilities has a negative impact on three important respects. First, if the responsibilities are imprecise, the necessary corresponding revenues will remain poorly defined. Second, without clear responsibilities, subnational government officials might prefer to invest in populist projects which benefit them in the short run rather than in projects with long term impact on the region's economy (such as infrastructure, education, etc.). Third, there will be a confusion whether subnational expenditures represent local priorities or centrally determined programs.

The "assignment problem" is the most fundamental issue in designing an intergovernmental fiscal system. The theory provides broad guidance in delineating expenditure responsibilities among various levels of governments. However, the key to the success of a decentralized system is matching expenditure responsibilities with the objectives of service assignment.

A report prepared by the US Advisory Commission on Intergovernmental Relations (ACIR) on Governmental Functions and Processes (1974) lists four principles in regards to setting the right incentives for efficient and equitable delivery of public services. As presented in figure 9, these principles are economic efficiency, fiscal equity, political accountability, and administrative effectiveness. They suggest that expenditure assignments should be made to governmental units that can

...(1) supply a service at the lowest possible cost; (2) finance a function with the greatest possible fiscal equalization; (3) provide a service with adequate popular political control; and (4) administer a function in an authoritative, technically proficient, and cooperative fashion.<sup>17</sup>

The principles of expenditure assignment provide a framework to determine whether each function could be best performed by central government or any other level of governmental unit. In more specific terms they relate economic, political, and administrative considerations to the geographic and population size considerations.<sup>18</sup>

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<sup>17</sup> ACIR (1974), p. 7.

1. *Economic Efficiency*: Functions should be assigned to jurisdictions
  - (a) that are large enough to realize economies of scale and small enough not to incur diseconomies of scale; [economies of scale]
  - (b) that are willing to provide alternative service offerings to their citizens and specific services within a price range and level of effectiveness acceptable to local citizenry; [public sector competition]
  - (c) that adopt pricing policies for their functions whenever possible. [public sector pricing]
2. *Fiscal Equity*: Appropriate functions should be assigned to jurisdictions
  - (a) that are large enough to encompass the cost and benefits of a function or that are willing to compensate other jurisdictions for the service costs imposed or for benefits received by them ; [economic externalities]
  - (b) that have adequate fiscal capacity to finance their public service responsibilities and that are willing to implement measures that insure inter-personal inter-jurisdictional fiscal equity in the performance of a function. [fiscal equalization]
3. *Political Accountability*: Functions should be assigned to jurisdictions(a)
  - (a) that are controllable by, accessible to, and accountable to their residents in the performance of their public service responsibilities; [access and control]
  - (b) that maximize the conditions and opportunities for active and productive citizen participation in the performance of a function. [citizen participation]
4. *Administrative Effectiveness*: Functions should be assigned to jurisdictions
  - (a) that are responsible for a wide variety of functions and that can balance competing functional interests; [general-purpose character]
  - (b) that encompass a geographic area adequate for effective performance of a function; [geographic adequacy];
  - (c) that explicitly determine the goals of and means of discharging public service responsibilities and that periodically reassess program goals in light of performance standards; [management capability]
  - (d) that are willing to pursue intergovernmental policies for promoting inter-local functional cooperation and reducing inter-local functional conflict; [intergovernmental flexibility] and
  - (e) that have adequate legal authority to perform a function and rely on it in administering the function. [legal adequacy]

Application of these assignment criteria is not an easy task. These principles might yield conflicting recommendations for expenditure assignment therefore each must be weighted against others in assigning functional responsibilities. For example, political accountability suggests that subnational governments should administer local services, such as education, which require continuous political control. However, if education services are assigned to subnational governments, wealthier jurisdictions will have more financial resources than poor jurisdictions to allocate for this function. Therefore, assigning this function to subnational governments will contradict to fiscal equalization criteria. On the other hand, assigning it to the central government means loss of political control for local residents.

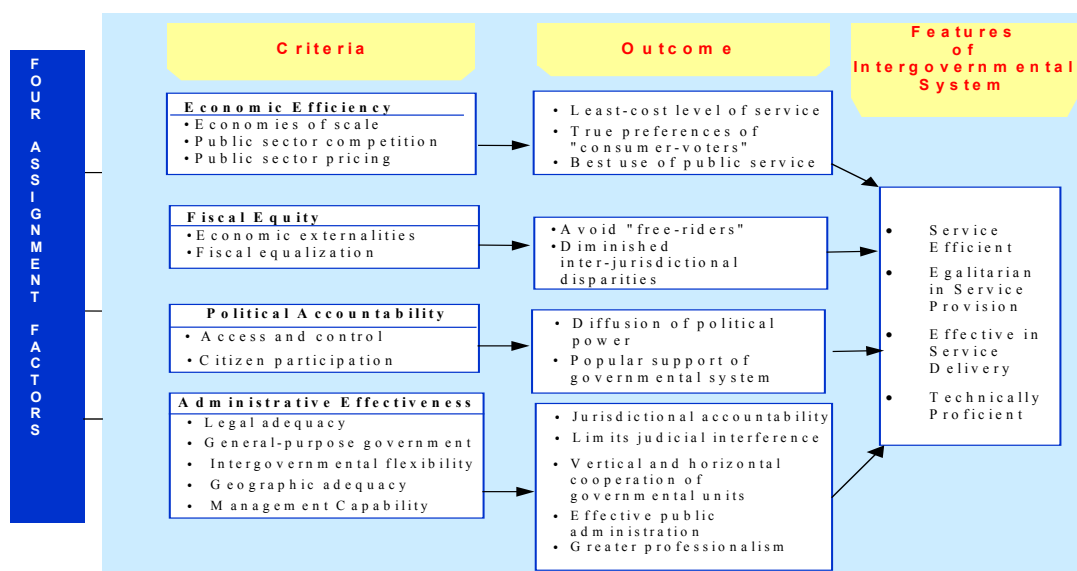
Table 4 provides an overview of expenditures patterns across countries reported in the Government Finance Statistics Yearbook 1998. As seen in the table, functions with high degree of spillover externalities (such as defense and welfare) are exclusively performed by central governments and functions which require high degree of political accountability (such as education) are performed by subnational governments in both federal and unitary countries.

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<sup>18</sup> ACIR (1974), p. 7.

FIGURE 9

Figure-9: Expenditure Assignment Process



Source : Adapted from ACIR. (1974). Governmental Functions and Process: Local and Areawide. Advisory Commission on Intergovernmental Relations, A-45. Washington, D.C.

TABLE 4A

## EXPENDITURE SHARES OF CENTRAL AND SUBNATIONAL GOVERNMENTS IN UNITARY AND FEDERAL COUNTRIES

	Defense		Education		Health		Housing		Police		Recreation		Welfare		Subsidies		Other	
	C	L	C	L	C	L	C	L	C	L	C	L	C	L	C	L	C	L
Albania	100%	0%	20%	80%	70%	30%	68%	32%	100%	0%	65%	35%	81%	19%	63%	37%	75%	25%
Azerbaijan	100%	0%	17%	83%	16%	84%	2%	98%	100%	0%	55%	45%	99%	1%	100%	0%	84%	16%
Belarus	98%	2%	18%	82%	21%	79%	0%	100%	81%	19%	42%	58%	97%	3%	92%	8%	74%	26%
Bulgaria	100%	0%	39%	61%	44%	56%	32%	68%	98%	2%	65%	35%	94%	6%	90%	10%	82%	18%
Croatia	100%	0%	81%	19%	99%	1%	63%	37%	99%	1%	31%	69%	99%	1%	54%	46%	64%	36%
Czech Republic	98%	2%	82%	18%	95%	5%	23%	77%	83%	17%	35%	65%	93%	7%	98%	2%	41%	59%
Denmark	100%	0%	53%	47%	5%	95%	69%	31%	88%	12%	43%	57%	46%	54%	65%	35%	73%	27%
Estonia	100%	0%	45%	55%	97%	3%	1%	99%	99%	1%	61%	39%	91%	9%	56%	44%	62%	38%
Iceland	100%	0%	47%	53%	99%	1%	31%	69%	92%	8%	45%	55%	78%	22%	82%	18%	78%	22%
Kazakhstan	86%	14%	22%	78%	57%	43%	0%	100%	75%	25%	55%	45%	73%	27%	66%	34%	79%	21%
Latvia	99%	1%	28%	72%	95%	5%	20%	80%	93%	7%	53%	47%	94%	6%	91%	9%	66%	34%
Lithuania	100%	0%	30%	70%	98%	2%	0%	100%	97%	3%	61%	39%	91%	9%	99%	1%	78%	22%
Mauritius	100%	0%	100%	0%	100%	0%	77%	23%	99%	1%	79%	21%	99%	1%	100%	0%	91%	9%
Moldova	100%	0%	32%	68%	40%	60%	23%	77%	85%	15%	64%	36%	95%	5%	93%	7%	57%	43%
Mongolia	100%	0%	28%	72%	13%	87%	38%	62%	51%	49%	61%	39%	99%	1%	31%	69%	56%	44%
Norway	100%	0%	37%	63%	23%	77%	13%	87%	83%	17%	35%	65%	81%	19%	85%	15%	66%	34%
Poland	100%	0%	43%	57%	88%	12%	18%	82%	96%	4%	45%	55%	95%	5%	88%	12%	62%	38%
Slovak Republic	100%	0%	100%	0%	100%	0%	40%	60%	95%	5%	72%	28%	99%	1%	96%	4%	73%	27%
Slovenia	99%	1%	76%	24%	99%	1%	22%	78%	94%	6%	55%	45%	99%	1%	77%	23%	81%	19%
United Kingdom	100%	0%	33%	67%	100%	0%	59%	41%	48%	52%	35%	65%	80%	20%	91%	9%	78%	22%

TABLE 4B

	Defense			Education			Health			Housing			Police			Recreation			Welfare			Subsidies			Other		
	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L
Australia	100%	0%	0%	28%	72%	0%	52%	47%	1%	23%	44%	33%	13%	83%	3%	20%	46%	34%	90%	8%	1%	58%	33%	9%	46%	46%	8%
Bolivia	100%	0%	0%	57%	37%	6%	38%	47%	15%	23%	31%	46%	100%	0%	0%	24%	14%	62%	93%	6%	2%	30%	39%	30%	78%	5%	17%
Switzerland	90%	5%	5%	10%	55%	36%	57%	25%	19%	14%	23%	63%	7%	67%	26%	13%	31%	56%	78%	14%	8%	33%	44%	23%	39%	28%	33%
United States	100%	0%	0%	5%	43%	52%	57%	32%	11%	72%	9%	20%	18%	28%	55%	24%	11%	65%	69%	22%	8%	64%	26%	9%	69%	13%	19%
Russian Fed.	100%	0%	0%	14%	NA	86%	15%	NA	85%	7%	NA	93%	73%	NA	27%	15%	NA	85%	90%	NA	10%	89%	NA	11%	64%	NA	36%
Indonesia	100%	0%	0%	93%	NA	7%	91%	NA	9%	98%	NA	2%	99%	NA	1%	100%	NA	0%	100%	NA	0%	14%	NA	86%	100%	NA	0%

C= Central Government, S= State or Provincial Government, L= Local Government

Source: International Monetary Fund, 1998. Government Finance Statistics Yearbook 1998.



## **5.2. Revenues**

The essence of decentralization is that subnational governments have the authority and responsibility to own-finance local services at the margin. Complete fiscal autonomy over revenues requires that in principle local governments can change tax rates and set tax bases. Box 3 illustrates varying levels of local revenue autonomy in different tax designs. The general principles of revenue assignment to different levels of government are listed in fiscal federalism and local government finance literature as (Oates, 1972; Bird, 2000):

1. The tax base assigned to subnational governments should be immobile in order to allow local authorities some freedom to vary rates without the base vanishing. Inter-jurisdictional mobility of tax base makes taxation of mobile factors difficult to subnational governments.
2. Redistributive taxes should be assigned to the central government. Taxes imposed on mobile factors for redistribution purposes might result in inefficient jurisdictional allocation of the factors of production. Uniform redistributive taxes minimize locational distortions of economic activities.
3. Services provided by subnational governments should to the extent possible be financed through user charges and other local fees and taxes that are related to benefits. Efficient allocation of resources requires subnational governments recover their expenses from the beneficiaries of their services. Examples of benefit related revenues include taxes levied on motor vehicles and fuels and construction fees.
4. Taxes that are subject to important economies of scale in collection efforts should be centralized.
5. Taxes subject to cyclical fluctuations need to be protected by a system of counter-cyclical rate adjustments in order to avoid subnational governments exploitation of fiscal power.
6. Taxes levied on tax bases that are unevenly distributed should be centralized. Uneven distribution of tax bases among subnational governments forces the residents of one subnational area bear the economic burden of taxes imposed by another jurisdiction. Taxation of natural resource is the best example of this type of taxation practice.
7. The revenue yield should be stable and predictable over time.
8. The revenue system should be easy to administer efficiently and effectively.
9. Subnational taxes should be visible to encourage subnational government liability.

**Box- 3: Fiscal autonomy in subcentral governments**

Own taxes	Base and rate under local control.
Overlapping taxes	Nationwide tax base, but rates under local control
Nontax revenues	Fees and charges. Generally, the central government specifies where such charges can be levied and the provisions that govern their calculation.
Shared taxes	Nationwide base and rates, but with a fixed proportion of the tax revenue (on a tax-by-tax basis or on the basis of a "pool" of different tax sources) being allocated to the subcentral government in question, based on (1) the revenue accruing within each jurisdiction (also called the derivation principle) or (2) other criteria, typically population, expenditure needs, and/or tax capacity.
General purpose grant	Subcentral government share is fixed by central government (usually with a redistributive element), but the former is free to determine how the grant should be spent; the amounts received by individual authorities may depend on their efforts.
Specific grants	The absolute amount of the grant may be determined by central government or it may be "open-ended" (that is, depend on the expenditure levels decided by lower levels of government), but in either case central government specifies the expenditure programs for which the funds should be spent.

Source: Anwar Shah, *The Reform of Intergovernmental Fiscal Relations In Developing & Emerging Countries*, Policy and Research Series #23, World Bank 1994.

### 5.3. Intergovernmental Transfers

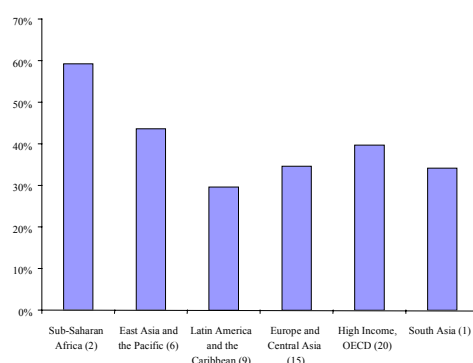
The revenue and expenditure assignments give rise to vertical and horizontal imbalances within a nation's intergovernmental finances. In fact, every intergovernmental transfer system has two dimensions: (i) *the vertical dimension*, concerned with the distribution of revenues between central and local governments; and (ii) *the horizontal dimension*, concerned with the allocation of financial resources among the recipient units.

A vertical imbalance occurs when the expenditure responsibilities of subnational governments do not match with their revenue raising power; the issue of vertical imbalance is widespread in all regions (see Figure 10). At least 30 percent of the subnational governments' revenues come from intergovernmental transfers in all regions. A horizontal imbalance occurs when own fiscal capacities to carry out the same functions differ across subnational governments. In all countries, these imbalances are handled through a variety of transfer mechanism in order to allow subnational governments to perform their assigned functions. Figures 11 through 15 present the importance of intergovernmental transfers in the composition of subnational governments' revenue structure across regions.

There are different forms of transfer mechanism: sharing revenues and tax bases, establishing conditional or unconditional grant systems. Central government and subnational governments can share revenues based on a formula or share a tax base by one of them applying a surcharge on other's tax. In the case of establishing grant system, conditional grants require matching elements by recipient government but unconditional grants are given to recipient government with full discretion to spend. The choice of transfer mechanism depends on the objectives of the intergovernmental policies. If the only concern of the intergovernmental system is to address vertical fiscal gap, this could be achieved either by revenue sharing or by "gap-filling" unconditional grants. The horizontal imbalances can be alleviated with equalization transfers from the central government to subnational government. However, in practice, measuring the horizontal imbalance and relative fiscal capacities of subnational governments is very difficult task and only very few countries review them. The countries that undertake a comprehensive review of horizontal balances are Australia, Canada, and Germany (Ahmad and Craig, 1997).

FIGURE 10

VERTICAL IMBALANCE BY REGION



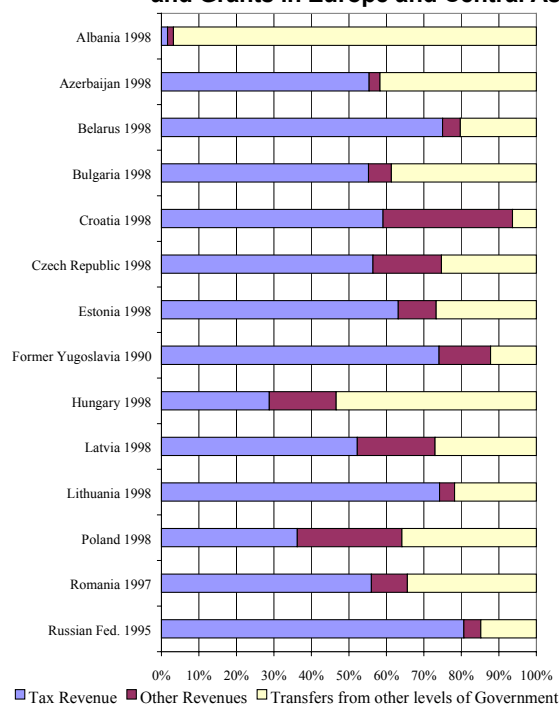
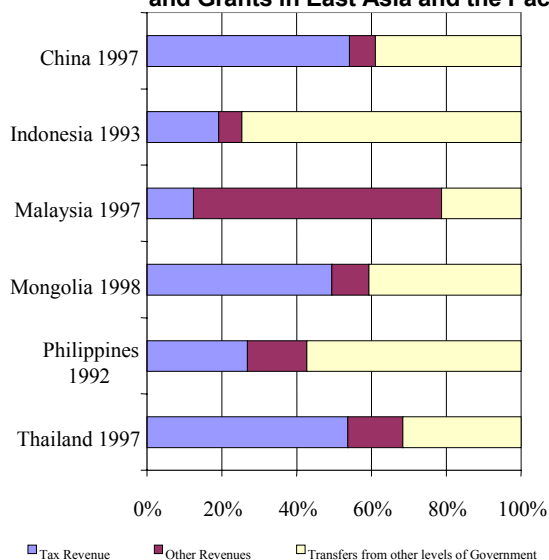
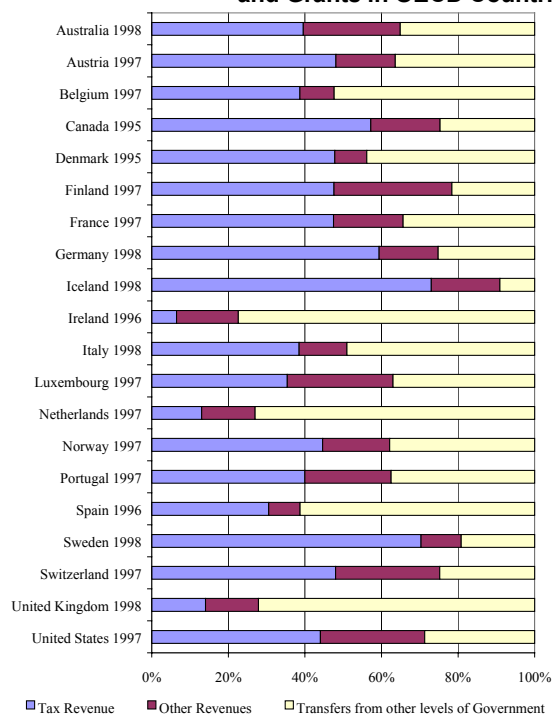
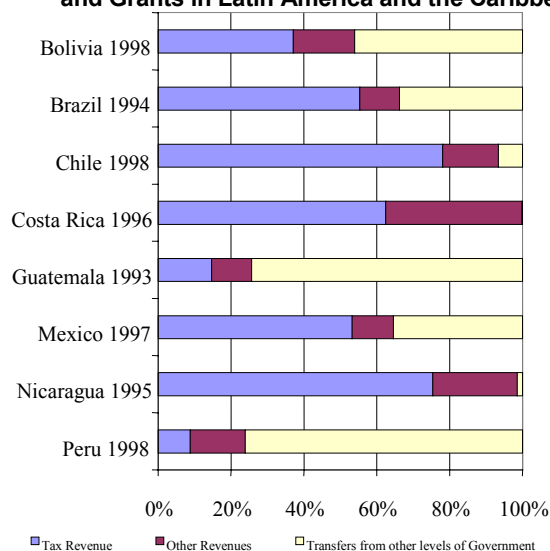
Note: Measured as transfers to sub-national governments as a share of sub-national expenditures. Simple average of most recent observations in available countries. Numbers in parenthesis indicate number of countries represented.

Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

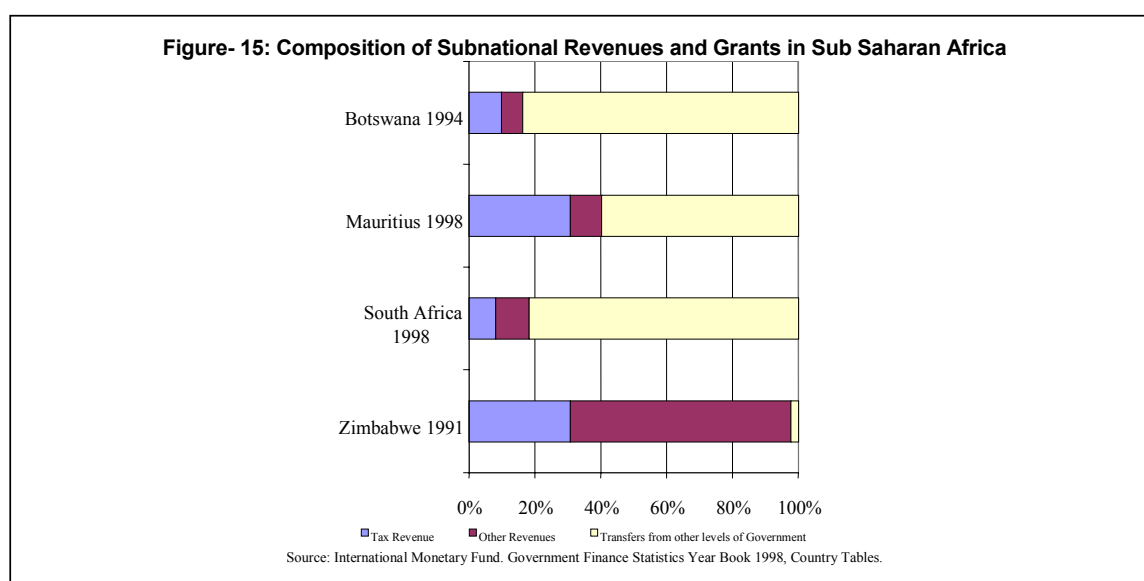
The intergovernmental transfer system of a country usually has diverse objectives to meet and in most cases, these objectives may need to be met through a combination of policy tools. According to Ahmad and Craig (1997), there are three different policy responses to establishing the link between vertical and horizontal balances:

1. Correct each imbalance by separate policy measures: The vertical imbalance at each level is resolved by tax-sharing or grant arrangements. Horizontal imbalances are then resolved by payments from regions with higher fiscal capacity to poorer regions. This is the approach used in Germany.
2. Implement an integrated system of equalization grants: The vertical and horizontal imbalances are dealt with simultaneously through a system of grants, including equalization payments and special purpose grants. This is the Australian and Canadian approach.
3. Correct only the vertical imbalance and ignore horizontal balance: As under the first option, vertical balances are resolved by tax sharing and grants, but no action is taken to correct horizontal imbalances. Capital and labor migration then responds, not only to earned income differentials, but also to the regional net fiscal benefits (net benefit received from government expenditure and of taxes paid). There may be, however, special purpose grants servicing central government objectives, which may also reduce horizontal imbalances at least in some functional areas. This is broadly the approach in the United States.

## FIGURES 11-12-13-14

**Figure- 11: Composition of Subnational Revenues and Grants in Europe and Central Asia****Figure- 12: Composition of Subnational Revenues and Grants in East Asia and the Pacific****Figure- 13: Composition of Subnational Revenues and Grants in OECD Countries****Figure- 14: Composition of Subnational Revenues and Grants in Latin America and the Caribbean**

There are three key factors in the design of intergovernmental fiscal transfers: the size of distributable pool, the basis for distributing transfers, and conditionality (Bird, 2000). Determining the distributable pool has an important impact on the stability of the intergovernmental fiscal relations system. Sharing a fixed percentage of all central taxes is a better way of establishing transfer system rather than sharing on an ad hoc basis. Sharing must be based on the basis of a formula. Discretionary or negotiated transfers are unstable and unpredictable in nature. The formula for revenue sharing should take needs and capacity into consideration. Once the first two factors have been sorted out, the last question is whether the transfer should be made conditional on a measure. Expenditure conditionality ensures that the transfer amount is spent on a specified service. On the other hand, performance conditionality links transfers to a performance criteria.

**FIGURE 15**

#### 5.4. Subnational Borrowing/Debt

There are three primary reasons why subnational borrowing can be considered as an appropriate tool for subnational public finance:

1. **Intergenerational equity:** The benefits of certain investment projects, such as infrastructure and education, are spread over time, which means that not only present residents of a locality, but also future residents will consume the services provided by the projects. Therefore, the benefit principle of taxation suggests that future residents should also contribute the cost of investment. For this purpose borrowing is an appropriate tool that offers a means through which payments for capital projects can be spread over the life of the project so as to coincide more closely with the stream of future benefits (Oates, 1972).
2. **Economic Development:** Delaying infrastructure investments might have a negative impact on subnational economic performance. Such a negative impact will have a direct effect on residents' life in terms of less employment opportunities and decline of earning levels. Therefore, borrowing is an appropriate tool for subnational governments in investing on infrastructure projects to stimulate regional economy.
3. **Synchronization of Expenditure and Revenue Flows:** Access to financial tools offers an opportunity to subnational governments to synchronize expenditures incurred and revenue collection. For a variety of reasons expenditure incurred and tax intake may not be fully synchronized for a particular year. In such a situation, borrowing provides subnational governments to smooth out the mismatch and provide services without disruption.

There are at least two different channels through which subnational governments can borrow: through a public intermediary such as infrastructure bank or direct borrowing from private capital markets. The international experience suggests that lending through a public entity, either central government lending or public financial intermediary, suffers from political favoritism (World Bank, 1990). Direct access to private markets entails development of market-based

relationship between lenders and subnational governments, which requires the use of private credit rating and bond insurance agencies to monitor subnational borrowing. Establishing these institutions offers a potential for improving transparency and political accountability in local government management. As capital markets emerge, residents of local governments would learn more about the financial health of their governments.

Subnational borrowing is an important component of the devolution of fiscal powers to local authorities. However, a well-designed regulatory framework for subnational borrowing is necessary to ensure that subnational borrowing does not provide perverse incentives to lending institutions and subnational governments for excessive lending and borrowing. Such a framework includes standardized accounting procedures for subnational governments, disclosure of subnational governments' liabilities and repayment capacity (see Figure 16). However, these measures by themselves will not be sufficient to curb moral hazard problem. The macro concern of moral hazard occurs when subnational governments are backed by the central government by providing guarantees to their borrowing. In these circumstances, the incentive structure is set for excessive borrowing of subnational governments, which would ultimately lead subnational governments to default on loans.

**FIGURE 16**

**REGULATORY FRAMEWORK FOR SUBNATIONAL BORROWING  
IN TRANSITION COUNTRIES**

Country	Are local governments allowed to borrow?		Is there a regulatory framework for borrowing?	Are there any limitations on borrowing?	Are the purpose for which money can be borrowed limited?	Is there regulation for municipal bankruptcy?
	At Home	Abroad				
Albania	Yes		Yes			
Armenia	Yes	No	Yes	Yes	No	No
Bulgaria	Yes	Yes	Yes	Yes	Yes	No
Croatia	Yes	Yes	Yes	Yes	Yes	No
Czech Rep.	Yes	No	Yes	No	No	No
Estonia	Yes	Yes	Yes	Yes	Yes	No
Hungary	Yes	Yes	Yes	Yes	No	Yes
Kazakhstan	Yes	No	Yes	Yes	Yes	No
Kyrgyz Rep.	Yes		No			No
Latvia	Yes	Yes	Yes	Yes	Yes	No
Lithuania	Yes		Yes	Yes	Yes	No
Poland	Yes		Yes	Yes	Yes	No
Romania	Yes	Yes	Yes	Yes		No
Russia	Yes	No	Yes	Yes	Yes	No
Slovakia	Yes	Yes	No	No	No	No
Slovenia	Yes		Yes	Yes	Yes	No
Ukraine	Yes	Yes	No		Yes	No

Source: Deborah Wetzel, 2001. "Decentralization in the Transition Economies: Challenges and the Road Ahead" PREM, World Bank.

A common proposal to deal with subnational governments' default on loans is to institute limits on the borrowing ability of subnational governments (Ter-Minassian and Craig, 1997). There are two reasons limiting subnational governments' borrowing ability (Bird, 2000). First, if there is no constraint on subnational governments borrowing, the propensity to behave in a fiscally irresponsible way is very high. In the absence of the checks and balances of the subnational debt issuance mechanism, subnational governments may increase their current expenditures well above their capacity to finance them and close the gap through borrowing, especially in countries where general inability of central governments to impose hard-budget constraints exist. The second reason for imposing restrictions on subnational borrowing is macroeconomic stabilization. Since central government has the responsibility for stabilization policies, it is important that it has full control over public debt.

## 6. CONCLUDING REMARKS

This module has stressed that fiscal decentralization is a multifaceted complex issue. Legal and constitutional framework, as well as institutional structure of the public administration system in each country has a bearing on the outcome fiscal decentralization application. The success of fiscal decentralization reforms is inextricably tied to the

question of "sorting-out" public sector responsibilities among different levels of government. There is no prescribed set of rules for "sorting-out" that apply to all countries.

Although specific aspects of fiscal decentralization process can be worked out in the context of each individual country, the common components of designing a decentralized system of intergovernmental fiscal relations in all countries are assignment of responsibilities for governmental functions, assignment of the power among levels of government to tax people and collect revenues, the nature of intergovernmental transfers system and ability of subnational governments to borrow.

The failure to design these interrelated components in a consistent way may lead to undesirable results. However, the issue of designing an effective intergovernmental structure is not limited to these components. It involves electing local government officials, having approved budget locally, absence of mandates on local governments as regards to employment and salaries, keeping adequate books of account and monitoring, and monitoring progress towards an effective fiscal decentralization.

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## FISCAL FEDERALISM IN BELGIUM

By Marcel Gérard

Belgian federalism is an evolving federalism and any portrait of it is nothing more than the representation of a temporary, often precarious balance, on a course whose outcome is uncertain. It is, therefore, necessary to situate the present in this movement and I will begin this study with a necessary historic overview of the entities that now comprise this distinctive federation called Belgium. Next, I will present this original experience and examine the devolution of fields of jurisdiction and the elaboration of the means used.

Beyond its complexity, and perhaps because of it, Belgian federalism is an interesting, even fascinating experience, insofar as its profile changes depending on the question at hand: the federated entities that assume responsibility for cultural or personal matters do not exactly cover the geographic areas of the federated entities that are responsible for questions more directly related to the territory, such as the economy. Is this not an attempt, albeit an imperfect one, to recognize the multifaceted nature of humankind? Moreover, is it not an attempt to reflect in institutional mechanisms that belonging to a culture or the sharing of a language are not necessarily identified with rootedness within a clearly defined territory? An economist, theorist or practitioner of the public economy knows that relevant territory with respect to public property may vary depending on the property: the territory of a theatre differs from that of a centre for disabled workers, which, in turn, is not the same as that of a job-creation policy in an area experiencing negative growth.

### 1. A LOOK AT THE PRESENT

As I indicated in the introduction, an examination of the present demands a brief look at history and some relevant contemporary data.

#### 1.1. A bit of history...

Belgium<sup>1</sup> is a hodgepodge resulting from the assembly, through marriage, conquest and treaty, of a series of geographic entities, vassals of the king of France or the German emperor, dotted with cities jealous of their privileges.<sup>2</sup> In the 15th century, the same person was the prince of a series of earldoms and duchies that included, broadly speaking, in addition to other territories that are now part of France, such as Franche-Comté and Burgundy, the current kingdoms of Belgium and the Netherlands, excluding the episcopal principality of Liège, whose territory at the time covered a large part of Wallonia and the Flemish province of Limburg. It is his descendant, Charles V, who also became king of Spain, emperor of Germany and sovereign of part of Sicily and the Americas, who proclaimed in 1519 the indivisibility of the Netherlands, comprising 17 provinces.

The success of Protestantism in these territories, more so in the northern than the southern portion, threatened the unity of the 17 provinces and encouraged Philip II to engage in internal reconquest, which stopped just north of Antwerp. This boundary of the Catholic reconquest, attributable to the sovereign's decision to turn his arms instead against England (in what became the Invincible Armada fiasco), determines even today the border between the Kingdom of the Netherlands (the United Provinces, which became independent in 1579) and the Kingdom of Belgium. The 10 southern provinces remained Spanish, then became Austrian in 1713 before becoming independent in 1790, very briefly as the "États Beligiques Unis," or *United Belgian States*, i.e. several states, not just one state, in which central power was absent. The Brabant revolution did not last long. Joined with the Principality of Liège, in 1792 these states became the "Belgian Provinces" of France, i.e. French Departments.

The Kingdom of the Netherlands was established in 1814 by prerogative of William of Orange, who was hardly receptive to the religious and linguistic originality of his southern subjects and the French-speaking bourgeoisie, which fomented the revolution that led, in 1830, to the establishment of the Kingdom of Belgium.

The result was a French-speaking state headed by a French-speaking bourgeoisie. While the official language of the Kingdom of the Netherlands was Dutch, French was the official language of the Kingdom of Belgium of 1830. French was the language of the bourgeoisie and of the governing class, the only voting one, both in Flanders and today's Wallonia.<sup>3</sup> The people in the Flemish part of the country did not understand French and people in Wallonia still did not master it: Flemish, Walloon, Picard and Lorraine are dialects. Since the inhabitants of Brussels were closer to power,

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<sup>1</sup> See *Comprendre la Belgique Fédérale*, De Boeck and Larcier / La Ligue des Familles, Bruxelles, 1997; see also Perin (1988).

<sup>2</sup> Charters recognized the cities' privileges, especially their right to autonomous internal management. Upon his accession, the prince was asked to come and confirm the charter. At that time, he made his joyful entrance into the city.

<sup>3</sup> On the use of French in Belgium and Europe in that time, see a.o. Mabilley (1997), pp. 126-127, who quotes Gubin (1979), pp. 26-27.

they increasingly became French-speaking: in 200 years, the proportion of French-speakers and Dutch-speakers in Brussels was reversed (Dutch-speakers roughly account for 15% of the population today).

In Belgium, which was officially French-speaking but in which a majority of the population did not understand the language, it is easy to imagine what happened when the right to vote became widespread, first plural voting, then universal male suffrage and women's suffrage in 1945.<sup>4</sup> The Flemish movement obtained "language legislation," i.e. the possibility of using Flemish in the justice system in 1873, in the administration in 1878, in education in 1883, in the universities in 1932, and demanded "cultural autonomy."

Until after World War II, Flanders, where a majority prevailed, was agricultural and relatively poor. However, Wallonia, to the south, where a minority prevailed, was one of the world's most industrialized regions. Alas, such industry relied, by and large, on coal, a non-renewable resource, and the attendant iron smelting. It was in the hands of Belgian capitalism, which gradually withdrew from the Walloon industrial sector instead of reconverting its industries.

The Walloon movement shifted from defending a language in the first half of the century to demanding "economic regionalization" when, starting in 1958, coalmine closings, the prelude to a lengthy descent into economic hell, sounded the death knell for prosperity built on iron and coal. In light of Belgian capitalism's detachment, Walloon leaders demanded "structural reforms" and the substitution of public initiative for faltering private capitalism. This occurred in the 1960s, which marked the apogee of ideologized Keynesian economics.

In the meantime, the Flemish Region discovered an industrial vocation centred on a network of small businesses, i.e. local capitalism, the attraction of the port of Antwerp and massive US investment in the 1960s. It also discovered that within the Belgian state it had become the wealthy and thus the "transferring" entity to the Walloon Region, without which it could manage very well.

Thus, Belgian federalism is the outcome of an "anti-French-speaking bourgeoisie" social movement, characterized in the north by solidarity in respect of a language, which would turn into jealousy over a territory when the French-speaking Brussels bourgeoisie swarmed out of the city, and focused in the south on a mythical economic autonomy that was supposed to revive employment and preserve well-being.

One feature of that federalism was the introduction of a "language boundary." Designed in the 1960s to determine exclusive language areas for administrative purposes, French in the South, Flemish in the North, and the bilingual area of Brussels as well, the border was further used to fix the territory of the Regions (see the appended maps) and received a constitutional status making it quasi definitive. As a consequence, the bilingual Region of Brussels-Capital has a territory clearly smaller than the one of the effective urban agglomeration of Brussels.

Today, Belgian federalism is part of a broader one more closely aligned with the European model. In certain fields, the Belgian federal entity is now little more than an intermediate, almost useless cog between the Belgian Regions and the European authorities. It is significant that, following the very recent Belgian institutional agreement in the spring of 2001, which completed, in particular, the transfer to the Regions of jurisdiction over agriculture, a field that is clearly under European responsibility, the federal minister of agriculture resigned, then promptly took up the same portfolio in the Flemish government.

## 1.2. and some current data

Contemporary Belgium presents a number of contrasts.

In the heart of this small country of roughly 10 million inhabitants, "Brussels appears today like a large, highly internationalized metropolitan centre that is benefiting from European unification and economic globalization, but its development is obliterated by a political framework that limits its territory and reduces its possibilities for financing. In contrast with the Flemish Region, Wallonia is experiencing a level of unemployment and economic development, measured by per-capita GDP, that is more similar to the one of Spain than to the one of Germany or the Netherlands" (Gérard, 1999, translated), as indicated in Table 1, drawn from Capron (2000). Furthermore, "the dominant socio-economic web of Wallonia is rather unfavourable to growth" (Gérard, 1999, translated) since "a socio-political structure in which social struggles are rooted in tradition is hardly attractive to capital" (Van Hamme, 1998, our translation) and "this historic process explains that in the old industrial zones the pool of potential entrepreneurs has been eroded by premature salarization in big industries" (*ibid.*)

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<sup>4</sup> The right to vote was extended to European Union nationals in respect of local elections, starting with the communal elections in 2000.

TABLE 1

**PER CAPITA GDP IN THE REGIONS OF BELGIUM**  
(European Union mean: 15 = 100)

	Walloon Region	Flemish Region	Brussels-Capital Region	Belgium
1955	103	92	155	103
1965	93	93	163	100
1975	90	106	161	107
1985	87	106	167	106
1996*	90	116	174	113

\*1996 data include the new German Länder.

Source: Capron (2000).

However, Gérard (1999, translated) goes on to say that “the levels of well-being measured in terms of poverty and inequality are similar and place Wallonia and Brussels, like Belgium as a whole, among the least poor, most egalitarian countries in Europe and the world. In 1994, monetary poverty, i.e. the relative importance of households having at their disposal at best half of the median income, i.e. 37,815 BEF (937.4 €) monthly for a household with one child and 17,200 BEF (426.4 €) for an isolated individual, represented 4.7% of households.<sup>5</sup> [...] As for income distribution, it is often evaluated using an interquartile ratio of the income of the wealthiest quarter of the population and the poorest quarter. In 1994, the ratio stood at 3.31. A comparison of the Regions reveals rates of 3.3% in Brussels, 4.6% in Flanders and 5.5% in Wallonia and, based on 1995 fiscal data, 5.2% in Flanders and 5.9% in Wallonia. However, the interquartile ratio is higher in Brussels than in Flanders and in Wallonia, i.e. 3.44, 3.31 and 3.23, respectively. [...] These figures rank Belgium with the Scandinavian countries and the Netherlands, among the European countries with the lowest poverty rates.<sup>6</sup> The same is true with respect to inequality: Belgium and Sweden are the most egalitarian countries.<sup>7</sup> [...] Belgian's good performance, irrespective of Regions, stems from highly efficient social protection that provides substantial replacement income and quality health care services that are available to everyone at very low individual cost.”

Consequently, it is understandable that French-speaking, especially Walloon, political leaders especially value the unity of this social protection, especially social security, but also the centralized determination of salaries<sup>8</sup> and a common perspective on the progressive graduation of income tax, while the Flemish representatives regularly propose its partial defederalization. Social security causes implicit transfers from the Flemish Region to the Walloon and Brussels-Capital Regions: “from the studies of Van Rompuy and Verheierstraeten (1979) up to the study by De Boeck and Van Gompel (1998),” writes Docquier (1999, our translation), “many studies have attempted to estimate the scope of interregional solidarity by breaking down public spending aggregates. [...] Substantial amounts have been put forward. [...] De Boeck and Van Gompel (1998) conclude that 186.5 billion BEF (4.6 billion €) were transferred in 1996 from Flanders to Wallonia.” Three main causes can explain these transfers: differences in economic performance and, therefore, in ability-to-pay, demographic structure (the population of Wallonia is older), and health care spending habits (the Walloons spend more in respect of a given objective risk). Cattoir and Docquier (1999, our translation) estimate these transfers at 68.9 billion BEF (1.7 billion €) to Wallonia and 23.2 billion BEF (575 million €) to Brussels. These authors suggest that “most of the implicit transfer stems from differences in ability-to-pay. Less than 20% of these transfers are attributable to differences in spending.”<sup>9</sup>

The following data, drawn from Docquier (1999), illustrate the foregoing observations. They complete the data presented in Table 1 and also support the comments of the Conseil Supérieur des Finances (1999).

<sup>5</sup> See B. Delhaussse and S. Perelman, 1998, also reproduced in Docquier (editor), 1999.

<sup>6</sup> On this point, B. Delhaussse and S. Perelman refer to B. Cantillon, I. Marx and K. Van den Bosch, 1997.

<sup>7</sup> See A.B. Atkinson, L. Rainwater and T. M. Smeeding, 1995.

<sup>8</sup> Salaries in Belgium result largely from collective agreements negotiated between workers' and employers' representatives in a business, industry sector or the country overall and not the region. Sectoral and national agreements, called “intersectoral” agreements, are imposed by law on all businesses.

<sup>9</sup> According to some experts, including permanent Deputy Minister for Social Affairs M. Jadot, there are major differences between Eastern and Western parts of the country than between Northern (Flemish Region) and Southern (Walloon Region) parts.

TABLE 2

	REGIONAL INDICATORS			
	(% of the total)			
	Walloon Region	Brussels-Capital.	Flemish Region	Belgium as a whole
Population, 1999	32.7	9.2	58.1	100
GDP, 1996	24.9	14.5	60.6	100
Taxable, 1996	30.4	8.6	61.0	100
Tax, 1996*	28.9	9.1	62.0	100
65 and over, 1996	16.3	17.4	15.6	16.0
20 and under, 1996	24.9	23.1	23.7	24.0
GDP growth 85-96	1.58	1.28	2.47	2.03
GDP growth, 91-96	1.13	0.57	1.59	1.28
Unemployment, 98	13.3	16.5	5.3	8.9

\* Personal income tax (impôt des personnes physiques or IPP).

Source: Docquier (1999).

For that latter agency, Belgian federalism cannot be studied without taking into account nine of the country's characteristics: the open nature of its economy, its high indebtedness ratio, its high tax pressure, unequal distribution of added value among the Regions, changes in taxable income to the detriment of Brussels and in favour of Flanders, differences in the evolution of the real estate market (more at the level of the "arrondissements" than the Regions), more extensive and structural unemployment in Wallonia than in Flanders, the growing importance of the "language boundary" as a barrier to migration, and the greater intensity of economic relations between the Regions than population movements.

## 2. TWOFOLD, CHANGING FEDERALISM

Belgium maintains a twofold federalism,<sup>10</sup> centred on cultural or linguistic Communities, on the one hand, and regional or territorial divisions, on the other hand, even though the territory of the Communities is also fixed. Indeed, since it was amended in May 1993, the Belgian Constitution begins with the statement that Belgium is a federal state which consists of Communities and Regions.

The *Communities* are organized on linguistic lines and are responsible for services pertaining to individuals, such as education, culture and health. There are three Communities, i.e. the Flemish Community, the French Community, now also called the Wallonia-Brussels Community, and the small German-speaking Community. The *Regions* are organized on territorial lines and are responsible for matters such as the economy, agriculture and employment. There are three Regions, i.e. the Flemish Region, the Wallonia Region, and the Brussels-Capital Region.

*The territories of the Communities and Regions differ*, as Table 3 below illustrates. Each entity has a legislative and an executive body. However, the bodies in the Flemish Community and the Flemish Region have been merged, while in the territory of the Brussels-Capital Region, three bodies *de facto* integrated within the regional body, i.e. the French Community Commission, the Flemish Community Commission and the Two-Community Commission assume responsibility for Community fields of jurisdiction. Furthermore, since 1993, certain fields of jurisdiction of the French Community have been assumed, in Wallonia, by the Walloon Region.

<sup>10</sup> See the maps in the appendix.

TABLE 3

BREAKDOWN OF FEDERATED LEVELS IN BELGIUM				
Federal level	Belgian state: 10 million inhabitants			
Community level	German-speaking 0.06 million inhabitants	French-speaking		Flemish
Regional level	Wallonia 3.3 million inhabitants	Brussels-Capital 1 million inhabitants		Flemish 5.9 million
Language used	German	French	Bilingual (French and Dutch)	Dutch

Source : *Comprendre la Belgique Fédérale*, op. cit.

It should be noted that Belgium does not have regional or Community sub-nationalities.<sup>11</sup> All Brussels voters may vote in regional, senatorial (and thus Community) and European elections for candidates from the French electoral college or the Flemish electoral college. Only candidates in the elections of the Brussels regional council must irrevocably choose their linguistic affinity.

*The jurisdictions for which these entities are responsible and the means at their disposal stem from a federalization process marked by various stages, which in themselves represent as many compromises between the partners.*

Cattoir (1988)<sup>12</sup> summarizes the first four stages. A fifth stage must now be added, which has been adopted in the summer of 2001.

The first stage was the introduction in the Constitution of the concepts of Community and Region, on December 24, 1970. This decision gave Belgian federalism one of its defining characteristics, i.e. the twofold federalism mentioned earlier, which Cattoir calls “the coexistence, next to the federal level, of a dual federated one.”

The second stage allowed for the definition of the fields of jurisdiction of the Communities and the territories of the Regions, introduced the merging of the Flemish Community and the Flemish Region, and attributed financial means to the federated entities, through the so-called “special” laws of August 8-9, 1980, voting on which required a majority in each of the two linguistic groups in the federal parliament and an overall two-thirds majority. At that time, Cattoir has noted, the financing for the Regions was assured primarily by a transfer from the central government defined in light of three identically weighted criteria, i.e. population, revenues generated by personal income tax and surface area (the so-called “three-thirds” rule), and the financing for the Communities was based on a 45/55 rule, corresponding, by and large, [...] to the relative demographic importance of the French and Flemish Communities.

The third stage, in 1988-1989, saw the establishment of the Brussels-Capital Region, with its specific bodies, including the Community commissions (under the special law of January 12, 1989), the transfer to the Communities and Regions of new fields of jurisdiction (nearly one-third of state spending, under the special law of August 8, 1988), and the organization of a modified financing system that placed greater emphasis on the principle of territoriality from the standpoint of tax collecting (under the special law of January 16, 1989).

The year 1993 marks a turning point in the history of Belgian federalism. It is then, writes Cattoir, that the State became federal and residual power was attributed to the federated entities: the so-called “Saint-Michel” and “Saint-Quentin” agreements (each referring to the saint’s day on which the agreement occurred) gave the Communities and Regions new means, attributed new fields of jurisdiction to the Regions, especially in the realms of agriculture and foreign trade, and transferred certain jurisdictions from the French Community to the Walloon Region and the French Community commission of the Brussels-Capital Region (under the special law of July 16, 1993).

The spring of 2001 saw a new round of negotiations among the political parties with a view to further broadening the fields of jurisdiction of the federated entities and their ability to gain broader control over the means at their disposal. Simply stated, the Flemish parties wanted broader fiscal autonomy, especially in order to reduce taxes, and the French-speaking parties wanted more extensive means to fund education, an endemic problem in the French Community, which had been bled white financially for many years. Valenduc (2002) has noted that the recent institutional or ‘Saint-

<sup>11</sup> The fact that there is no Community sub-nationality is to be related to the fact that the territory of the Community is fixed; it could be expected indeed that Community belonging be independent of the location of the individual.

<sup>12</sup> Ph. Cattoir, 1998, *Fédéralisme et solidarité financière, étude comparative de six pays*. Brussels: Crisp, pages 23 *et seq.* I am quoting (and translating) pages 22 and 23 which clearly describe these first four stages.

Polycarpe' agreement, radically modified the division between the federal and regional governments of jurisdiction over fiscal policy.

Thus, Belgium is a federal State comprising three Communities and three Regions, whose areas of jurisdiction and the means at their disposal I will examine later. As noted earlier, *the exercising of such jurisdiction occurs against a backdrop of complicated institutional entanglement* since some Community fields of jurisdiction are exercised by the Regions, and vice versa.

In its 1998 report, the Conseil Supérieur des Finances<sup>13</sup> observed, first of all, that the Flemish Community simultaneously assumes responsibility for fields of jurisdiction attributed to the Community and those attributed to the Flemish Region. The merging of the Flemish legislative and executive branches has created asymmetry in the Belgian federal system, i.e. a Flemish government sitting in Brussels, which is located outside the Flemish Region but in an area where the Flemish Community exercises authority, but two French-language governments, i.e. the government of the French Community in Brussels and that of the Walloon Region in Namur – although its jurisdiction includes the territory of the small German-language Community, the Walloon government is *de facto* French-speaking –.

As for the French Community, while it assumes responsibility for all of the fields of jurisdiction attributed to the Community, it has nonetheless transferred responsibility for some of the fields to the Walloon Region, partly for budgetary reasons, and to the French Community commission of the Brussels-Capital Region.<sup>14</sup>

Consequently, the Walloon Region and the Brussels-Capital Region assume responsibility for their regional fields of jurisdiction and certain fields of jurisdiction of the French Community.<sup>15</sup>

### 3. THE FIELDS OF JURISDICTION OF FEDERATED ENTITIES

Sections 127 to 129 of the Belgian Constitution stipulate that the Communities assume responsibility for the following fields of jurisdiction:

- ◆ cultural matters;
- ◆ education, except for determining the beginning and end of compulsory schooling, minimum conditions governing the granting of diplomas, and the pension plan;
- ◆ services offered to individuals (called in French “matières personnalisables”);
- ◆ the use of languages in respect of administrative matters, teaching and contacts between employers and their staff;
- ◆ intra-Community and international cooperation, including the conclusion of treaties, in respect of cultural matters, teaching and services offered to individuals.

Services offered to individuals include, in particular, health policy and policy governing the disabled, but not social security, which falls under federal jurisdiction, although this point is regularly called into question by some.

The Constitution does not specifically define the Regions' fields of jurisdiction, which may be modified through legislation adopted by special majority. According to the list established by the Conseil Supérieur des Finances (1999), the Regions assume the following main fields of jurisdiction:

- ◆ economic policy, including assistance in respect of investment and employment;
- ◆ employment;
- ◆ transportation;
- ◆ public works;
- ◆ the financing of subordinate powers;
- ◆ scientific policy pertaining to their fields of jurisdiction;

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<sup>13</sup> Conseil Supérieur des Finances (1999).

<sup>14</sup> In 1993, the social and health-related fields of jurisdiction of the French Community were transferred to the Walloon region as regards exercising of such jurisdiction within the region's territory, and to the French Community commission (Cocof) in the Brussels-Capital region (a sub-entity of the region, whose executive branch comprises members of the regional executive branch) with respect to the exercising of such jurisdiction within the territory of the Brussels region, which also assumed the French-speaking Brussels Community's fields of jurisdiction in the realms of tourism, school transportation, vocational training, school buildings and sports infrastructure.

<sup>15</sup> Moreover, the Brussels-Capital region assumes the former fields of jurisdiction of the agglomeration of Brussels and, from the standpoint of its territory, the fields of jurisdiction assumed by the former Province of Brabant.



- ♦ energy;
- ♦ wastewater treatment and the protection and distribution of water;
- ♦ policy governing waste and environmental protection;
- ♦ monuments and sites.

Since the conclusion of the 1993 accords, the fourth stage mentioned earlier, the following fields of jurisdiction have been added:

- ♦ foreign trade;
- ♦ agriculture;
- ♦ international relations from the standpoint of the Regions' fields of jurisdiction.

The Conseil Supérieur des Finances notes that with regard to agriculture and foreign trade, in particular, these fields of jurisdiction are shared with the federal government. The reform of 2001 has altered this division of powers in favour of the Regions.

It should be noted that scientific policy is regional in areas that fall under the jurisdiction of the Regions. In concrete terms, basic research is the responsibility of the Communities and, partly, of the federal government, while applied research (or technology) is the responsibility of the Regions.

The report of the Conseil Supérieur des Finances mentioned earlier proposes a presentation of various fields of jurisdiction using fiscal federalism diagrams in the manner of Musgrave (1959) and Oates (1991), in particular the breakdown of allocative, distributive, stabilizing and incentive functions.

#### **4. FINANCING OF FEDERATED ENTITIES**

The financing mechanism in respect of the Communities and Regions resulting from the special financing act of January 16, 1989 is a good illustration of the specific dynamic of Belgian federalism. This mechanism makes provision for a transitional phase, from 1989 to 1999, followed by a permanent phase, starting in 2000, although the "permanent" nature must be put in perspective at present, since it applied for one year only. The discussion that follows is based, in particular, on the report of the Conseil Supérieur des Finances (1999) and Pagano (1999) (Spinoy (1998) offers an alternative presentation), while the final subsection (4.3), devoted to the broadening of the fiscal autonomy decided in the spring of 2001, will centre partly on Valenduc (2002) and the formalization of point 4.1.5. on Cattoir and Verdonck (1999).

First, as the Conseil Supérieur des Finances (1999, our translation) has noted, "Belgian federalism sanctions the principle of the financial autonomy of the federal entities, each of which receives the means necessary to exercise its fields of jurisdiction, thus ensuring the entity's budgetary autonomy. Financial autonomy also includes the possibility of borrowing." Then it specifies that "to transfer means does not necessarily mean to ensure fiscal autonomy." According to Cattoir and Verdonck (1999, our translation), this system is "dominated by a concern for balance between the autonomy of the federated entities and the political and monetary union of the federation." According to Spinoy (1998, our translation), "the system of financing the federated entities is characterized, in principle, by the entities' financial responsibility and reversible solidarity."

##### **4.1. Financing of the Regions**

The transfer of a portion of personal income tax underpins the financing of the Regions, which also benefit from own-source tax revenues and non-tax revenues.

Table 6 illustrates the importance of the Regions' and the Communities' different types of revenues.

#### 4.1.1. Financing of the Regions through a transfer from the federal government and its link with the personal income tax

The law governing regionalization of August 8, 1988 transferred to the Regions fields of jurisdiction that represented in the federal budget preceding the transfer 234.7 billion BEF (5.8 billion €) out of a total excluding interest charges of 1517 billion BEF (37.6 billion €). It was decided to *change the personal income tax into a tax shared*<sup>16</sup> between the federal government and the Regions and, consequently, to implement a transfer mechanism through which the federal government would transfer to the Regions a portion of proceeds from this tax, which stood in 1988 at some 836 billion BEF (20.7 billion €). Two questions arose at that time. First, how could the public finances of the federal government, then engaged in a sweeping deficit-reduction operation in order to comply with the criteria that would allow Belgium to join the euro zone, i.e. the Maastricht criteria,<sup>17</sup> be preserved, and how could the amount relinquished by the federal government be apportioned among the Regions?

From the outset, two extreme solutions were possible. The first solution, which favoured the Walloon Region, centred on the share of the relative importance of the Regions in the amount transferred. The second solution, more favourable to Flemish Region, apportioned funds on the basis of the Regions' contributions to personal income tax revenues, applying the territoriality principle of *fair return*.<sup>18</sup>

Table 4 below, drawn from Pagano (1999), illustrates the debate.

TABLE 4

## FINANCING OF THE REGIONS IN BELGIUM

Region	Expenditure transferred (billions of BEF)	Income tax revenues (%)	The same relating to the budget transferred	Difference
	(a)	(b)	(c) = (b) x tot (a)	(c) - (a)
Flemish Region	121.1	58.57	137.5	16.3
Walloon Region	87.3	30.07	70.6	-16.7
Brussels Region	26.3	11.36	26.7	0.4
<b>Total</b>	<b>234.7</b>	<b>100</b>	<b>234.7</b>	<b>0</b>

(1 Euro = 40.3399 BEF)

At the beginning of the transitional period (1989-1999), the duly regionalized budget transferred served as a basis, i.e. column (a) in the table. Over ten years, the breakdown were to gradually shift to a breakdown based on the criterion of the regional yield of personal income tax, i.e. column (c), according to a linear combination (the weight of column (a) declines 10% each year and the weight of column (c) increases at the same pace). While the initial breakdown favoured the Walloon Region, it gradually shifted in favour of the Flemish Region (with the application of the principle of fair return), but accompanied by a remedial mechanism, the national solidarity measure (in French: *Intervention de Solidarité Nationale* or *ISN*), which I will examine later.

The central government's budgetary interests were satisfied since the amount thus allocated to the Regions only increased by the rate of inflation, i.e. zero growth in real terms. However, starting in 1994, a gradual link to real growth in GNP appeared, limited to 10% of such growth in 1994, 15% in 1995, 20% in 1996, 70% in 1997, 75% in 1998 and 97.5% in 1999. Moreover, the federal government retained a portion of the amount to be transferred to the Regions in the form of a loan from the Regions to the central government, remunerated at the market interest rate and repaid by means of annual repayments of up to 85.7%.

<sup>16</sup> Let us note that the Belgian personal income tax has not been properly turned into a *shared tax* as long as we understand a *shared tax* as a which generates unknown revenue *ex ante* and is allocated according to fixed proportions, say fifty percent for the regions or twenty percent for a given region; in Belgium the amount to be shared is predetermined and its allocation among regions evolves in line a.o. with the relative regional revenue of the personal income tax.

<sup>17</sup> See, in particular, Spinoy (1998) and E. de Callatay and R. Savage (1998). It should be noted that the agreement concluded between the federal government, the Communities and the Regions on December 15, 2000 binds the federated entities to the attainment of fiscal objectives, i.e. achieve a financing capacity of 0.3% of GDP in 2001 and 0.1% of GDP between 2002 and 2005, under the surveillance of the Conseil Supérieur des Finances, and apportions this obligation among them (see *Bulletin de Documentation du Ministère des Finances de Belgique*, 61st year, No. 2, pages 161-167, 2001).

<sup>18</sup> It should be noted that the latter apportionment method centred on the principle of the taxpayer's place of residence; only later was the sore point raised of the apportionment according to the principle of the source – Charles, Deschamps and Weickmans, (1998), Gérard (1999) –, especially favourable to the Brussels-Capital Region since many people who work in Brussels do not reside there.

The permanent phase, starting in 2000, calls for the allocation of the shared portion of personal income tax based on the regional yield of the tax and the increase in the amount at the same pace as inflation and growth in GNP. The national solidarity measure is now in effect and the Regions are no longer bound to lend money to the federal government.

#### 4.1.2. *Inter-Region equalization:*<sup>19</sup> *the national solidarity measure*

Since 1990, a Region whose per-capita revenues from personal income tax are lower than the national average receives each year a 468-BEF (11.6 €) indexed transfer per inhabitant per year per percentage point difference between such revenues and the national average. In other words, the shift from a breakdown that favoured the Walloon Region to a breakdown favourable to the Flemish Region described earlier has been offset by the national solidarity measure, the Belgian version of *inter-Region equalization*. This has led to a transfer in favour of the Walloon Region that reached 20 billion BEF (0.5 billion €) in 1993 and also, since 1997, to a transfer in favour of the Brussels-Capital Region on the order of 600 million BEF (14.9 million €).

That the Brussels Region – as usual in Belgium we use the terms Brussels Region and Brussels-Capital Region without distinction – benefits from equalization illustrates a trend-setting development that cannot be overlooked since it illustrates a ground swell in respect of the characterization of the Regions of Belgium. In the mid-1960s, for a mean taxable income of 100 in Belgium as a whole, the figure for Flanders was 93, for Wallonia, 97, and Brussels, 138. Three years later, in 1969, the figure stood at 96 for Flanders and Wallonia and 129 for Brussels. In 1979, Flanders stood at the national mean, Wallonia below the mean at 96, and Brussels above the mean at 110. In 1991, Flanders caught up to Brussels, both of which stood at 101, leaving Wallonia at 95. Since 1993, Brussels and Wallonia have been below the national mean in terms of mean taxable income and, since 1997, the latter has also benefited from equalization.

#### 4.1.3. *The fiscal autonomy of the Regions: own-source revenues*

The Regions have at their disposal own-source tax and non-tax revenues. *Non-tax own-source revenues* include, among other things, *hunting and fishing fees and forestry operation fees*.

The Regions' *own-source tax revenues* stem from:

- ◆ formerly federal taxes, proceeds from which and legislative jurisdiction over which have been partially or wholly transferred to the Regions and are now called *regional taxes*;
- ◆ personal income tax, discussed earlier, which has the status of a *joint tax*;<sup>20</sup>
- ◆ new taxes adopted by the Regions.

Before pursuing the matter, it would be useful to make a distinction, with the Conseil Supérieur des Finances (1999), whose report written in 1998 also bears examination in order to ascertain to what extent the Regions have made use of their autonomy, and Valenduc (2002), in respect of the aforementioned taxes, between *complete autonomy*, *autonomy in respect of rates*, *autonomy in respect of margins*, and the *absence of autonomy*. These distinctions are noteworthy in light of the 2001 reform.

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<sup>19</sup> See, in particular, Boadway and Hobson (1993) concerning the economics of equalization.

<sup>20</sup> This term, used in Belgium, is however misleading since it actually means that Regions are allowed to levy extra tax or grant rebates with respect to the federal government tax.

### a) Regional taxes

Regional taxes, formerly national taxes, from which the proceeds, collected by the federal government, are entirely attributed to the Regions, initially numbered eight under the law of January 16, 1989.

A first group of taxes, i.e. *the tax on gambling and betting, the tax on coin-operated amusement devices and the tax on the opening of drinking establishments*, were previously refunded to the Regions. As the Conseil Supérieur des Finances (CSF) has noted, "the 1989 law respecting the financing of the Communities and Regions in this respect confirmed the current situation." On these taxes, "the Regions enjoy *complete autonomy* and may freely determine the taxation base, exemptions and tax rates" (Conseil Supérieur des Finances, 1999, our translation).

The second group comprises the *real estate tax* and *transfer duty upon death and inheritance tax*. In this instance, the fiscal autonomy of the Regions is no longer complete since the federal government is empowered to determine the taxable base. The Regions enjoy *autonomy solely with respect to tax rates*.

The real estate tax, which stands at 1.25% in the Walloon and Brussels-Capital Regions and 2.5% in the Flemish Region, is a levy on rental value, i.e. an imputed value called the cadastral income, of real estate, which federal authorities may decide to partially or totally charge on corporation tax or personal income tax. According to the CSF (our translation), "the discussion of the grounds for the law respecting financing justify as follows the choice made with regard to the real estate tax:

- ♦ to establish the tax base [...] requires a vast administration and to regionalize it would lead to an impressive extension of this administration which, in particular, would increase the cost of collecting the tax;
- ♦ cadastral revenue intervenes in respect of the administration of several national taxes [...]."

As for inheritance taxes, in respect of which Flanders has reduced the marginal rates, the government confined itself, in 1989, according to the CSF, to "mentioning that, in relation to 1980, autonomy has been broadened since the Regions may determine the exemptions."

As for *registration fees on the transfer for payment of real property*, autonomy is even more restricted. Here, it is a question of *autonomy in respect of margins* in that the federal government is empowered to set the tax base, exemptions and rates, and the Regions may only establish additional taxes (tax levies) or grant refunds.

There is an *absence of autonomy* with regard to the *tax on vehicle use*, for fear of encouraging fictitious registrations in the Region with the lowest taxation.

Moreover, the CSF has noted that "from the standpoint of taxes in respect of which the fiscal autonomy of the Regions is not complete, a general principle has been established whereby modifications in the tax base and, as the case may be, the rates and exemptions, require the agreement of the regional governments."

To the foregoing observation, it must be added that, since 1993, *environmental taxation has been reserved for the Regions*. This is true of so-called *ecotaxes*, actually excise taxes levied on consumer goods likely to harm the environment, e.g. because of their containers, of *water* and *waste taxes*, except for radioactive waste (the Walloon Region levies a tax on waste water and another tax on waste, while revenues from the Flemish Region's environmental taxes are directly paid to a specialized body, the *Mina – Fonds* (Spinoy, 1998)), and of the *Eurovignette* on vehicles and combinations of vehicles with a maximum weight of under 12 tonnes.

In addition, since 1993, the Regions may levy *additional duties on radio-television fees*, which, as we will see later, are a Community tax. The Regions may cede back proceeds from the fees to the Communities or assume certain of their expenditures.

### b) Additional levies and rebates on the personal income tax

According to the CSF, "the Regions also have the possibility of establishing additional taxes or granting rebates on the portion of personal income tax attributed to them as a joint tax." Under the law of January 1989, doing so was subject to prior agreement between the different levels of power and could not lead to greater overall fiscal pressure during the first three years. Subsequently, the King, i.e. the federal government, may decide the maximum amount of the additional taxes. Within the same maximum limits, rebates could only appear starting in fiscal 1995 in respect of 1994 revenues. The Regions have not actually made use of this provision, which was substantially altered in 2001.

### c) New taxes

In light of provisions in the Belgian Constitution and a general taxation principle applied in Belgium, embodied in the Latin expression *non bis in idem*, the Regions may levy a tax on any matter provided that there is no federal tax on this matter or that the federal government has not shown the need to levy such a tax.

This means, in particular, that the Regions could not levy a tax on added value or an excise tax (two taxes that are coordinated throughout Europe), a corporate income tax or personal income tax, outside their autonomy in respect of margins in the latter domain.

#### 4.1.4. Other non-tax revenues of the Regions

These include two types of revenues, i.e. federal transfers and own-source non-tax revenues. In the Walloon Region, a transfer must also be added from the French Community.

Cattoir and Verdonck (1999, our translation) have noted, with respect to federal transfers, that they are, first and foremost, a “right of withdrawal on the federal budget intended to finance programs aimed at putting the unemployed to work. An amount equivalent to unemployment compensation is granted to each Region concerned for each full-time equivalent job for which the Region assumes responsibility.” There is also a *special form of aid*, called *mortmain*, granted to the City of Brussels to offset the costs that it assumes as a federal and international capital, especially since it does not collect the property tax on buildings used for this purpose.<sup>21</sup>

Furthermore, the Walloon Region receives aid from the French Community in order to assume the fields of Community jurisdiction transferred to it in 1993, especially in the social and health sector, which engender in the Walloon Region expenditure in excess of the aid received from the French Community (17 billion BEF or 0.42 billion € in spending in 1998 as against 13.8 billion BEF or 0.34 billion € in aid).

#### 4.1.5. Summary and remark

Cattoir and Verdonck (1999) have proposed a formalization that clearly summarizes the system described in this section. I have modified it somewhat in order to highlight the criterion for determining whether a Region is eligible to the national solidarity measure or not. The revenues,  $R^j$ , of a Region comprise the Region’s tax revenues and non-tax own-source revenues,  $R_0^j$ , its share of the personal income tax revenues transferred, noted  $X$ , and, as the case may be, aid in conjunction with the national solidarity measure. Thus, in a given Region  $j$ , where  $IPP^j$  and  $IPP^{tot}$  denote the personal income tax revenues of the Region and Belgium as a whole, respectively, and  $POP^j$  and  $POP^{tot}$  the population figures and  $p$  the inflation rate, in the year  $t$  subsequent to the implementation of the transitional phase but included in the permanent phase:

$$R^j = R_0^j + X \frac{IPP^j}{IPP^{tot}} + 468(1+p)^t 100 \text{ Max} \left[ \left( 1 - \frac{IPP^j / POP^j}{IPP^{tot} / POP^{tot}} \right), 0 \right] POP^j$$

An event that subsequently marginally increases the personal income tax revenues of the Region concerned, e.g. in the wake of an employment-support initiative undertaken by the Region, will affect the Region’s revenues depending on the tax revenues of the other Regions and the total population, expressed as follows:

$$\frac{\partial R^j}{\partial IPP^j} = \left[ X - 468(1+p)^t 100 POP^{tot} \right] \frac{IPP^{tot} - IPP^j}{(IPP^{tot})^2}$$

or simply

$$\frac{\partial R^j}{\partial IPP^j} = X \frac{IPP^{tot} - IPP^j}{(IPP^{tot})^2}$$

<sup>21</sup> On the cooperation mechanisms between the federal government and the Brussels-Capital Region, see also the analysis of the cooperation agreement proposed by Poirier (2002).

depending on whether or not the national solidarity measure comes into play. It is readily apparent that a Region benefiting from the national solidarity measure is less well paid than another in respect of a budgetary effort that generates an increase in local tax revenues.

Moreover, changes in the personal income tax revenues in a Region affect the means at the disposal of the other Regions. This externality can assuredly not be overlooked in a federation comprising only three federated entities. Indeed,

$$\frac{\partial R^j}{\partial IPP^k} = - \left[ X - 468(1+p)^t 100 POP^{tot} \right] \frac{IPP^j}{(IPP^{tot})^2}$$

where k denotes the Region in which personal income tax revenues have changed, where the term in square brackets is limited to X if the Region j does not benefit from the national solidarity measure.

The sign of this term between square brackets is obviously crucial to a comparative statics exercise. In the comparison conducted by Cattoir and Verdonck, it is negative in the two Regions that benefit from the national solidarity measure, i.e. the Walloon and Brussels-Capital Regions. This makes it possible to establish Table 5 below, for the permanent phase of the application of the law respecting financing of 1989, i.e. the year 2000.

TABLE 5

## EFFET D'UN ACCROISSEMENT DES RECETTES D'IPP DANS UNE RÉGION

$\Delta^+ \text{ IPP in reg. } j$	$\Delta R \text{ in W. Reg.}$	$\Delta R \text{ in Fl. Reg.}$	$\Delta R \text{ in Br. Reg.}$	$\Delta R \text{ federal level}$
$\Delta^+ \text{ IPP in W. Reg.}$	-	-	+	+++
$\Delta^+ \text{ IPP in Fl. Reg.}$	+	+	+	++
$\Delta^+ \text{ IPP in Br. Reg.}$	+	-	-	+++

Source: Cattoir and Verdonck (1999) (I have simplified the presentation).

As the authors have noted, it is clear that "the federal government is the biggest winner when personal income tax revenues increase at the regional level." This situation arises, first and foremost, because the federal government returns only part of the personal income tax that it collects to the Regions and because, if the increase occurs in a Region benefiting from the national solidarity measure, the transfer in this respect to the Region diminishes. This explains why the effect on the means of the federal government is more important (+++) if the increase in personal income tax revenues occurs in the Walloon or Brussels-Capital Region than in the Flemish Region (++). For the rest, we can conclude, as do the authors cited, that "aside from a paradox concerning revenues, i.e. an inversion of per-capita revenues relative to the Regions following the implementation of equalization, the inter-regional equalization system also leads to poverty traps that are especially important for the Regions benefiting from equalization. [...] In other words, any economic catching-up that leads to an increase in taxable income in one of the two Regions is immediately punished by a loss of tax revenues in these Regions." (our translation)

#### 4.2. Financing of the Communities

The funding base of the French-speaking and Flemish Communities is, even more so than for the Regions, centred on a transfer from the federal government related to three taxes, i.e. the radio-television fee, personal income tax and, above all, the value-added tax (VAT). According to the typology used earlier, there is an *absence of fiscal autonomy* since the financing of the German-speaking Community relies on aid that is not connected to a tax.

The *radio-television fee* is refunded according to the location of the appliance. Some 80% of the fees on radios and television in Brussels are refunded to the French Community and 20%, to the Flemish Community. It should be noted that the special law respecting financing of July 16, 1993 made this tax, until then a shared federal tax, a Community tax: the fee is fully refunded to the Communities.

The *link with personal income tax revenues* closely resembles the situation with respect to the financing of the Regions, i.e. initially 47.7 billion BEF (1.18 billion €) and 37.7 billion BEF (0.93 billion €) respectively, for the Flemish Community and the French Community. It should be noted that the link with growth in GNP is accompanied by a guaranteed result by 2005 (based on 2% in annual growth for the period 1993-2004 (see Spinoy (1998) for more details)).

The *transfer related to the VAT* originally amounted to 167.4 billion BEF (4.15 billion €) for the Flemish Community and 129 billion BEF (3.20 billion €) for the French Community. These amounts are indexed and thus reflect inflation but not growth in real terms, including after the end of the transitional period, and are adapted according to the number of inhabitants under the age of 18, which, in practice, gives a regressive character to financing since this proportion is diminishing. The Conseil Supérieur des Finances (1999) has quite judiciously noted (our translation) that “reference to tax here is purely notional, since the amounts attributed are not even a function of revenues generated by the tax. A funding system would reach an identical result, without giving the illusion of a fiscal autonomy that does not exist.” The total amount thus obtained was, during the transitional period, divided between the two main Communities using a 57.55 – 42.45 rule.<sup>22</sup> During the permanent period, the rule must, according to the special law respecting financing, “be adapted according to objective criteria set by the law.” A law enacted in 2000 stipulated that the breakdown would be prorated according to the number of young people between the ages of 6 and 17 regularly attending elementary and secondary schools.

As is true of the Regions, the Communities benefit from *own-source tax and non-tax revenues*. The Communities could levy taxes under the same conditions as the Regions (see point (c) above), but in reality the Communities have never exercised this power, essentially for want of being able to determine who is a taxpayer of either the French-speaking or the Flemish Community in the Brussels-Capital Region. As for non-tax own-source revenues, mention should be made of the tuition fee paid by higher education students.

TABLE 6

## RECETTES ET DÉPENSES BUDGÉTAIRES DES COMMUNAUTÉS ET DES RÉGIONS POUR 2000

	Walloon Region	French Community	German- speaking Community	Flemish Region and Community	Brussels- Capital Region	CoCOM <sup>1</sup>	CoCOF <sup>2</sup>
<b>1. Shared tax revenues</b>							
Personal income tax	129.5	59,2	-	338,8	36,7		
VAT	-	159,8	-	213,1	-		
Radio-TV	-	10,6	0,2	18,0	-		
<b>2. Own-source tax revenues</b>							
Estates	9.9	-		19,7	6,4		
Registration	6.3	-		16,3	4,1		
Property	0.7	-		3,9	0,6		
Environment	5.9	-		-	-		
Other	2.0	-		3,1	3,9		
<b>3. Non-tax revenues</b>							
Job-market integration	4.7	-		6,8	1,0		
Aid to French-speaking com.	11.6	-		-			4,3
Other	14.2	12,2	4,5	9,7	7,9	2,1	4,3
<b>4. Total</b>	<b>184.8</b>	<b>241,8</b>	<b>4,7</b>	<b>629,4</b>	<b>60,6</b>	<b>2,1</b>	<b>8,6</b>
<b>5. Expenditures</b>	<b>194.5</b>	<b>246,3</b>	<b>4,8</b>	<b>619,5</b>	<b>65,9</b>	<b>2,1</b>	<b>8,8</b>
<b>6. Balance</b>	<b>-9.7</b>	<b>-4,5</b>	<b>-0,1</b>	<b>+9,9</b>	<b>-5,3</b>	<b>0,0</b>	<b>-0,2</b>

<sup>1</sup> Two-Community Commission, <sup>2</sup> French Community Commission (1999 figures).

Source: Ministry of Finances, *Bulletin de Documentation, Annexe Statistique* – 2000 edition.

(1 € = BEF 40,3399)

<sup>22</sup> The mechanism is, in reality, more complex since a transitional correction had to be introduced to reflect that French-language education initially represented not 42.45% but 43.51% of the cumulative expenditures of Dutch- and French-language education (see Spinoy (1998)).

### 4.3. The spring 2001 agreements

The so-called Lambermont or Saint-Polycarpe agreements, reflected in legislative terms in the *special law of July 13, 2001 transferring various fields of jurisdiction to the Regions and the Communities* and the *special law of July 13, 2001 respecting the refinancing of the Communities and the extension of the fiscal jurisdiction of the Regions*, extended regional jurisdiction, especially in the realms of agriculture, foreign trade and authority over local powers, broadened the means of the Communities<sup>23</sup> (means that were increased, indexed to inflation and, starting in 2007, partially to growth, and the apportionment of which between the French Community and the Flemish Community will, from now on, depend not only on the number of students but also on personal income tax revenues) and the Regions, especially with regard to the latter, through the attribution of broader fiscal autonomy.

With reference to Valenduc (2002) and the legislation, we can reexamine the fate of personal taxes and personal income tax. Another useful reference is Van der Stichele and Verdonck (2001).

First, the fate of the *Communities* demands brief examination. The additional means attributed (assuming a constant 3% inflation, a 2% real growth and stability in the proportion of young people in the population under the age of 18) would rise, according to my calculations, from 8 billion BEF (0.20 billion €) in 2002 to almost 123 billion BEF (3.05 billion €) in 2012, i.e. an increase in means of 2% at the beginning of the period to 23% at the end of the period. However, these additional means will be gradually apportioned more extensively according to the so-called principle of fair return, i.e. to personal income tax revenues, 80% of Brussels' revenues being allocated to the French Community and 20% to the Flemish Community. This will mean a *reduction in the distribution of means based on needs (supposed to be in line with the number of students)*. The French Community accounts for 43% of students but only roughly 36% of tax revenues and its share of the additional means would decline from 40% to 36% in 10 years and its share of overall VAT financing, from 42.8% to 41.6%. It should be noted that the personal income tax portion of the financing of the Communities is already divided according to territorial personal income tax revenues.

Let us now examine the financing of the *Regions* and their broader fiscal autonomy.

#### a) Regional taxes: almost complete autonomy

The list of regional taxes comprises taxes on gambling and betting, the tax on coin-operated amusement devices, the tax on the opening of drinking establishments, transfer duty upon death and inheritance tax, the real estate tax, registration fees on the transfer for payment of real property, mortgage fees, registration fees on inter vivos donations of personal property and immovable property, the radio-television fee,<sup>24</sup> the taxes on the use of vehicles, the vehicle registration tax and the Eurovignette, while ecotaxes "are no longer regulated by the special law governing financing but fall under federal jurisdiction"<sup>25</sup> (our translation).

The Regions enjoy *complete autonomy* with respect to most of these taxes. The Flemish government has already decided to eliminate the radio-television fee within its territory. However, there are a few exceptions. The establishment of cadastral revenue, on which the real estate tax is based, remains under federal jurisdiction. The establishment of the tax base of the tax on the use of vehicles and the vehicle registration tax is the responsibility of the Regions but the exercising of such jurisdiction is subordinate to a cooperation agreement between Regions and the federal level, on leasing firms. The Regions are also responsible for the Eurovignette tax but they must conclude a cooperation agreement in respect of vehicles registered abroad.

Inheritance taxes and registration fees on inter vivos donations are payable where the inheritance was opened or where the donation was made. However, if the testator or the donor was established successively in several places during the five preceding years, the place of the lengthiest stay prevails.

The federal government continues to ensure free of charge the collection of taxes but federated entities may decide to directly collect certain groups of taxes.

<sup>23</sup> Vincent Vanden Berghe, a Louvain-la-Neuve economist, summarized the situation in an interview to Belgian daily newspaper *La Libre Belgique*, in May 2001: "If the agreements are approved, federal government aid to the Communities will increase significantly starting in 2002 and will be tied to growth in Belgian GNP starting in 2007. The French Community will then be in a position to face 'normal' growth in its expenditures. However, it should be emphasized that these agreements alter the distribution rule governing federal government aid to the Communities. Gradually and fully starting in 2012, the additional means, which will grow over time, will be apportioned according to the local personal income tax revenues in the regions" (our translation).

<sup>24</sup> It will become a regional tax but the Communities will receive compensatory annual aid, from the Regions but through the federal government.

<sup>25</sup> *Le Fiscologue*, 809, 10-08-2001, page 3.



## **b) Personal income tax: broader autonomy in respect of margins**

As Valenduc writes (our translation), “the power of the Regions to establish additional taxes or rebates has been broadened and the preliminary agreement procedure has been replaced by an obligation to first communicate with the Minister of Finance and a specific mission of advice giving assigned to the Court of Accounts.”

However, the autonomy of the Regions must reflect a framework guided by a number of principles. The Regions may not modify either the tax base or the tax calculation established by the federal government and they continue to operate *on the margins*, although this margin has been broadened through additional taxes or rebates, in the form of proportional or lump-sum tax credits that may or may not be differentiated by income bracket. These additional taxes or rebates may not, however, reduce the progressive graduation of the tax, bearing in mind the array of provisions that determine it up to the basis for calculating additional taxes. The legislation states (our translation) that “the principle of progressive graduation must be understood as follows: as taxable income increases, the ratio of the amount of the reduction and the amount of personal income tax due, before the reduction, may not increase or, as the case may be, the ratio between the amount of the increase and the amount of the personal income tax due, before the increase, may not diminish.” Moreover, they may not exceed 3.25% until the 2003 taxation year, and 6.75% starting on January 1, 2004. The Flemish government is expected to make use of its authority to grant rebates. The special law stipulates that “the Regions exercise their jurisdiction in respect of general tax reductions or increases, additional taxes or tax reductions without reducing the progressive graduation of personal income tax and at the exclusion of any unfair tax competition” (our translation).

## **c) Other taxes**

The new law governing financing invokes the principle of *non bis in idem* when it stipulates, in section 4, that “the exercising by the Regions of fiscal jurisdiction [...] must comply with the principle aimed at avoiding double taxation.”

## **5. CONCLUSION: HAVE WE REACHED THE END OF THE FEDERALIZATION OF BELGIUM?**

Have we reached the end of the federalization of Belgium? We can examine this question from the standpoint of jurisdiction and that of taxes.

### **5.1. Jurisdiction**

First, from the standpoint of jurisdiction, it should be noted that until very recently, i.e. 1998 or 1999, the French-language parties were unanimous in refusing any new Community-based discussion, essentially out of a concern for protecting the federal nature of inter-individual solidarity from which French-speakers benefit. The main issue, as noted earlier, is social security, but also the progressive graduation of income tax and the method of establishing salaries. *The Commission for State Reform of the Flemish Parliament* adopted five avenues for concrete reform (Docquier, 1999, page 20; Van Den Brande, 1988, pages 4-5):

- ◆ reduce Belgium to two federated entities, i.e. Flanders and Wallonia, with a special status for Brussels and the German-speaking Community;
- ◆ place the Flemish and French-speakers on an equal footing at all levels of power in Brussels;
- ◆ transfer new fields of jurisdiction to the Regions, including the health insurance and family allowance sectors in the realm of social security, railway infrastructure and the operation of the railways, scientific policy and foreign trade;
- ◆ transfer to the Flemish Region administrative supervision over municipalities with special language status on the outskirts of Brussels and in the small Fourons (in Dutch: Voer ) region;
- ◆ broaden fiscal autonomy through the complete or partial regionalization of personal income tax.

In exchange for broader means for the Communities, i.e. for education in the French Community, a number of the Flemish demands mentioned earlier were met in the Spring of 2001: guaranteed participation in all levels of power in Brussels (or at least financial incentive for that purpose), new transfers of jurisdiction over foreign trade and agriculture, administrative supervision over municipalities with special language status on the outskirts of Brussels and in the small Fourons (in Dutch: Voer) region, and the broadening of fiscal autonomy.

However, no component of interpersonal solidarity has been transferred: the progressive graduation of tax has remained largely intact, and social security continues to fall under federal jurisdiction, including health insurance and family allowances. One might think that the Flemish parties will go back onto the offensive in this respect. In early August, the

press, for example, mentioned Walloon laxity concerning exclusion from the right to unemployment benefits. The Walloon agency in charge of managing the unemployed appears to be less prompt than its Flemish counterpart in denouncing to the federal agency that pays unemployment benefits jobless individuals who refuse jobs that satisfy predetermined criteria. This is one of the paradoxes of the Belgian system in that the management of the unemployed is part of employment policy, which is regionalized, while the payment of unemployment benefits is part of social security, which falls under federal jurisdiction. Similarly, health policy is regionalized but the funding of health care relies, by and large, on social security, ...which is federal.

## 5.2. Taxes

The autonomy in respect of margins of the Regions has become effective from the standpoint of personal income tax. However, the Regions enjoy no fiscal autonomy with respect to corporation tax or value-added tax (VAT).

As for VAT and excise tax, a European framework is imposed on Belgium and revenues from VAT are already apportioned among the Communities, although the reference of Community allotment to the tax is rather artificial. Given the size of the country, it is easy to imagine that differentiated taxes would give rise among individuals to trans-regional purchases, as is now the case in border areas. This would not have any impact on trade between persons liable for tax for whom the principle of taxation at the rate of the place of destination would undoubtedly apply as it does in respect of trade between entities of different member states of the European Union.

The foregoing paragraph raises two, more general questions concerning tax competition between jurisdictions and the place of taxation.

### a) Tax competition between jurisdictions: personal income tax and corporation tax

*The limited mobility of residents between the Walloon and Flemish Regions means that the autonomy in respect of margins of these Regions with regard to personal income tax generates little tax competition*, thus dissipating any fear of the harmful consequences of recent agreements in this respect. *However, mobility is much greater between Brussels and its Flemish periphery*<sup>26</sup> (see Table 2, which indicates that Brussels accounts for 14.5% of GDP but only for 8.6% of the tax base, those figures reflect at once the delocalization of wealthy inhabitants of Brussels toward the periphery of the city located in Flemish territory, and the phenomenon of commuters). *In this instance, the risk of tax competition is serious*. It demands a solution, without which the financial paralysis of the Brussels-Capital Region is to be feared.

The mobility of economic activity also causes hesitation with respect to the introduction of an *autonomy in respect of margins regarding corporation tax*. At present, the Regions may grant direct assistance to investment, for example, through *capital premiums*, provided that this is acceptable to European authorities, but not tax assistance such as *investment tax credits*. This means that *fiscal autonomy is non-existent from the standpoint of the nominal taxation of companies but not as regards the effective taxation of companies*, which in turn demands deciding *how to apportion among Belgium's Regions the taxable income of a company that has establishments in more than one Region*. Is the solution to "fall into line with the rules recommended by the OECD in respect of international fiscal conventions and with the practices of big federal countries, and recognize permanent regional establishments of Belgian companies and levy corporation taxes at the geographic level?" (Gérard 1999, translated). Moreover, problems concerning *transfer prices* would inevitably arise. At a time when the European Union is examining corporate taxation, with particular emphasis on obstacles to convergence in this respect, Plasschaert (1999) maintains that fiscal autonomy in this field would be rather inefficient.

### b) Place of taxation and the situation of the Brussels-Capital Region

Charles, Deschamps and Weickmans (1998), quoted by Gérard (1999), have questioned the effect on the financing of the Regions of the *charging of personal income tax at the place of work instead of the place of residence*. "This is not a purely hypothetical change but a realistic hypothesis from the standpoint of broader fiscal autonomy for the Regions, thus bringing into line Belgian interregional practice and that recommended by the OECD in respect of international tax treaties and largely adopted by countries. Such a change would engender a marked increase in the portion of personal income tax allocated to the Brussels Region" (Gérard, 1999, translated). Precisely because of this highly symbolic reference to international treaties, Valenduc (2002) rejects this suggestion but proposes an alternative mechanism offering similar characteristics in favour of Brussels.

<sup>26</sup> All of the municipalities surrounding Brussels are located in Flemish territory. Even in the south and the east, i.e. toward the territory of the Walloon Region, there is always at least one Flemish municipality between Brussels and Wallonia. The majority of residents in the circle of Flemish municipalities around Brussels, where in several instances the majority of the population is French-speaking, and the first Walloon municipalities to the east and south, work in Brussels.

It is clearly a question of finding a solution to the problem of financing Brussels.<sup>27</sup> The means used are hardly important: more extensive aid from federal authorities, a contribution from the other Regions at the expense of a capital whose administrative territory, “permanently” confined and delineated, reflects neither a residential, cultural nor an economic area, or a different breakdown of shared personal income tax revenues that takes into account the place of its production and thus its source.

To conclude this study of Belgian federalism with Brussels’ situation is to conclude by evoking its most sensitive point.

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<sup>27</sup> See Lambert, Tulkens *et al.* (1999, 2000) concerning the financing of Brussels.

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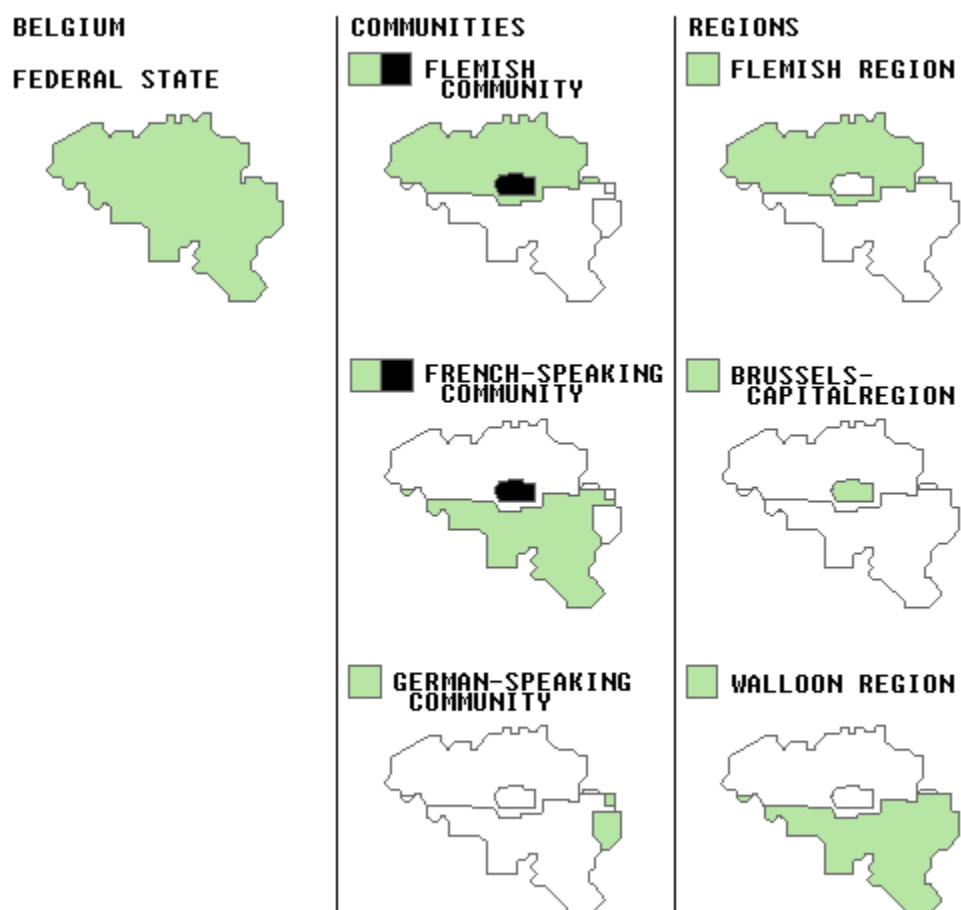
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## APPENDIX: COMMUNITIES AND REGIONS OF BELGIUM



Source : Belgian federal government Web site ([www.fgov.be](http://www.fgov.be)).<sup>28</sup>

# THE LAMBERMONT AGREEMENT: WHY AND HOW?

By *Géraldine Van der Stichele and Magali Verdonck*

## 1. INTRODUCTION

On October 17, 2000, the Prime Minister reviewed in his federal policy statement the key outcomes of the so-called Sainte-Thérèse agreement. On January 23, 2001, in the wake of a second round of negotiations, the so-called Lambermont or Saint- Polycarpe agreement led to the drafting of two special statutes, one “concerning the refinancing of the communities and the broadening of the tax jurisdiction of the regions” and the other “concerning the transfer to the regions and communities of various fields of jurisdiction.” Less than six months later, in July 2001, the draft legislation was voted on in the House of Representatives and the Senate.<sup>1</sup>

This study focuses on the section of the Lambermont agreement that deals with the reform of the financing act in order to highlight the balance achieved by the parties involved in the negotiations.

The study is divided into three sections, devoted to the refinancing of the communities, the fiscal autonomy of the regions from the standpoint of personal income tax, and the fiscal autonomy of the regions as regards regional taxes.<sup>2</sup> Each section includes a historical review of the financing mechanisms in effect up until now and a summary of the circumstances that led to new negotiations. Next, we review the contents of the agreement and assess their budgetary effect in respect of all of the entities concerned. Such an analysis allows us to draw a number of conclusions on the content and form of this new institutional reform.

A preliminary remark is necessary. In this study, we cannot overemphasize the description of the transitional mechanisms included in the special financing act of 1989. The legislation stipulated two types of transitional mechanisms, one centred on a contribution by the federated entities to efforts to put the budget in order and the other ensuring a gradual shift from a financing system based on needs to a financing system based on means, i.e. the derivation (or territoriality) principle of taxation. The details of these transitional mechanisms are complex and now obsolete. Consequently, we do not believe that a description of them would contribute significantly to the debate at hand. For this reason, we have decided to emphasize only the components of the permanent phase of the special financing act that shed light on what is at stake with regard to the Lambermont reform. Readers are encouraged to consult the bibliography for historic references.

## 2. REFINANCING OF THE COMMUNITIES

### 2.1. Background

The special financing act of January 16, 1989 was intended, among other things, to settle the question of the financing of the communities, to which new fields of jurisdiction had been transferred<sup>3</sup> pursuant to the special act of August 8, 1988. This special act, which is still in force, precisely defines the mechanism governing financial transfers organized between the federal and community governments. Starting in 1989, provision was made to adopt a new act in 1999 in order to define new criteria governing the apportionment of funds between the communities, which was to apply starting in the year 2000. However, in 1993, it was necessary to revise the special act, essentially to bail out the communities and bolster financial transfers among French-speakers in favour of the French-speaking community. This section reviews the contents of the statutes, in chronological order, and concludes with an explanation of the circumstances that led to a revision of the financing mechanisms under the Lambermont agreement.

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<sup>1</sup> The two special acts are dated July 13, 2001 and were published in the *Moniteur belge* on August 3, 2001 (see <http://just.fgov.be>). The authors wish to point out that any mention in this study of the special act of July 13, 2001 refers to the special act respecting the refinancing of the communities and the broadening of the tax jurisdiction of the regions.

<sup>2</sup> The regionalization of agriculture and the maritime fishery, external trade and development cooperation are also covered by the reform of the financing act. This study does not deal with this topic since an analysis of the budgetary impact on the various recipient entities is of limited interest as long as the regions do not implement a policy in this respect.

<sup>3</sup> In 1988, education was added to the cultural and “personalizable” fields of jurisdiction previously transferred to the communities, whose budgets were substantially increased through this new transfer.

### 2.1.1. The special financing act of 1989

The special financing act of 1989 implemented a financing mechanism in respect of the communities based solely on the principle of financial autonomy rather than on the principle of fiscal autonomy. The communities benefited from transfers from the federal government and enjoyed complete sovereignty concerning the use of such transfers (financial autonomy). However, the communities could not cause either the amounts or the sources of such funds to vary<sup>4</sup> (fiscal autonomy). The funds transferred to the communities comprised three key components: financial transfers (“VAT transfer” and “personal income tax transfer”), a shared tax (the radio-TV fee), and government funding in respect of foreign students.

The federal financial transfers earmarked for the communities, that is, the “VAT transfer” and the “personal income tax transfer”,<sup>5</sup> used separate methods of calculation.

The VAT transfer was calculated in three stages. Each year, an overall amount for the two communities was determined pursuant to the legislation, resulting from the transfer recorded in 1989 (296 385 million BEF) and changed annually in light of growth in the consumer price index. Contrary to the personal income tax transfer, this transfer was not tied to economic growth prior to the Lambermont agreement. The argument put forward in 1989 to justify the absence of a link with economic growth was that all of the federated entities had to participate in the budget consolidation effort. Furthermore, since the cost per student of education was high in Belgium, the negotiators took as their initial assumption that expenditures could be reduced and adjusted to the means available. This proved to be far from the case.

Next, this total amount attributed to the communities was adapted to demographic changes in the student population, with a view to reducing the community's means when needs decreased in the wake of a drop in the number of school-aged children. This demographic development was calculated separately for each community in the form of an adaptation factor. Between the two adaptation factors, the one most favourable to the communities was adopted and applied to the transfer overall. The less negative change observed in a community thus financially benefits the community in which the number of students is declining most rapidly, i.e. the Flemish community.

The third and final phase consisted in apportioning the total amount between the French-speaking and Flemish communities. The criterion considered in this regard was the financial need of the communities, reflected in the number of students in 1989, i.e. 42.45% for the French-speaking community, and 57.55% for the Flemish community. This allocative key was modified in 2000.<sup>6</sup> The VAT transfer represented on average 65% of the communities' total financial resources in 1998.

It should be noted that no explicit solidarity mechanism had been implemented in respect of this segment of financing since the consideration of needs, rather than means, as a criterion for allocation constituted implicit solidarity.

The personal income tax transfer differed in three ways from the VAT transfer, i.e. annual changes in the total amount, the criterion governing the breakdown and attribution of the transfer in the federal budget were all determined differently.

The total amount attributed in respect of the personal income tax transfer was equivalent to the basic amount of the permanent period,<sup>7</sup> adapted annually to changes in consumer prices and, starting in 1993 (see section 2.1.2), to growth in national revenue. The transfer was divided between the two communities according to each community's contribution to federal personal income tax revenues,<sup>8</sup> according to the derivation principle of taxation. It should be noted that this principle was inapplicable in the case of VAT since this tax, which concerns goods and not persons, cannot be localized. The personal income tax transfers attributed to the communities are derived from the federal government's personal

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<sup>4</sup> Theoretically, the communities derive from section 170, §2, of the Constitution their own taxing power. To date, this power exists only on paper since its implementation comes up against, in particular, the absence of a sub-nationality in Brussels. The special act of 1993 stipulated that the fiscal jurisdiction of the French-speaking and Flemish communities based on section 170, § 2, of the Constitution has not been rendered executable.

<sup>5</sup> These two transfers come from the overall revenues of the federal budget (budgetary principle of the non-allocation of revenues). That a transfer is financed by means of proceeds from VAT or personal income tax is, *a priori*, unimportant. However, the name given to a transfer has an unrecognized financial implication. The federal government attributes the transfers monthly in 1/12 instalments, starting in the first month of the budget year, although it only collects later in the year VAT and personal income tax revenues. Between the time when the State pays this money to the federated entities and the time when it actually collects the revenues, the recipient entities pay the State interest (section 54 of the special financing act). The financial impact differs depending on whether the personal income tax transfer or the VAT transfer is concerned since personal income tax revenues are collected monthly through payroll deduction while most revenue from VAT is collected quarterly. The interest payable is thus higher in the case of the VAT transfer.

<sup>6</sup> See the section on the Saint-Éloi agreement.

<sup>7</sup> This expression refers to components that are not part of the transitional phase of the special financing act, covering the years 1989 to 1999. This does not in any way mean, as this study proves, that they are actually permanent.

<sup>8</sup> In the case of personal income tax revenues collected in the Brussels area, the traditional 20/80 allocative key is used to determine the Flemish and French-speaking communities' shares.



income tax revenues, which explains its name and engenders the financial consequences indicated in the footnote number 5.

The personal income tax transfer accounts for between 24% and 29% of the communities' financial resources in 1998.

A shared tax is a tax collected by one level of government, a fixed percentage of which is refunded to another level of government. This is true of the communities' second source of financing, since revenues from the radio-television fee, collected by the federal government, are refunded to the communities depending on their location. Revenues collected within the Brussels-Capital region have a special status.<sup>9</sup> The federal government refunded 100% of the revenues.

TABLE 2.1

SOURCES OF FINANCING OF THE COMMUNITIES, 1991 TO 1998 (in millions of BEF)								
	1991	1992	1993	1994	1995	1996	1997	1998
<b>French-speaking community</b>								
VAT transfer	137105.9	139380.4	140983.2	146865.3	148291.2	148032.3	153367.2	153812.3
Personal income tax transfer	37526.1	39258.9	44107.0	46 408.4	48568.7	49602.0	52691.2	55946.2
Radio-TV fee	5618.8	7782.4	8031.6	8259.9	8605.0	9090.0	9150.8	9694.7
Funding for foreign students	1290.4	1322.4	1344.3	1385.6	1408.4	1409.0	1467.4	1470.6
Other	1546.1	3852.4	15087.2	12015.2	18660.1	15660.5	13611.8	12961.7
<b>TOTAL</b>	<b>183087.3</b>	<b>191596.5</b>	<b>209553.3</b>	<b>214934.4</b>	<b>225533.9</b>	<b>223793.8</b>	<b>230288.4</b>	<b>233885.5</b>
<b>Flemish community</b>								
VAT transfer	177882.7	182734.2	185792.8	193294.8	198028.9	198276.5	205214.6	207267.6
Personal income tax transfer	49046.3	53727.7	63734.2	69398.8	75477.7	79661.7	88936.7	95487.5
Radio-TV fee	9455.3	9790.0	17669.5	14625.5	15283.0	15632.7	16526.5	17232.8
Funding for foreign students	318.9	330.7	333.7	345.7	354.3	356.4	364.9	369
Other*	?	?	?	?	?	?	?	?

Source: Bayenet et al. (2000).

\* It is impossible to distinguish the "other" revenues of the Flemish community since they are included in the total of the "other" revenues of the merged region and community.

The last of the main sources of the communities' financing was **government funding in respect of foreign students**,<sup>10</sup> through which the federal government contributed each year to the financing of university instruction offered to foreign students. The amounts determined in respect of each community in 1989 (1 200 million BEF for the French-speaking community and 300 million BEF for the Flemish community) were adjusted each year to changes in the average consumer price index. In addition, these amounts could be adjusted to reflect the possible financial consequences for the communities of decisions made by the federal government in the course of exercising its fields of jurisdiction.

Table 2.1 indicates the amounts of the three sources of financing described earlier.

<sup>9</sup> Once again the 20/80 allocative key.

<sup>10</sup> Special financing act, section 62.

### 2.1.2. The Saint-Michel and Saint-Quentin agreements in 1993

The method of financing the communities and regions implemented under the institutional reforms of 1988-1989 was deemed, at the time, to be fairly complete, although it was not permanent. Less than four years later, in 1993, it was necessary to somewhat modify the method<sup>11</sup>.

Indeed, it turned out that the methods adopted in 1989 to calculate the breakdown of budgetary resources put the French-speaking community in a difficult position since it was incapable of financing education, mainly because of pay increases granted to teachers. It is important to mention that wages represent 80% of the expenditures of the French Community.

To solve this problem, the so-called Saint-Michel agreement was signed. It led to the special act of July 16, 1993<sup>12</sup> amending the special financing act of January 16, 1989.

A community-region merger based on the model of the merger carried out in Flanders<sup>13</sup> could have helped solving the financial problems in the French-speaking Community, but this possibility has been rejected by the French-speaking authorities. Nevertheless, a solidarity mechanism has been designed between the French-speaking entities through the so-called Saint-Quentin agreement, which put into effect the new section 138 of the Constitution. This agreement concerns only French-speaking entities.

Let us recall that at that time, in exchange for its participation in the two-thirds majority needed to complete the federal structure of the State, the ecologists demanded and obtained the introduction of ecotaxes (environmental taxes), a new form of regional tax as contemplated by the section 3 of the special financing act. Ecotaxes will be analysed in the section devoted to regional taxes.

Two types of amendments were introduced into the special financing act by the Saint-Michel agreement with a view to increasing the funds allocated to the communities.

The first measure concerns the personal income tax transfer. The portion of personal income tax earmarked for the communities increased by 4.5 billion BEF in 1993. Moreover, starting in 1994, real growth in gross national product was taken into account in the annual change in the overall amount of the personal income tax transfer earmarked for the communities and regions.

The second measure concerns the radio-TV fee and marks a change from the standpoint of principles since it has led to the establishment of community taxation.<sup>14</sup> Until then, the communities had at their disposal solely non-fiscal revenues, the allocated portion of revenues from taxes and fees (including part of the revenues from the radio-TV fee), and revenues from their own borrowings. In the wake of the Saint-Michel agreement, all revenues from the radio-TV fee have been attributed to the communities and the fee has become a community tax,<sup>15</sup> on the same footing as the regional taxes contemplated in section 3 of the special act.<sup>16</sup>

It should be noted that, if since then the radio-TV fee has commonly been called a community tax, this designation is somewhat inflated and may cause confusion since the fiscal autonomy of the communities in this realm is virtually nil. Only two factors distinguish it from a federal tax, i.e. the communities collect it and the federal government may only modify the tax, the tax base and exemptions from the fee with the consent of the two communities<sup>17</sup>.

The Saint-Quentin agreement implemented section 138 of the Constitution, introduced by the Saint-Michel agreement. This new section allowed the French-speaking community to transfer certain of its fields of jurisdiction to the Walloon region and to the Commission communautaire française (Cocof) in the Brussels-Capital region,<sup>18</sup> the alternative in the French-speaking community to the merger of the Flemish community and region. The objective of this paragraph is not

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<sup>11</sup> Bricman (1994), pages 193-194.

<sup>12</sup> M.B., July 20, 1993.

<sup>13</sup> Cf. *infra*, the so-called Saint-Quentin agreement.

<sup>14</sup> Special financing act, section 1(a).

<sup>15</sup> Special financing act, section 5(a).

<sup>16</sup> Bricman (1994), page 195.

<sup>17</sup> No fiscal autonomy is conceivable for the Communities because there are two Communities present in the Brussels Region and because the inhabitants of Brussels do not have to declare to which Community they belong (absence of subnationality). It is therefore impossible to have a differentiated fiscality between the Communities.

<sup>18</sup> In fact, at the time of the La Hulpe agreement, signed on May 21, 1990, it had already been decided that certain fields of jurisdiction of the French-speaking community, such as tourism investment and school transportation, would be partially financed by the Walloon region and the Brussels-Capital region, in exchange for which the two regions participated in decision-making in these fields. The fields of jurisdiction were not transferred, since no legal provision allows such a move.

so much to present in detail complex legal mechanisms or the fields of jurisdiction covered by the transfer decrees stemming from the Saint-Quentin agreement but to shed light on the budgetary impact of this agreement on the finances of the French-speaking community.

The transfer of the exercising of certain fields of jurisdiction was put into effect through the introduction of two decrees (Decree I and Decree II), each of which increased the French-speaking community's budgetary resources.

Decree I<sup>19</sup> organizes the "bridging loan." Six property companies, i.e. the SPABS (Sociétés publiques d'administration des bâtiments scolaires), specially created for that purpose became the owners of most of the school buildings in the French-speaking community, in exchange for payment to the community of 40.6 billion BEF. The SPABS borrowed this amount, called the bridging loan, from various financial institutions. This ingenious procedure was devised in order to circumvent the standard of the Conseil Supérieur des Finances governing borrowings that applies to all federated entities. However, it was understood that the SPABS could not meet their commitments since they do not dispose of their own resources. In practice, the Walloon region, Cocof and the French-speaking community offered a joint and indivisible guarantee in respect of the borrowings contracted by the property companies. It was decided from the outset that only regional guarantees, i.e. the Walloon region and Cocof, would be implemented.<sup>20</sup> It was thus a question, in the guise of a complex mechanism, of carrying out an off-budget operation that made it possible to allocate to the French-speaking community 40.6 billion BEF financed by Cocof and the Walloon region.

Section 7 of Decree II<sup>21</sup> organizes procedures governing the payment of budgetary resources pertaining to the other fields of jurisdiction,<sup>22</sup> responsibility for which was transferred by the French-speaking community to the Walloon region and Cocof. Since one of the key objectives of the Saint-Quentin agreement was to provide the French-speaking community with financial assistance, it was decided that the financial transfer would be less than the inherent cost of the fields of jurisdiction transferred. The mechanism for determining this transfer represents lasting aid to the community insofar as the community releases each year less funds than are necessary to cover the additional expenditures of the Walloon region and Cocof. For example, the fields of jurisdiction in question represented prior to the transfer a total of 21 billion BEF in the community budget in 1993, while the transfer paid to the Walloon region and Cocof by the community in 1994 reached only 15.37 billion BEF.

### 2.1.3. *The Saint-Éloi agreement in 1999*

The special financing act as formulated in 1989 stipulated that, starting in 1999, the breakdown of the VAT transfer between the communities would be carried out by means of new objective criteria. The special act did not define the criteria in detail, which led to various interpretations. It was only in May 2000 that the new act establishing the criterion to be introduced was finally enacted.

An initial proposal concerning the criterion should have given the French-speaking community an additional 2.4 billion BEF and withdrawn the same amount from the Flemish community, since the same budget allowance was involved. The Flemish rejected the proposal since they refused to accept a reduction in their transfer. The act of May 23, 2000 stipulates that the number of students to be considered is the number of students between 6 and 17 years of age regularly enrolled in elementary and secondary schools, including reduced-day schools, in an educational institution organized or subsidized by the French-speaking or Flemish community, as the case may be.<sup>23</sup>

This new allocative key gave the French-speaking community 1.8 billion BEF and reduced by the same amount the Flemish community's transfer. In order to reconcile the two initial contradictory demands, i.e. to increase by 2.4 billion BEF the French-speaking community's transfer and maintain the status quo with respect to the Flemish community's funding, the communities' transfers were rounded out by means of an increase in federal government funding in respect of foreign students and a change in the allocative key pertaining to the communities, which is more advantageous for Flanders than the previous key, i.e. 33% instead of 20%. Moreover, the French-speaking community relinquished the supplement to which it was entitled for 1999.

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<sup>19</sup> Decree I of the French-speaking community of July 5, 1993 respecting the transfer of the exercising of certain fields of jurisdiction from the French-speaking community to the Walloon region and the Commission communautaire française, *M.B.*, September 10, 1993.

<sup>20</sup> Doc. 167 (1992-1993) - n°4, 24.6.1993, Conseil de la Région Wallonne, page 9; Doc. 168 (1992-1993) - n°4, 7.7.1993, Conseil de la Région Wallonne, page 9.

<sup>21</sup> Decree II of the French-speaking community of July 19, 1993 respecting the transfer of the exercising of certain fields of jurisdiction from the French-speaking community to the Walloon region and the Commission communautaire française, *M.B.*, September 10, 1993.

<sup>22</sup> Tourism, subsidies in respect of local sports infrastructure, affirmative action, industrial conversion and professional retraining, transportation and certain facets of health care.

<sup>23</sup> Are excluded from the count students who have been identified as being subject to competitive recruiting, i.e. free of charge, in the territory of another community.

Indeed, in principle the new criterion should have applied starting in 1999, but because of delayed voting on the legislation, the mechanism was only adopted in 2000. Consequently, the French-speaking community sustained a loss of over 2 billion BEF in 1999. While accepting the loss is part of the negotiations, this renunciation runs counter to the special financing act of 1989, which spurred the Fédération des Instituteurs Francophones (FIC) to bring a complaint before the court of arbitration in order to demand the repayment of the amount due. To date, the court has not handed down a decision in this respect.

#### 2.1.4. Circumstances leading to new negotiations

Notwithstanding the rectifications made in 1993 to the system implemented by the special financing act of 1989, it quickly became apparent that the financial position of the communities was untenable. The reason for the budgetary problems was clearly pinpointed, i.e. the VAT transfer, the main source of financing for the communities, is not tied to economic growth, unlike the personal income tax transfers granted to the regions. The problem is all the more obvious in respect of the French-speaking community, which, unlike the Flemish community merged with the Flemish region, has been unable to benefit from the pooling of community and regional funds. The need to review the financing mechanism has become increasingly urgent in recent years, as Table 1 below shows (it presents the growth rates of the financial resources of the different entities between 1991 and 1998).

This table and, in particular, the last column, clearly indicates that growth in the financial resources of the French-speaking community is the lowest of all of the regional and community entities. It is the only entity whose revenues are increasing less rapidly than growth in GDP, because of the significant portion of its resources tied solely to inflation. The effect of this factor is also apparent in the Flemish community, where growth in resources is lower than that in the Brussels and Walloon regions. However, the effect is less painful than in the French-speaking community since the VAT transfer, tied to inflation alone, accounts for less of overall revenues.

**TABLE 2.2**

#### GROWTH IN THE FINANCIAL RESOURCES OF DIFFERENT ENTITIES BETWEEN 1991 AND 1998

	1991	1992	1993	1994	1995	1996	1997	1998	Growth between 1991 and 1998	Average annual growth
Brussels region		22.18%	6.02%	-6.69%	12.57%	7.85%	1.28%	6.47%	58.24%	6.77%
Walloon region		6.06%	12.50%	18.45% <sup>24</sup>	10.56%	4.73%	3.25%	8.07%	82.60%	8.90%
Flemish community		4.12%	6.92%	6.19%	6.16%	3.53%	8.15%	4.56%	46.93%	5.64%
French- speaking community		4.65%	9.37%	2.57%	4.93%	-0.77%	2.90%	1.56%	27.74%	3.56%
Growth in GDP	4.80%	5.20%	2.60%	4.80%	3.80%	3.10%	4.40%	4.30%	38.14%	4.72%

Source: Bayenet *et al.* and the authors' calculations.

The second component of the reform of the financing of the communities concerns refunding of the radio-TV fee. The review of the existing mechanism was necessary given the willingness of certain Flemish political decision-makers to eliminate the fee, deemed to be outmoded. Indeed, the initial purpose of the fee was to achieve redistribution by means of a tax on luxury goods, although television and car radios can no longer be considered as such. The application of the fee should be reviewed in order to allow one of the entities to eliminate it without the process being blocked because of the specific status of the bilingual Brussels-Capital region. The act of 1993 that established the relative autonomy of the communities in respect of this tax lacked precision concerning the procedure through which this autonomy was to be applied. Instead of defining the procedure, the negotiators opted for a sweeping reform of the tax's status.

<sup>24</sup> This percentage, especially high in 1994, stems from the Saint-Quentin agreement (*cf. supra*).

## 2.2. Future prospects

### 2.2.1. Contents of the agreement

In order to solve the problem of the structural underfinancing of the communities, the negotiations in October 2000 (Ste Thérèse agreement)<sup>25</sup> led to the following decision: in addition to linking the VAT transfer to inflation, provision was made to refinance the French-speaking and Flemish communities in the accrued amount of 8 billion BEF in 2002, 6 billion BEF in 2003, 6 billion BEF in 2004, 15 billion BEF in 2005 and 5 billion BEF in 2006. From 2007 up to and including 2011, 1 billion BEF will be added to the indexing and an adjustment will be made in respect of growth in gross national income (GNI).<sup>26</sup> Starting in 2012, the entire transfer will be indexed and adjusted to growth in GNI, according to a mechanism similar to the one applied since 1993 to the personal income tax transfer.

Once this new VAT transfer has been defined, the funds are divided between the communities under two separate programs. The funds available had the Lambermont reform not occurred, i.e. the 1989 VAT transfer adjusted to inflation, continue to be apportioned according to the student population criterion as defined in the act of May 23, 2000 (see section 2.1.3.). The new funds, i.e. the absolute amounts specified by the agreement and the supplement stemming from the linkage with GNI, are being distributed as follows: in 2002, 35% based on the allocative key applied to the personal income tax transfer earmarked for the communities<sup>27</sup> and 65% according to the apportionment rule applied to the VAT transfer, i.e. the student population criterion. The percentage of the VAT transfer apportioned according to the key applied to the personal income tax transfer will increase as follows: 40% in 2003, 45% in 2004, 50% in 2005, 55% in 2006, 60% in 2007, 65% in 2008, 70% in 2009, 80% in 2010, 90% in 2011, and 100% in 2012.

The new VAT transfer resulting from the Lambermont agreement increases the funds available to the two communities but reduces the solidarity that binds them. Instead of an initial allocative criterion based solely on needs, a portion of the VAT transfer will, from now on, be apportioned according to the communities' taxpaying ability. This portion will be 0.6% in 2002 and will gradually increase to 20.3% of the VAT transfer in 2011. It should be noted that when the derivation principle is applied, a federal State usually makes provision for solidarity transfers in order to offset the principle's absence of redistributive effect. This is true of the regions, in respect of which the national solidarity measure was implemented, and is true in most foreign federated States. However, no provision has been made for a solidarity mechanism between the communities to offset the growing importance of the derivation principle in the new mechanism.

The adjustment mechanism in respect of growth in the transfer is distinct from the one applied to personal income tax transfers. The Sainte-Thérèse agreement stipulates that "the adjustment to growth must take into account growth in GNI but also real revenues and additional contributions that federal authorities pay to the European Union. There is an attempt to achieve parallelism between the means available for federal authorities and the communities." [our translation]

To understand this statement, it should be noted that the absolute amounts added to the existing transfer mentioned in the first paragraph stem from an estimate of the margins available to the federal government in future years. Such estimates have been made assuming that the taxation system does not change and without taking into account an eventual increase in the contributions of the member States to the financing of the European Union, for example following the expansion of the EU.

To ensure that the federal government does not bear alone the cost of an increase in contributions to the EU, the Sainte-Thérèse agreement makes provision for taking into consideration this factor in determining growth in the financial resources of the communities. During negotiations leading to the Lambermont agreement, it was advisable, therefore, to convert into figures this political intention included in the Sainte-Thérèse agreement.

This question, one of the vaguest in the Sainte-Thérèse agreement, was subject to lengthy debate. Tension between the federal government and the communities overall was palpable. No entity wanted to renegotiate the matter each year. However, the establishment of a fixed criterion risked proving unfavourable to one level of government or the other. Annual change in the amounts equivalent to 91% of growth in GNI was finally adopted, based on anticipated contributions, bearing in mind the higher cost expected in the wake of the broadening of the European Union.

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<sup>25</sup> A political agreement was reached in October 2000 (Ste Thérèse agreement) and its legal translation was made in January 2001 (Lambermont agreement). Differences exist between those two steps.

<sup>26</sup> The notion of gross domestic product has been replaced by that of gross national income in conjunction with the harmonization of national accounts in Europe (SEC 95).

<sup>27</sup> The same allocative criterion is applied to the personal income tax transfer earmarked for the regions, based on the derivation principle of taxation.

This final solution offers three advantages. First, it gives the communities the ability to forecast their revenues. Next, it protects them against possible changes in agreements with the EU, in respect of which the communities are not consulted. Furthermore, they are a stabilizing factor in respect of federal government spending since, when the increase in its contributions to the EU is less than what it gains through the 91% link to growth in GNI, it may constitute reserves and draw on them when the increase in its contributions exceeds this amount.

In addition to taking into account contributions to the European Union, the Sainte-Thérèse agreement stipulated that the adjustment to growth would take into account change in the federal government's real revenues. This arrangement would have made the communities overly dependent on the reductions in federal fiscal pressure anticipated in subsequent years. In this hypothetical situation, the finances of one level of government would have been wholly at the mercy of decisions made by another level of government. Furthermore, the federal government would have benefited, at least from a political standpoint, from a tax reform, while the cost of such a reform would have been shared by other entities that would not have benefited in any way from it, but which, to the contrary, would have been compelled to engage in budget cutbacks in their own fields of jurisdiction.

For all of these reasons, a stalemate was reached in respect of this part of the Sainte-Thérèse agreement, given that the 91% determined according to the forecasts of future contributions to the European Union were a broad estimate that favoured the federal government, which found that the final compromise worked to its advantage.

It should be noted that this measure respecting the sharing of the cost of additional contributions to the EU concerns only the federal government and the communities (the regions were excluded from the arrangement and will not participate in any way in the increase in the federal government's costs. One can ask what the justification is for this discrimination. This situation has also played a role in the outcome of the problem discussed in the two preceding paragraphs. The differentiated treatment accorded the communities and the regions could have been even more pronounced if the communities had had to suffer the effects of the tax reform announced.

In order to resolve the second question concerning the communities, i.e. the radio-TV fee, the Sainte-Thérèse agreement stipulates that "the radio-TV fee [shall be regionalized]" and that "the transfer of the radio-TV fee shall be carried out in such a way that no community loses as a result any financial resources in relation to existing financing rules." [our translation]

Given that the radio-TV fee henceforth concerns both the regions and the communities, we will discuss this tax in the section devoted to regional taxes. However, it should be noted that the communities will no longer benefit from the real revenue generated by the radio-TV fee, which has achieved the status of a regional tax, but will receive a compensatory transfer from the regions, through the federal budget. The amount of this transfer in 2002 has been determined for each community, in light of the average of its radio-TV fee recorded from 1999 to 2001, expressed in 2002 BEF. In subsequent years, the amounts thus obtained will be tied to inflation.

To conclude this section, and without going into details, we would like to point out that, bearing in mind the specificity of the German-speaking community, a specific refinancing program has been elaborated in respect of this community, based on the number of students.

### *2.2.2. Budgetary effect of the Lambermont agreement*

Below is a budget projection concerning the VAT transfer of the French-speaking and Flemish communities between 2002 and 2010, which compares the financial resources available had the Lambermont agreement not been concluded and the funds available when the adjustment in respect of 91% of growth in GNI and the new mixed allocative key are taken into account.

**TABLE 2.3****BUDGETARY EFFECT OF THE LAMBERMONT AGREEMENT ON THE VAT TRANSFERS OF THE FRENCH-SPEAKING AND FLEMISH COMMUNITIES<sup>28</sup>***(in million BEF)*

		2002	2003	2004	2005	2006	2007	2008	2009	2010
French-speaking community										
Prior to Lambermont	VAT transfer	168349	172216	176418	180722	185132	189649	194276	199017	203874
After Lambermont	VAT transfer	171427	177944	184560	194757	201203	209995	219028	228295	237324
Difference	VAT transfer	3 078	5 727	8 141	14 034	16 071	20 345	24 751	29 277	33 449
Flemish community										
Prior to Lambermont	VAT transfer	223953	228510	233484	238566	243757	249060	254477	260012	265665
After Lambermont	VAT transfer	228563	237187	246065	260718	269681	282641	296324	310773	326507
Difference	VAT transfer	4 610	8 677	12 581	22 152	25 924	33581	42 846	50 761	60 841

Source: Davidson (unpublished article).

Remark: The hypotheses considered to make this projection are 2.28% growth in GNI and a 2.26% inflation rate throughout the period. Current trends respecting the communities' share of personal income tax are prolonged throughout the period.

Table 2.3. reveals that by 2010, the French-speaking community will receive up to 33.5 billion BEF in refinancing and the Flemish community, up to 60.8 billion BEF, or 38 000 BEF and 50 000 BEF per student, respectively. The discrepancy is attributable to the growing importance of the derivation principle of taxation in respect of criteria governing the refinancing transfer.

### 2.2.3. Conclusion

Over the past nine years, the financing mechanism pertaining to the communities has been amended three times: in 1993 (the Saint-Michel agreement), in 1999 (the Saint-Éloi agreement) and in 2001 (the Lambermont agreement). These reforms, of varying scope, have been initiated in light of the same basic observation, i.e. the structural underfinancing of the communities.<sup>29</sup> Each of these agreements has increased the communities' financial resources. Even the Saint-Éloi agreement, whose purpose was clearly defined in 1989, i.e. to establish new criteria governing the apportionment of the VAT transfer, ultimately contributed as well to refinancing the communities.

The French-speaking community, which has not benefited from the positive effect of the amalgamation of the community and the region, as has been the case in Flanders, has been per force placed each time in the position of the party claiming compensation during negotiations since it was incapable of financing education. However, the French-speaking community, having rejected once and for all the solution of amalgamating its two main entities, has nonetheless adopted solidarity measures pertaining to French-speakers that are contributing to financing the French-speaking community. It should be noted that transfers between segments of the French-speaking community have always completed an agreement reached at the national level in order to refinance the communities, i.e. in 1990, the La Hulpe agreement following the adoption of the special financing act in 1989; in 1993, the Saint-Quentin agreements in the wake of the Saint-Michel agreement; in 2000, the adoption of Decree II(a) amending Decree II of the French-speaking community in the wake of the Saint-Éloi agreement; and in 2001, the Saint-Boniface agreement in the wake of the Lambermont agreement.<sup>30</sup>

Note that these intra-French agreements took place after the national agreements three times out of four.

The question today is whether the Lambermont agreement constitutes the step towards an accomplished federal state, in the sense that the federated entities have the structural financial means necessary to fully carry out their responsibilities.

<sup>28</sup> This table is converted in Euro in Appendix II

<sup>29</sup> The source of the problem is well known, i.e. the financing mechanism stipulated in the special financing act of 1989 was inadequate.

<sup>30</sup> The summary table in Appendix I lists these agreements.

### 3. FISCAL AUTONOMY OF THE REGIONS WITH RESPECT TO PERSONAL INCOME TAX

#### 3.1. Background

##### 3.1.1. The special financing act of 1989

The special financing act of January 16, 1989 described the main sources of financing of the regions: the federal “personal income tax transfer”, the equalization grant, the regional taxes and a specific purpose grant. The design of the federal “personal income tax transfer” was the same as for the communities: an overall amount, defined in 1989, changed annually in light of the growth of the consumer price index and the GNI growth, and was then attributed to the regions according to each region’s contribution to federal personal income tax revenues. The equalization grant was attributed to the regions having personal income tax revenues per capita below the national average. The regional taxes are described in the following section. The specific purpose grant was a closed-ended matching grant from the federal government to the regions. It is a compensation for each unemployed for whom the regions create a job and it should be equal to the amount of unemployment benefits that the federal government does not need to pay anymore. In fact this grant systematically reached the upper limit fixed by the federal budget. The remainder of the revenues of the regions was composed of own fiscal revenue (different from regional taxes), non-fiscal revenues and debt.

Furthermore, the regions were granted the possibility of collecting piggyback taxes on the federal personal income tax (expressed as a percentage of the amount of taxes paid by the taxpayer to the federal government). The special financing act of January 16, 1989 stipulated that as of January 1, 1994, the regions could, in addition to levying piggyback taxes, grant refunds provided that the amount of such refunds did not exceed the amount of the personal income tax transfer attributed to the region<sup>31</sup>. Section 9 of the special financing act stipulates that, with a view to safeguarding the economic union and monetary unity, the federal government may impose a maximum percentage in respect of the additional taxes and refunds by royal decree adopted following consultation with the governments concerned. However, this maximum percentage has never been defined.

##### 3.1.2. Circumstances leading to new negotiations

The initial objective of the Saint-Éloi agreement on November 30, 1999 was only to define the new criteria for the attribution of the federal VAT transfer between the communities and did not concern the regions. Nevertheless, everyone being around the table, the Flemish negotiators took the opportunity to express their demand of increased fiscal autonomy<sup>32</sup>. The agreement states in its fourth part: “a lump sum linear reduction of 3.2 billion BEF for 2000 on income tax is compatible with the special financing act and is not likely to threaten the economic and monetary union.” [our translation]

On June 18, 2000, the Flemish government approved in first reading a draft decree respecting a 2500-BEF tax reduction for all taxpayers in respect of 2001 (the Dewael decree). Under the procedure imposed by section 9 of the special financing act, the consultative committee comprising the three regional executives and the federal government met in July in order to issue an opinion on this decree, at which time some shortcomings of the special financing act were brought to light. In effect, some imprecisions led to diverging political claims. This explains why the consultative committee failed to adopt a clear position and why only a political agreement such as the Sainte-Thérèse agreement finally put an end to the debate.

The main reasons why diverging political claims appeared is, first, that interpretations of the Saint-Éloi agreement differed. The box below reveals the origin of the polemic. This provision should have eliminated any problem concerning the interpretation of section 9 of the special financing act and, while a text had been signed, the French and Flemish translations could be interpreted differently.

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<sup>31</sup> This is the definition of a joint tax, section 6, §2, special financing act.

<sup>32</sup> See Henry, Filleul and Pagano (2000). For a complete description of the Saint-Éloi agreement, see J. HENRY, G. FILLEUL et G. PAGANO (2000), « L'accord institutionnel dit de la Saint-Éloi », *Courrier hebdomadaire*, CRISP, n°1696, Bruxelles.



**French text**

Le Comité de concertation est d'avis qu'une réduction linéaire forfaitaire de 3,2 milliards pour l'année 2000 sur l'impôt sur le revenu est compatible avec la LSF et n'est pas de nature à mettre en danger l'union économique et monétaire.

**Dutch text**

Het overleg comité is van oordeel dat lineaire, forfaitaire kortingen voor een globaal bedrag van 3,2 mld voor het jaar 2000 op de inkomstenbelasting volledig vallen binnen het toepassingsgebied van de huidige financieringswet en niet van aard zijn de economische en monetaire unie in gevaar te brengen.

The French version of the agreement was worded ambiguously. French-speakers interpreted it as an authorization for the regions to grant a linear tax reduction, i.e. proportionally identical for all taxpayers, in a total amount of \$3.2 billion BEF. This did not modify the progressivity of the tax and was, therefore, compatible with the special financing act. As for the Flemish parties, this agreement authorized the regions to grant lump sum and linear tax reductions (in the Dutch text the words are in the plural), i.e. identical for all taxpayers, which modified the progressivity of the tax since the lump sum reductions were proportionally of greater benefit in respect of low income individuals.

For the French-speakers, this second interpretation was incompatible with the requirements of the special financing act about the safeguard of the economic and monetary union. Indeed, even if this first use of regional autonomy with respect to personal income tax altered the progressivity of the tax in a way to benefit the low income individuals, it opened the way to an reverse situation and could finally threaten the economic and monetary union.

Second, the federal government's jurisdiction over the progressivity of the tax was invoked to counteract the possibility of granting lump sum refunds that altered the progressivity of the tax. However, it should be noted that no legal trace exists of a federal monopoly on the progressivity of the tax.

Third, even if the interpretation of the Saint-Éloi agreement had been unanimous, the text defined solely the limits to regional autonomy for 2000, bringing no solution for the years ahead.

Finally, Flanders, which was seeking the utmost fiscal autonomy, wanted to go beyond the Saint-Éloi agreement in order to avoid the opinion of the consultative committee in respect of any change in its policy governing personal income tax.

### **3.2. Future prospects**

#### **3.2.1. Contents of the agreement**

The political agreement of October 16, 2000 already established the four key principles to be applied when fiscal autonomy in respect of personal income tax was implemented, as the following excerpt reveals.

"[...] The limitations on the tax jurisdiction of the regions respecting personal income tax must be established unequivocally in the special financing act. These limitations are indicated below.

The special financing act shall set a margin within whose limits the regions may grant piggyback taxes or refunds as a percentage or in lump sum amounts that may or may not be differentiated by tax bracket or apply general tax deductions related to their fields of jurisdiction. This margin stands at 3.25% as of January 1, 2001 and 6.75% as of January 1, 2004. The special act shall stipulate that the regions will exercise such tax jurisdiction without reducing the progressivity of the personal income tax and while excluding unfair tax competition." [our translation]

Based on the special act of the Lambermont agreement (that goes beyond the political agreement of Sainte-Thérèse), we indicate below the principles governing the new autonomy in respect of personal income tax and its practical implementation.

### a) Limits of fiscal autonomy

The first principle set out in the Sainte-Thérèse agreement is that beyond the piggyback taxes or refunds stipulated in 1989 and 1993, regional autonomy may henceforth take the form of **general lump sum reductions** instead of proportional ones (characteristic of the piggyback taxes). Furthermore, tax deductions **related to the regions' fields of jurisdiction** are permitted, with a view to allowing the regions to make use of the tax tool to see through regional policies. One frequently cited example is the tax deductions that encourage the use of pollution-free energy.

During the negotiation of the Lambermont agreement, an additional phase was completed by allowing not only tax deductions but also all tax increases related to regional jurisdiction. Additional clarification was made during this second phase of the negotiations: the accepted term is "tax reductions," which must take the form of a tax credit, and not a "tax deduction."<sup>33</sup> The difference is that in the first instance, the tax due is calculated according to the federal system and is then reduced by the amount of the regional tax credit. The tax deduction, on the other hand, usually refers to a reduction in the basis of assessment. This second technique should be rejected since the tax base is used by the federal government, the regions, the provinces and the communes and the modification of the tax base by the regions would affect the finances of the other entities. The alternative would have been to establish a second tax calculation, which would have made the operation costly from an administrative standpoint. Consequently, in order to avoid errors of interpretation, the term was modified between the Sainte-Thérèse and Lambermont agreement.

The second principle concerns the fiscal autonomy margins established in the Sainte-Thérèse agreement. The margins were set at 3.25% until December 31, 2003 and 6.75% starting January 1, 2004. Consequently, the regions are authorized to implement "general proportional additional taxes and general, lump sum or proportional tax reductions, differentiated or undifferentiated by tax bracket, and to implement general tax reductions and increases,"<sup>34</sup> provided that the sum of these measures does not exceed the maximum percentages<sup>35</sup> [OUR TRANSLATION]. These margins cover revenues from the federal personal income tax localized in each region. These revenues are actually calculated prior to the application of tax increases or reductions implemented by the regions and prior to the application of piggyback taxes levied by the communes and the provinces. These tax reductions or increases do not, therefore, affect the transfer that the regions receive from the federal government (the apportionment of which, between the regions, is based on the derivation principle).

Similarly, the equalizing transfer<sup>36</sup> is calculated on the basis of federal personal income tax revenues and, therefore, before regional fiscal decisions are made in respect of personal income tax. Were the opposite true, the amount of the equalizing transfer would have been affected by regional additional taxes or tax refunds while the fiscal capacity of each region remained unchanged. It is precisely this fiscal capacity and not actual tax revenues that must be considered in an equalizing transfer.

The September 16, 2000 agreement also stipulated that the regions would not be authorized to reduce the tax's progressivity. During negotiations in conjunction with the drafting of the legislation, two questions arose.

First, what is the reference progressivity, i.e. in relation to what may the regions not reduce the progressivity? This reference was an essential prerequisite to the establishment of the calculation method. In the absence of a reference, as was the case when the negotiations were initiated, this implies that the regions could not reduce the progressivity in relation to its previous level. A region that introduced a reduction that increased progressivity (cf. *infra*) would no longer have been able to backtrack if, for example, it decided that the reform was too costly. It was, therefore, decided that the reference progressivity would be that stemming from the application of the income tax code. Each region could thus always return to the level of progressivity adopted by the federal government.

Officials still had to objectively define the reduction in progressivity. This definition is found in the comment on section 11 of the special act of July 13, 2001,<sup>37</sup> which amounts to saying that for any two taxpayers the one with the higher income may not benefit from a tax reduction proportionally higher than the tax reduction from which the taxpayer with the lower

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<sup>33</sup> Section 9 of the special act of July 13, 2001 amending section 6 of the special financing act.

<sup>34</sup> Section 11, paragraph 4 of the special act of July 13, 2001 replacing section 9, §1 of the special financing act.

<sup>35</sup> As far as possible, the federal government will pass on these changes on payroll taxes.

<sup>36</sup> Section 48 of the special financing act stipulates that the national solidarity measure equalizing transfer attributed to each region is equivalent to 468 BEF indexed since 1988, multiplied by the number of inhabitants in the region and the percentage difference between per-capita personal income tax revenues in the region and per-capita personal income tax revenues throughout the Kingdom, provided that the difference is negative.

<sup>37</sup> The definition found in the comment in the fifth paragraph of section 11 of the special act of July 13, 2001 is hardly clear. For information purposes, it reads as follows: "As taxable income increases, the ratio of the amount of the reduction and the personal income tax due, before the reduction, may not increase." [OUR TRANSLATION]

income benefits. A last-minute amendment was introduced, which broadens this definition to include cases where the region introduces a tax increase.

It should be noted that this definition implies that the regions, if they may not reduce progressivity are, however, authorized to increase it. They may, therefore, strive to achieve more or equally redistributive taxation but, under no circumstances, less redistributive.

The last principle introduced by the Sainte-Thérèse agreement is that the regions may exercise their jurisdiction over autonomy in respect of personal income tax, with the exception of any unfair tax competition.<sup>38</sup> The commentary pertaining to the section stipulates that the three restrictions described earlier limit regional autonomy and reflect the desire of the framers of the special legislation to avoid undesired consequences such as tax migration and delocalization between the regions. The framers' desire is clearly understood although it does not define the notion of "unfair tax competition."

In its provisional advice,<sup>39</sup> the council of state notes that the precise scope of this notion is unclear and that it is impossible to ascertain whether this notion must be perceived as an applicable jurisdictional control criterion, in this instance, by the court of arbitration. The sentence was nonetheless maintained in order to provide a basis for eventual recourse launched by a region that feels cheated by a tax measure introduced by another region that nonetheless meets the conditions stipulated by the legislation.

The council of state recommends that the vague notion of "unfair tax competition" be replaced by the notion of an economic and monetary union, more broadly centred on law, which would provide a more relevant control criterion. We object to this recommendation. Detrimental tax competition engenders a tax rate war in order to attract the tax base. Rates in the different regions may be identical to each other but below the current level. In this case, tax revenues decrease markedly but, given the uniformity of rates, the economic and monetary union is not threatened. The latter notion is thus not sufficient, in our view, to protect the Federal State from the detrimental effects of unfair tax competition.

## **b) Margins control and technical feasibility**

A region that intends to introduce a tax reform with respect to additional personal income taxes or refunds must follow two procedures.

First, it must inform accordingly the federal government and the governments of the other two regions. In conjunction with this exchange of information, a collaboration procedure is necessary to ensure the technical applicability of the reform. Such a procedure has yet to be defined in a cooperation agreement between the regions and the federal government.<sup>40</sup>

Second, it must request the opinion of the general assembly of the court of auditors. The opinion deals with compliance with the margins and with the non-reduction of the progressivity of personal income tax. In order for the court of auditors to have the means to issue an opinion, the reform projects and proposals must be accompanied by "sufficient statistical data."<sup>41</sup> In the case of a draft decree, the opinion is requested prior to the submission to the council of the proposal; in the case of a proposed decree, the opinion is requested after its approval by a commission but prior to its examination during a plenary session.<sup>42</sup>

The opinion of the court of auditors is submitted within one month. If the deadline is exceeded, the regions are not bound to take account of the opinion. Furthermore, the opinion is not binding. It was initially proposed that the regions that disregard the opinion of the court of auditors be subject to a fine. During the negotiations, this penalty was abandoned in favour of another option, i.e. that no region could implement a tax reduction or increase without first obtaining a favourable opinion from the court of auditors, which made it unnecessary to define the fines. The negotiators ultimately abandoned the idea of disallowing the implementation of a measure without first obtaining a favourable opinion from the court of auditors, although they did not restore the fine procedure.

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<sup>38</sup> Section 9, paragraph 5 of the special act of July 13, 2001 amending section 6 of the special financing act.

<sup>39</sup> Conseil d'État, 31.227/VR, page 42.

<sup>40</sup> This cooperation agreement is defined in section 92(a), §3 of the special act of August 8, 1980 respecting institutional reforms.

<sup>41</sup> Section 12 of the special act of July 13, 2001 inserting a section 9(a) into the special financing act.

<sup>42</sup> In light of this timing, which is original to say the least, the court of auditors will not systematically examine a final text since legislators will still have an opportunity to amend the decree, either through a commission and during a plenary session in the case of a draft, or solely during the plenary session in the case of a proposal.

There remains only one way to enforce a negative opinion of the court of auditors, i.e. recourse to the court of arbitration. In this respect, a shortcoming has once again been noted in the special act. No specific procedure is stipulated, except that the court of arbitration may request an additional opinion from the court of auditors. The traditional procedure will thus be applied, one that calls for the suspension of the decree in question only if certain conditions are met<sup>43</sup>.

To illustrate the problems related to this procedure, let us assume that a region introduces a tax reduction. The court of auditors hands down an unfavourable opinion but the region goes ahead, adopts the decree and implements it. Another region seeks recourse before the court of arbitration. Since the conditions for suspending the decree are not met, the decree remains in force during the entire period of examination by the court of arbitration, which can last for many months. The court of arbitration ultimately cancels the decree. At this point, the question of retroactivity arises: how can the region recover the amount of the tax reduction from the taxpayer?

It should be noted that, in conjunction with its responsibility for providing opinions,<sup>44</sup> the court of auditors will develop, with the consent of the federal government and the regional governments, an open, uniform evaluation model that will make it possible to test the regional reforms contemplated.<sup>45</sup>

Moreover, the court of auditors will prepare an annual report on the outcome of all of the regional fiscal measures in force during the preceding year.<sup>46</sup>

### 3.2.2. Budgetary effect of the Lambermont agreement

In order to precisely estimate the budgetary effect of the implementation of regional fiscal autonomy in respect of personal income tax, it is necessary to ascertain the value of 1% of the personal income tax in the region concerned. Moreover, it is necessary to assess the effect that this change in taxation could engender from the standpoint of the same region's tax base, e.g. more extensive work supply following a reduction in the tax on labour. It is also necessary to examine the cross effect on the other regions when the tax base, i.e. individuals, move from one region to another in order, for example, to take advantage of a more favourable taxation system.

In conjunction with this study of the Lambermont agreement, we will not venture so far as to evaluate the effect of taxation on the behaviour of taxpayers or cross effects, although such information would be very valuable and research in this respect will certainly be published in the near future. Consequently, we are confining ourselves to estimating the cost (or loss of earnings), in absolute amounts, of an increase or a reduction in personal income tax pressure, all other things being equal.

**TABLE 3.1**

#### ESTIMATE OF THE LOSS OF EARNINGS FOR A REGION FOLLOWING A TAX REFUND<sup>47</sup> (in millions BEF)

Estimated loss of earning for a tax refund					
Year	2002	2003	2004	2005	2006
Walloon region	3 458	3 614	3 787	3 971	4 164
Brussels region	1 074	1 112	1 154	1 200	1 247
Flemish region	7 550	7 931	8 353	8 802	9 272

Source: FUNDP projections.

Table 3.1 indicates that if the Walloon region wishes to reduce personal income tax by 1% for all taxpayers, it will cost it 3.5 billion BEF to do so in 2002. The corresponding figure for the Brussels-Capital region is 1.07 billion BEF, and for the Flemish region, 7.5 billion BEF.

The purpose of this exercise is to point out that a tax refund is costly to a region and that it is not because a 6.75% reduction in personal income tax is allowed that region that it can necessarily implement such reductions. In 2004, for

<sup>43</sup> These conditions are stated in article 20, §1 of the special act of January 6, 1989 about the Court of Arbitration : « Moyen sérieux et préjudice grave et difficilement réparable ». Note that for the Court of Arbitration financial damages are usually not considered as a « préjudice difficilement réparable ».

<sup>44</sup> The council of state, in its provisional opinion, has noted that the framers of the special legislation are once again broadening the jurisdiction of the court of auditors without basing their decision on a capacitation explicitly stipulated in the Constitution (council of state 31.227/VR, page 53).

<sup>45</sup> Section 12 of the special act of July 13, 2001 inserting a section 9(a) in the special financing act.

<sup>46</sup> Section 12 of the special act of July 13, 2001 inserting a section 9(a) in the special financing act.

<sup>47</sup> This table is converted in Euro in Appendix II

example, if the Flemish community wished to make use of the entire allowable margin, i.e. 6.75% of personal income tax revenues, it would cost it roughly 56 billion BEF to do so, equivalent to nearly 8% of its total budget.

## 4. FISCAL AUTONOMY WITH RESPECT TO REGIONAL TAXES

### 4.1. Background

#### 4.1.1. *The special financing act of 1989*

Section 3 of the special financing act of January 16, 1989, as amended by the special act of July 16, 1993, defined a number of so-called regional taxes. At the time, the regions were granted their own tax jurisdiction in this respect. However, the tax jurisdiction varied depending on the tax considered. Thus, depending on the case, the regions could alter the tax rate, the tax base and tax exemptions, or only some of these components. Moreover, the regions did not systematically benefit from the entire amount of those taxes' revenues.

Table 4.1. below indicates the breakdown of jurisdiction between the federal government and the regions.

**TABLE 4.1**

#### BREAKDOWN OF JURISDICTION OVER REGIONAL TAXES BEFORE 2001

Regional taxes	Base	Rate	Exemption	Revenue
Tax on gambling and betting	Regional	Regional	Regional	100% regional
Tax on automatic amusement devices	Regional	Regional	Regional	100% regional
Tax on the opening of drinking establishments	Regional	Regional	Regional	100% regional
Estate tax and inheritance tax	Federal	Regional	Regional	100% regional
Real estate tax	Federal	Regional	Regional	100% regional
Registration fees on the transfer for payment of real property	Federal	Federal	Federal	59% federal 41% regional
Road fund tax on automobiles	Federal	Federal	Federal	100% federal
Ecotaxes	Federal	Federal	Federal	100% federal

The choices made in 1989 (and in 1993) have, consequently, given rise to different degrees of fiscal autonomy.

The first three taxes indicated in the table, **the tax on gambling and betting, the tax on automatic amusement devices and the tax on the opening of drinking establishments**, were the only truly "own taxes" of the regions. The regions were empowered to set the tax base, the tax rate and tax exemptions and all of the revenues from such taxes were allocated to the regions. However, it should be noted that such revenues were fairly small, i.e. roughly 4% of the regions' total revenues.

**Estate tax and inheritance tax and the real estate tax** were only partially regionalized since it was the federal government that established the tax base in respect of both taxes. However, the reason for this reduced autonomy differed between the two. Until 2001, the tax base in respect of estate tax and inheritance tax had been maintained at the federal level since its definition had significant implications from the standpoint of redistribution.<sup>48</sup> As for the real estate tax, the reason was more technical in nature. Since cadastral revenue serves as the tax base for the regional real estate tax, piggyback communal taxes and a portion of federal personal income tax, it was desirable to maintain a single tax base to avoid making tax calculation unduly complex. Rates and exemptions fell under the regions' jurisdiction and revenues from both taxes were entirely allocated to the regions.

<sup>48</sup> In March 1998, the Cabinet introduced an action for cancellation before the court of arbitration, maintaining that the Flemish government had undermined the federal government's jurisdiction over the establishment of the tax base in respect of the estate tax. Aside from modifying the rates, Flanders also reduced the number of brackets to which the rates applied and it created a new category of persons for "legal cohabitants," while the "uncles-nephews" category was combined with the "other persons" category. Furthermore, in the case of lineal heirs and spouses, a distinction was made between the deceased's movable and real property. As for the brackets and categories of persons, the recourse was rejected, as the court maintained that the provisions in the decree being challenged did not affect the composition and the rules governing the evaluation of the total estate. The deliberations preceding the elaboration of the special financing act reveal that by ascribing to the federal government the authority to set the tax base, the framers of the special legislation wished solely to maintain a uniform method of evaluating the property in an estate, both in terms of assets and liabilities (*Doc. Parl.*, Chambre, 1998-1999, n° 635/18, page 275). However, the court did not express an opinion on the distinction between movable and real property, since it maintained that this provision had neither been introduced nor amended by the decree subject to the recourse, but stemmed from an earlier decree (see decision No. 82/99 of July 15, 1999 of the court of arbitration).

The federal government exercised complete jurisdiction over **registration fees on the transfer for payment of real property**. In addition, only 41.408% of revenues from such fees were earmarked for the regions. However, the regions were authorized to collect piggyback taxes or to grant refunds of this tax as long as the entire amount of the tax was not allocated to them.<sup>49</sup> This possibility has never been put into practice.

Although the road fund tax on automobiles appeared under “regional taxes,” it presented none of the characteristics of a regional tax. The federal government set the tax base, tax rate and exemptions. Moreover, revenues from the tax were part of federal government revenues,<sup>50</sup> which means that it could be deemed a *de facto* federal tax.

As for taxes similar to excise taxes that are levied on a consumer product because of the nuisance it is reputed to engender, also called ecotaxes, it was the federal government that establishes the tax base, the tax rate and tax exemptions. Revenues from ecotaxes, which should have been apportioned among the regions, also went to the federal government. The special financing act stipulated that the minister of finance and the regional governments must conclude an agreement to determine collection costs.<sup>51</sup> Until 2001, no agreement had been reached (the federal government maintained that the collection of the ecotaxes cost it too much in relation to the revenues collected). For this reason, revenues from the ecotaxes have never been returned to the regions.

With the exception of the ecotaxes, the federal government collected without charge the regional taxes on behalf of the regions, which could resume collection at their expense, solely in the case of taxes all revenues from which are allocated to them.<sup>52</sup> Only the Flemish region has availed itself of this possibility and assumed the collection of the real estate tax starting in 1999.<sup>53</sup>

#### 4.1.2. Use of this autonomy in the past

This section focuses on the use to which the regions have put the fiscal autonomy granted to them since 1989. For this reason, the road fund tax on automobiles and the ecotaxes, over which the regions have not, until now, exercised genuine tax jurisdiction, are excluded. This exercise makes it possible to discern a general trend and to imagine the scope of the changes to be expected in the future with respect to regional taxes.

When the regions were able to choose the rate of the tax on gambling and betting, the former national rate of 11% rose to 15% in the Flemish region and the Brussels region, and fell below 11% in the Walloon region. The 10-BEF tax on leg bands for racing pigeons illustrates in a quasi-anecdotal manner the question of tax competition since, after the tax was eliminated in Flanders, it was also eliminated in Wallonia and Brussels.

As Table 4.2. indicates, the rates of the tax on automatic amusement devices vary significantly.

**TABLE 4.2**

#### REGIONAL LUMP SUM TAXES ON AUTOMATIC AMUSEMENT DEVICES

	Wallonia	Flanders	Brussels
A: Bingo, pinball machines	55 000 F	144 000 F	72 000 F <sup>54</sup>
B: The same as A (fairgrounds and seasonal operation)	36 000 F	52 000 F	52 000 F
C: Flippers, bowling	9 000 F	14 000 F	14 000 F
D: Juke-box	6 000 F	10 000 F	10 000 F
E: Not classified	4 000 F	6 000 F	6 000 F

No region has implemented the tax jurisdiction acquired in 1989 with respect to the tax on the opening of drinking establishments.<sup>55</sup>

<sup>49</sup> Special financing act, section 4 §5.

<sup>50</sup> Special financing act, section 10 §1.

<sup>51</sup> Special financing act, section 5 §3, second paragraph.

<sup>52</sup> Special financing act, section 5 §3.

<sup>53</sup> Decreet van 9 juni 1998 van de Vlaamse Gemeenschap houdende bepalingen tot wijziging van het Wetboek van Inkomstenbelastingen voor wat betreft de onroerende voorheffing, art. 2 (M. B., July 18, 1998).

<sup>54</sup> It should be noted that a proposed decree aimed at doubling the bingo tax and thus establishing the same rate as in Flanders, starting January 1, 2002, has been submitted to the Conseil de la Région de Bruxelles-Capitale.

<sup>55</sup> Mention should also be made of a proposed decree aimed at reducing this tax to zero starting January 1, 2002 submitted to the Conseil de la Région de Bruxelles-Capitale.

The possibility of engaging in tax competition as regards estate tax and inheritance tax has already begun since, under ordinary law, the Flemish region has:

- ♦ modified its tax scales, thus reducing the progressivity of the tax, and has modified the relationship between the tax rate and kinship;
- ♦ made a distinction between the deceased's movable and real property in order to apply rates when the estate falls to a certain type of legatee and has granted exemptions such that they conflict with the establishment of the tax base.

As for transfers of businesses, there were two series of conditions governing the application of a reduced 3% rate in the Walloon and Brussels regions. Since December 22, 1999, this rate has been 0% in the Flemish region provided that certain other conditions are met.<sup>56</sup> Aside from potential tax competition, this situation engendered a genuine lack of consistency with respect to duties on gifts for which the definition of the tax base was the same, but for which the jurisdiction had remained at the federal level.

Since the regionalization of the **real estate tax**, the Walloon region and the Brussels region have maintained the former federal rate. However, since 1990, the Flemish region has set the base percentage at 2.5%. The rates on social housing have changed in the same manner, i.e. they have been maintained in the Walloon and Brussels regions, but doubled in the Flemish region.

In conjunction with the increase in its basic rates, the Flemish region granted a subsidy on account in respect of the real estate tax to businesses that satisfied certain investment and employment conditions. Furthermore, it automatically granted the deduction to which households were entitled<sup>57</sup>, expressing it as an absolute amount rather than a percentage.

As long as registration fees were not fully returned to the regions—such was not the case until 2001—the regions could not establish the tax rates or exemptions, but were confined to collecting piggyback taxes or granting refunds. No region has ever implemented piggyback taxes or refunds.

To conclude this section, we wish to point out that the trend observed reflects the change that economic theory pertaining to reactions of entities in a framework of tax competition could have predicted. The Flemish region has clearly decided to tax proportionally more heavily the less mobile tax bases. In 1999, revenues from the real estate tax and registration fees provided an appreciably larger share of regional taxes in Flanders (47% of the total) than in Wallonia (37%) or Brussels (35%). Conversely, taxation was lighter on the most mobile base, i.e. estate tax and inheritance tax. In Flanders, this tax accounted for 46% of regional tax revenues, as against 54% in Wallonia and 57% in Brussels.

The Brussels and Walloon regions have made less use of their potential fiscal autonomy until 2001. Those regions had less budgetary margins than the Flemish region and could not afford to take risks in the evaluation of the budgetary effects of a fiscal reform.

#### 4.1.3. *Circumstances leading to new negotiations*

The main objective of transferring in their entirety certain taxes to the regions was to enhance regional fiscal autonomy, the key demand of the Flemish region.

This objective stemmed, with regard to certain taxes, from a concern for consistency. Thus, for example, the regions had jurisdiction over the rates of estate tax but had no such jurisdiction from the standpoint of duties on gifts. The two taxes have highly similar structures and objectives.

Flanders demanded complete autonomy in respect of other taxes in order to avoid a recurrence of the problems of defining jurisdiction that arose in the realm of estate tax. A conflict pitted the Flemish region, which maintained that it was exercising its jurisdiction in terms of exemptions on this tax, against the federal government, which deemed it to be a change in the tax base, which comes under federal jurisdiction. Legal proceedings to resolve such conflicts are cumbersome and lengthy, which is one reason why the Flemish regions wanted to become its own arbitrator.

The scope of regionalization was largely symbolic in the case of still other taxes. The Flemish region demanded jurisdiction over the rate for the Eurovignette, although the rate results from a joint decision of six countries of the European Union. However, there was a desire to paint a picture (albeit an illusory one) of complete regionalization.

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<sup>56</sup> Decree of December 22, 1999 adopted by the Flemish region.

<sup>57</sup> In the two other regions, taxpayers needed to ask for the subsidy.

## 4.2. Future prospects

### 4.2.1. Contents of the agreement

The political agreement of October 16, 2000 marked a new phase in the process of decentralizing taxes and offered guidelines for its practical application.

“The so-called regional taxes and certain taxes that are an extension thereto, e.g. vehicle registration fees, the Eurovignette, mortgage registration fees, and duties on gifts, and the radio-TV fee shall be regionalized.

The transfer shall take into account the following conditions:

#### a) Levelling or budgetary neutrality in respect of federal power

When all revenues from these taxes are transferred, the federal government shall be compensated to cover the loss of revenue sustained. From the standpoint of budgetary neutrality, the portion of personal income tax allocated to the regions shall be reduced by the additional tax revenues of each region.

#### b) Avoid fiscal delocalization

When regional tax jurisdiction is allocated, the risk of tax migration, delocalization and harmful tax competition between the various governments shall be avoided. If need be, associated measures should be elaborated in this respect. Compulsory cooperation agreements shall be concluded with respect to the road fund tax on automobiles and vehicle registration fees.

#### c) No loss of funds for the communities and regions

The transfer of regional and related taxes and the radio-TV fee shall be carried out in such a way that no region or community loses as a result funds governed by the existing financing rules.

#### d) German-speaking community

As for the German-speaking community, it shall assume complete jurisdiction over the radio-TV fee.” [our translation]

The following sections focus on the way in which the objective of regional autonomy is reflected in the Lambermont agreement, the technical procedures required to implement it, i.e. decisions made concerning the collection of regional taxes and the mechanisms introduced to maintain budgetary neutrality, and conditions governing certain taxes to combat tax migration, delocalization and harmful tax competition.

### a) Regionalization

This section examines the procedures pertaining to regionalization introduced by the Lambermont agreement. The outcome of demands for fiscal autonomy is summarized in the table below, which has the same structure as Table 4.1. (the components modified by the new agreement are indicated in boldface).<sup>58</sup>

The first three taxes, i.e. the tax on gambling and betting, the tax on the opening of drinking establishments and the tax on automatic amusement devices, were already regionalized and have not been modified in any way.

The tax base in respect of estate tax and inheritance tax has been officially regionalized.<sup>59</sup> Duties on gifts, over which the regions now exercise complete jurisdiction and from which they receive all revenues, have also been added.

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<sup>58</sup> Sections 5 and 6 of the special act of July 13, 2001 amending sections 3 and 4, respectively, of the special financing act.

<sup>59</sup> In actual fact, the regions already enjoyed relative freedom with respect to the establishment of the tax base stemming from their jurisdiction over exemptions (*cf. supra*).



TABLE 4.3

## JURISDICTION OVER REGIONAL TAXES UNDER THE LAMBERMONT AGREEMENT

Regional taxes	Base	Rate	Exemption	Revenues
Tax on gambling and betting	Regional	Regional	Regional	100% regional
Tax on automatic amusement devices	Regional	Regional	Regional	100% regional
Tax on the opening of drinking establishments	Regional	Regional	Regional	100% regional
Estate tax and inheritance tax	Regional	Regional	Regional	100% regional
<i>Duties on gifts</i>	Regional	<i>Regional</i>	<i>Regional</i>	<i>100% regional</i>
Real estate tax	<i>Regional</i>	Regional	Regional	100% regional
Registration fees on the transfer for payment of real property	<i>Regional</i>	<i>Regional</i>	<i>Regional</i>	<i>100% regional</i>
<i>Mortgage registration fees</i>	Regional	<i>Regional</i>	<i>Regional</i>	<i>100% regional</i>
Road fund tax on automobiles	<i>Regional</i>	<i>Regional</i>	<i>Regional</i>	<i>100% regional</i>
Vehicle registration fees	<i>Regional</i>	<i>Regional</i>	<i>Regional</i>	<i>100% regional</i>
Eurovignette	<i>"Regional"</i>	<i>"Regional"</i>	<i>Regional</i>	<i>100% regional</i>
Ecotaxes	<i>Federal</i>	<i>Federal</i>	<i>Federal</i>	<i>100% federal</i>
Radio-TV fee	<i>Regional</i>	<i>Regional</i>	<i>Regional</i>	<i>100% regional</i>

The only change in the real estate tax concerns the tax base. The regions have the possibility of defining their own tax base in respect of the real estate tax and of substituting it when calculating the tax for federal cadastral revenue. At the same time, the cadastral revenue established by the federal government will always be in force as regards the calculation of taxes other than the real estate tax, in particular, personal income tax. Each property may, therefore, have two separate, fictitious rental values, i.e. one set by the region, used as the base for the (regional) real estate tax and piggyback (communal) taxes, and the other, the cadastral revenue set by the federal government used as a base to calculate personal income tax, the tax on non-residents, and corporation tax. Broader regional autonomy thus engenders a sacrifice from the standpoint of the administrative cost of calculating the tax due.

The remark in section 6 of the special act of July 13, 2001 stipulates that, with respect to administration of the assessment roll, a compulsory cooperation agreement must be concluded between the region(s) and the federal government covering the joint management of patrimonial documentation data in order to maintain a centralized database that is as complete and consistent as possible.

Registration fees on the transfer for payment of real property have been completely regionalized (tax base, tax rate and exemptions), and the regions now receive the 52% of the revenues previously reserved for the federal government, with the result that in future they will receive all of the revenues. Mortgage registration fees and the partial or total sharing of immovable property located in Belgium, transfers for a consideration between co-owners of jointly owned portions of such property, and the conversions stipulated in sections 745(d) and 745(e) of the Code Civil, even when there is no co-ownership, are also part of the new regional taxes.

Jurisdiction over and all revenues from the road fund tax on automobiles and vehicle registration fees have also been transferred to the regions. It should be noted that the road fund tax on automobiles was already a "regional tax" since it was included in section 3 of the special financing act of 1989, although such jurisdiction was purely theoretical.

The introduction of a new criterion for apportioning revenues from the Eurovignette in respect of the portion of revenues engendered by vehicles registered in states that are not participating in the Eurovignette system, since the taxpayer does not reside in any of the regions, also warrants mention. This portion of revenues will be apportioned among the regions according to the number of taxable kilometres of the road network<sup>60</sup> located within their territory.<sup>61</sup> It should be noted that regional autonomy with regard to the Eurovignette is purely symbolic since it is at the European level that the parameters of the tax are determined.

The former fictitious regional status of the ecotaxes has disappeared and such taxes are now solely under federal jurisdiction. This is the only tax that has been subject to a reversal from the standpoint of fiscal decentralization, a decision that strikes us as entirely judicious since it seems hard to justify economically the decentralization of an indirect

<sup>60</sup> The road network subject to the Eurovignette tax.

<sup>61</sup> Section 7(4) of the special act of July 13, 2001 amending section 5, §2 of the special financing act.

tax on a mobile tax base. The regionalization of the ecotaxes, provision for which was made in the Sainte-Thérèse agreement, only reflected the objective of symbolic autonomy and not that of well thought-out autonomy. In the wake of the Sainte-Thérèse agreement, it turned out that no regional environmental body wished to assume jurisdiction over the ecotaxes. At the conclusion of this initial round of negotiations, the bodies in question learned that they would have to engage in cooperation contracts even though a uniform system fully satisfied them. It is these arguments that led to a change in the status of the ecotaxes between the conclusion of the Sainte-Thérèse and Saint-Polycarpe agreements.

The radio-TV fee, the sole community tax since 1993, has become a regional tax, with the exception of revenues from the fee in the German-speaking region. In light of this regionalization, the possibility granted until then to the regions of levying piggyback taxes in this respect has, logically, been eliminated.

## b) Collection

Section 7(7) of the special act of July 13, 2001 proposes the amendment of section 5, §3, paragraph (1) of the special financing act governing the rules in force for the **collection of all regional taxes**. The general rule remains unchanged. The federal government will continue to collect free of charge regional taxes, in keeping with its own procedural rules, although the regions are now entitled to assume responsibility for their collection. One regional tax is an exception, i.e. the radio-TV fee. The communities will continue to collect the fees until December 31, 2004 at the latest, in exchange for remuneration.<sup>62</sup> However, nothing prevents the regions from resuming this service in their own name prior to this date.

The Lambermont agreement introduces certain specific rules with which the regions must comply should they decide to collect their own taxes:

- ◆ In order to ensure the organizational efficiency of the federal finance ministry, the regions may not collect an isolated tax in their own name but are obligated to exercise this jurisdiction by group of taxes, i.e. the three small taxes,<sup>63</sup> the three mobility taxes,<sup>64</sup> the real estate tax alone, and the combined estate tax, duties on gifts and registration fees.
- ◆ A region's decision to directly collect taxes will only come into force in the second financial year after it has notified the federal government of its decision. This rule will ensure that the regions have sufficient time to establish adequate administrative structures.
- ◆ When the collection of a group of taxes is transferred to a region, the latter is free to establish its own rules concerning administrative procedures but will continue to apply federal judicial procedures, which, along with recourse to the council of state, remain under federal jurisdiction. The objective is to ensure the coherence of the Kingdom's judicial system.
- ◆ The transfer of administrative jurisdiction must be accompanied by an optimal exchange of information between the tax services of the authorities concerned. This exchange is crucial when the authorities need information from other authorities in order to properly determine a taxpayer's tax liability.

## c) Budgetary neutrality

The Sainte-Thérèse agreement announced a twofold budgetary neutrality. On the one hand, **vertical budgetary neutrality** implies total compensation for the federal government following the transfers of revenues from the new regional taxes by means of a reduction in the personal income tax transfer granted to the regions. It is no longer a question of increasing in this way the regions' financial resources in order to enable them to finance the exercising of the new fields of jurisdiction allocated to them. The principle of vertical budgetary neutrality therefore reinforces the key objective pursued by this transfer, i.e. the granting to the regions of broader fiscal responsibility. On the other hand, **horizontal budgetary neutrality** should ensure that no region is put at a disadvantage in respect of the financing measures now in force. In actual fact, the application of this twofold principle becomes sensitive if budgetary neutrality must be assured beyond the first year.

The first year, it is simple to deduct from each region's personal income tax transfer the new amounts attributed to each one through new regional taxes. This amount to be deducted is called the negative term. However, in subsequent years, the genuine fiscal autonomy of the regions implies that the reduction in the personal income tax transfer cannot systematically, fully offset the revenues from the new regional taxes, *a fortiori* if the regions modify the tax rates and bases. It was thus necessary to define changes in the negative term that make effective the fiscal responsibility of the regions while ensuring stable financing over time.

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<sup>62</sup> Collection fees will be established by an agreement concluded between the finance ministry and the regional governments (section 7(7) of the special act of July 13, 2001).

<sup>63</sup> The tax on gambling and betting, the tax on automatic amusement devices and the tax on the opening of drinking establishments.

<sup>64</sup> The road fund tax on automobiles, vehicle registration fees and the Eurovignette.

Several solutions were suggested. We are presenting them in chronological order along with the reasons that led the regions to reject all of them except the last one, which was ultimately adopted. We are also presenting the effect that each possibility has on the budgets of the entities concerned. An examination of these intermediate steps reveals that the decisions may reach a high degree of technicality that makes debates obscure and undemocratic, while the impact could be painful for certain regions. Moreover, we will see how the order in which the various solutions were examined may influence the solution ultimately adopted.

At the outset, the federal government proposed defining the negative term of each region as the average of revenues from newly transferred taxes collected in 1999, 2000 and 2001 (the averages were to be expressed in 2002 BEF). The first proposal concerning the change in this negative term was to increase it solely according to the inflation rate in respect of the three regions. This initial idea was bound to be rejected quickly since it was too costly to the federal government, which would have transferred revenues whose growth was more or less tied to economic growth and would have received, in exchange, amounts whose growth was tied to inflation alone. The definition of the negative term for the first year was never called into question, but the question of its evolution in time sparked a lively controversy.

The first alternative contemplated was to link the regional negative terms to inflation and growth in GNI, although this method raised a new problem, of redistributive order, between the regions. The personal income tax transfer attributed to each region changes in light of growth in GNI *and* the regional share of overall personal income tax revenues. Consequently, the three negative terms would have increased at the same pace as growth in GNI while the personal income tax transfers would have changed less (more) rapidly than growth in GNI for those regions whose share of personal income revenues decreases (increases). The personal income tax transfers of the regions that grow relatively poorer would have gradually been undermined while the other(s) earned a bit more each year. To summarize, differences in wealth are reinforced by any criterion of change applied uniformly to the three regions.

This problem was pinpointed by the regions experiencing a drop in their share of personal income tax revenues, i.e. the Brussels and Walloon regions, and the authorities contemplated abandoning the notion of uniform change in respect of the three negative terms and implementing a regional change equivalent to growth in the respective personal income tax transfers. Thus, if the negative term represented x% of the personal income tax transfer in 2002, the same percentage was deducted from subsequent years and a separate percentage would be calculated for each region. The advantage of this measure is that growth in the total of the three negative terms is equivalent to growth in GNI. This measure has the same budgetary impact for the federal government as the preceding solution, but in this instance, the anti-redistributive effect is cancelled and double neutrality is achieved.

Flanders rejected in extremis this new proposal, arguing that it did not wish to lose the gain tied to the first proposals, a gain that it had not in the least acquired. An additional argument maintained that a region whose share of personal income tax revenues declined would effectively have lost financial resources because of this change in the negative term. However, this state of affairs was acceptable since, at the same time, this region would have benefited from the overcompensation afforded by the equalizing transfer.<sup>65</sup>

The compromise ultimately adopted consists in maintaining a uniform growth rate for the three regions, but by reducing this rate in relation to the GNI rate, i.e. 91%<sup>66</sup> of growth in GNI (more precisely, it is a link to inflation plus 91% of real growth in the economy). Thus, the regions that are relatively wealthier maintain an advantage over the other regions, while the losses of the regions that are relatively poorer are reduced to a minimum. Budget neutrality is no longer achieved, on the one hand by the federal government, which loses the difference between a link to 100% and a link to 91% of growth each year. The budgetary impact on the regions is positive for some and the losses virtually nil for the others. In a word, neither vertical budgetary neutrality nor horizontal budgetary neutrality is achieved.

Given the anti-redistributive effect inherent in the final choice of linking changes in the negative term to a single rate of 91% of growth, the negotiators decided to implement a temporary insurance mechanism in respect of the regions. The risk of experiencing the negative effect of the new deal is greater for the Brussels region because regional taxes account

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<sup>65</sup> See Cattoir and Verdonck (1999) for an explanation of this phenomenon. Briefly, this article shows that when a region grows poorer from the standpoint of personal income tax, its share of the personal income tax transfer diminishes but the equalizing transfer from which it benefits increases in such a way that the financial loss stemming from the first component is more than offset by the gain through the equalizing transfer. All things being equal, a region whose inhabitants grow poorer enjoys an increase in budgetary revenues.

<sup>66</sup> The reduced growth rate was initially set at 90% of GNI during preparatory deliberations, based on a calculation designed to cancel the losses of the poorest regions. The negotiators ultimately opted for 91% of GNI, which reflects a determination to give the appearance of consistency to the special financing act that would result from the negotiations. The 91% figure appears in communities' financing formula but, in this instance, it is a figure based on real estimates, as we explained in section 2.2.1. Thereassez sans cela was no justification for adopting this figure, with the result that confusion now reigns in respect of this already sufficiently complex draft special act.

for a larger portion of its revenues, but the mechanism applies to the three regions. It is in this perspective that the safety net was introduced.

The safety net's relatively simple principle is set out in section 17, §2 of the special act of July 13, 2001 and consists in compensating the regions whose revenues from the new regional taxes change too unfavourably in relation to the negative term that they relinquish to the federal government. However, the main objective of this idea was lost during its technical implementation. It has been stipulated that if the total revenues from the newly transferred regional taxes decline nominally below the average between 1999 and 2001 (in 2002 BEF), the region concerned will be compensated for the difference between this average and actual revenues. Compensation is integral for the first five years and decreases gradually over the five subsequent years, after which time the mechanism will be eliminated. This safety net obviously plays only a political role since, were it to be applied one day, it would mean that a region had experienced a genuine fiscal catastrophe. Since the amounts in respect of 2007, for instance, will be compared in nominal terms to an amount in 2002 BEF, revenues will have to have declined by more than the accumulated inflation between 2002 and 2007 before the region benefits from the mechanism.

Table 4.4. illustrates the functioning of the safety net. It indicates revenues from the old regional taxes in the Brussels region from 1991 to 2000 and we simulate what Brussels would have received in the form of a safety net transfer had the safety net been introduced in 1994. To this end, we have calculated the average regional tax revenues between 1991 and 1993, expressed in 1994 BEF. We thus obtain the reference amount of 9788.2 millions BEF, with which total revenues for 1994 and subsequent years will be compared. Each year for which this amount exceeds total regional tax revenues, the Brussels region obtains a compensatory transfer.

TABLE 4.4

## SIMULATION OF A SAFETY NET APPLIED TO THE BRUSSELS REGION IN 1994

(000 000)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total regional taxes	8796	9249.3	9543.3	9524.4	9208.2	10186.7	9849.4	11804.7	12321.1	14286.5
Inflation	3.6%	4.2%	2.4%							
Safety net	-	-	-	263.83	580.03	0	0	0	0	0

Sources: Tax authorities and Bayenet *et al.* (2000).

This simulation reveals that, had the safety net existed in 1994, it would have functioned the first two years. In subsequent years, because of the non-indexation of the reference amount, the safety net would no longer have been effective. If we examine total regional tax revenues in 1997, we see that *real* growth in revenues is negative and that real revenues are lower than in 1993, despite which the Brussels region would not have been compensated. The same calculation has been made with respect to the Walloon and Flemish regions. In both instances, the safety net is inoperative since revenues continue to grow in these regions. We can conclude that the concept of a safety net is certainly necessary, but only in respect of the Brussels region, and that its final design makes it unsuitable to fulfil its objective.

This facet of budgetary neutrality concerned the federal government and the regions. We will now describe budgetary neutrality as it pertains to the federal government, the regions and the communities, i.e. compensation stemming from the regionalization of the radio-TV fee.

In keeping with the principle of budgetary neutrality, the communities continue to collect the radio-TV fee (in exchange for compensation), the entire amount of which is repaid to the regions according to the location of taxpayers. In exchange for the additional revenues, the regions' personal income tax transfers are reduced by the average amount of radio-TV fee revenues within their territory between 1999 and 2001, expressed in 2002 BEF and linked to inflation in subsequent years.<sup>67</sup> The amount recovered by the federal government through this reduction in the personal income tax transfer is then transferred to the communities. If real revenues from the radio-TV fee change faster or slower than inflation, it is the regions that will feel the budgetary impact.

<sup>67</sup> Section 17 of the special act of July 13, 2001, inserting a section 33(a) in the special financing act.

#### d) The fight against harmful tax delocalization

The agreement of October 16, 2000 warns the regions against the **risk of fiscal delocalization**. To avoid the harmful impact that a region would sustain should unhealthy tax competition arise, various measures have been put forward. The measures adopted pursuant to the Lambermont agreement vary according to the mobile or immobile nature of the tax base of the tax considered.

Taxes in respect of which the tax base is immobile, e.g. the real estate tax, the tax on the opening of drinking establishments, the tax on automatic amusement devices, and the tax on gambling and betting, are not subject to any measure aimed at avoiding fiscal delocalization, which, in fact, is impossible.

Estate taxes and duties on gifts rely on fairly mobile tax bases. While mobility is limited in relation to the taxes examined later, the reason for protecting the regions against competition in respect of these taxes is that the amounts in question are substantial. In the case of estate taxes, for example, only 10.8% of lineal estates leave assets in excess of 5 million BEF, although they account for 47.5% of the overall tax base and over 80% of revenues from the tax.<sup>68</sup> In order to limit the competition that could arise in order to attract this valuable 10.8%, it has been decided to introduce constraints not on the tax rates but on the definition of the criterion of location. The region that benefits from estate taxes (and duties on gifts) is the one in which the deceased person (the donor) is established and if the deceased person (the donor) lived in several places during the five years preceding the death (or gift), the region in which the individual was established for the longest time during this period will benefit from the tax.

The road fund tax on automobiles, vehicle registration fees and the Eurovignette are taxes in respect of which the bases are deemed to be highly mobile. In the first two instances, revenues are collected at the place where the individual or corporate entity in whose name the vehicle is registered is established. This criterion creates a risk of delocalization, mainly among businesses that are tempted to set up operations in the region where the tax is the lowest. To remedy this situation, the Lambermont agreement obliges the regions to conclude a cooperation agreement<sup>69</sup> covering cases where the tax is paid by a corporation, an autonomous government-owned enterprise or a non-profit association engaged in leasing.<sup>70</sup> The cooperation agreement centres on the definition of the tax base, the tax rate and exemptions. Such a cooperation agreement is also imposed in conjunction with the Eurovignette in cases where the vehicle is registered abroad. However, the Eurovignette is a special case, since the rate is actually set by six countries of the EU.

#### 4.2.2. Budgetary effect of the Lambermont agreement: the big unknown

The problems stemming from the projection of the budgetary effect of regionalizing taxes reveals the spirit in which the agreement was concluded. A series of taxes were regionalized without the issue of the regionalization's technical feasibility being raised. Certain taxes that are still under federal jurisdiction are registered without taking into account their regional localization, since this information is not necessary under the current framework. The Lambermont agreement stipulated that each region's negative term is the average, between 1999 and 2001, of the revenues from taxes transferred located in the region. We can, consequently, ask on what basis regional breakdowns will be made in respect of these three years.

Furthermore, revenues from regional taxes are highly volatile. An estimate of future changes in such revenues requires a comprehensive statistical approach that does not come under the purview of this article.

Several estimates are circulating at present<sup>71</sup> in which are contemplated variable hypotheses concerning (1) anticipated growth rates in regional tax revenues (a growth rate sometimes equivalent to growth in GNI, sometimes equivalent to inflation + 50% of growth in GNI, and so on); (2) per-capita change in personal income tax in each region (continuation of the current trend or a recovery in the Walloon and Brussels regions); and (3) regional breakdowns of the newly regionalized taxes. It is sufficient to observe the divergences in the results of these various estimates to understand that further discussion will probably occur between regional entities in order to determine the criterion governing the regional breakdown to be implemented.

<sup>68</sup> See the report of the Conseil Supérieur des Finances (1998), page 117.

<sup>69</sup> A cooperation agreement as contemplated by section 92(a), §2, of the special act of August 8, 1980 respecting institutional reform (cf. section 6 of the special act of July 13, 2001).

<sup>70</sup> It should be noted that the French precedent was highly useful in drawing attention to this potential problem. Indeed, following the decentralization of the registration tax, one of the French departments cancelled this tax. Shortly thereafter, almost all leasing automobiles bore the number of this department on their licence plates.

<sup>71</sup> Mention should be made of estimates provided by the Facultés Notre-Dame de la Paix in Namur, the projections of the CEPESS, and those of the Brussels region's finance minister.

For these reasons, we have decided not to present summary tables of the effect on regional budgets of the Lambermont agreement.

However, we do believe that it is germane to mention that the effect of the new regionalization on certain taxes will not be of the same magnitude in the three regions. It is the Brussels region that will undergo the most sweeping changes in the structure of its revenues, because regional taxes account for a larger share of its revenues, essentially because of the density of its built heritage. Prior to the Lambermont agreement, regional taxes accounted for roughly 20% of Brussels' overall revenues, as against 9% in Wallonia and 6% in Flanders. In the wake of the Lambermont agreement, regional taxes will account for an estimated 50% of overall revenues in the Brussels region. Half of Brussels' revenues will depend on these taxes, compared with only one-third in the Walloon region and even less in the Flanders region, because of the merging of the community and regional budgets.

## **5. CONCLUSION**

The foregoing analysis leads us to draw a number of lessons from the recent institutional reform, both from the standpoint of form and content.

With regard to content, we wish to answer three questions. Does the Lambermont agreement appear to be balanced in respect of the different entities concerned? What is the state of Belgian federalism in the wake of this new round of negotiations? What does the future hold in store?

The unrefined vision of the agreements, which often arises in discussion and the media, takes the form of a simple fair's fair: the Flemish region is obtaining its keenly sought fiscal autonomy and, in exchange, the French-speaking community is receiving sufficient funds to get it out of the red.

Our analysis enables us to be more nuanced and to put into perspective the refinancing of the two communities, accompanied by a loss of intercommunity solidarity, and broader fiscal autonomy for the three regions. Legislators have sought to clearly delineate this new autonomy, e.g. through the introduction of margins in respect of personal income tax, the redefinition of criteria governing the localization of taxes that engender a significant risk of delocalization, and the cooperation agreements required with regard to taxes centred on mobile tax bases. These measures were essential given that the amounts that the Flemish community is gaining through the community refinancing mechanism (and which it said it did not need) is largely allowing it to finance a reduction in its fiscal pressure.<sup>72</sup> These guidelines should limit the risk of harmful effects of fiscal competition.

It can thus be said that French-speakers' demands have been met, but have been limited by the proportional reduction in intercommunity solidarity measures. Similarly, Flemish demands have been met, but have been limited by the measures aimed at reducing the detrimental effects of tax competition. Moreover, autonomy with respect to personal income tax refunds may not be deemed to be a major gain since such autonomy was acquired in 1989. It is the form of the guidelines that has been changed: instead of a limitation in terms of interregional cooperation, the limitation now focuses on margins. In our view, the agreement is balanced from the standpoint of the two entities that requested the reform.

We are less positive about the Walloon and Brussels regions, which have been swept along by this reforming movement against their better wishes. Of course, putting the French-speaking community back on an even keel should ultimately prove beneficial, although they are nonetheless facing a budgetary situation that is less stable than it was previously. To take advantage of this new revenue structure, or at least to avoid losing thereby, is a major challenge in the future for these entities.

This observation is especially true for the Brussels region, whose revenues are, proportionally, more extensively affected by the reforms. Consequently, the region is more likely to be adversely affected by the non-effectiveness of the safety net.

We would like to draw the reader's attention to the worrisome situation of the Brussels region. Aside from the disadvantage mentioned earlier, Brussels will unquestionably be the region most exposed to tax competition because of its central geographic position and the limited size of its territory. Furthermore, consideration of Brussels' specific nature in the reform is once again largely insufficient. It is not so much a question of the federal government's financially assisting Brussels with respect to its role as a multiple capital but of finally recognizing its status as a City-State, as is

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<sup>72</sup> The Flemish region has already announced that it intends to adopt various measures in this regard, in particular the elimination of the radio-TV fee, a reduction in registration fees, estate taxes and duties on gifts, the tax on the opening of drinking establishments, and so on.

the case in other federal countries.<sup>73</sup> Some observers have gone so far as to ask whether the application of a general law system for Brussels is not purely and simply discriminatory.<sup>74</sup>

In the wake of voting on the Lambermont agreement, Belgian federalism is developing in the direction established by the reforms of 1980. The federal government is more decentralized at present and its fields of jurisdiction are diminishing for the benefit of the regions, not the communities. However, it appears that Belgium is heading for a more mature federalism, i.e. a federalism that is leaving more leeway for cooperation between federated entities, although one may regret that horizontal solidarity is declining and risks weakening this federal structure. There is hope with respect to the gains to be derived from a federal structure, above all if we give credence to the efforts announced in terms of the management of taxation.<sup>75</sup> The implementation of effective regional and community decision-making processes is one positive effect of tax competition, which compels the entities to be more efficient.

As for the future, we know that this form of federalism is not permanent, because a federal structure is never stable, as witnessed by the permanent changes in federations as experienced as Switzerland, and because the Flemish community makes no secret of its desire for broader autonomy. All of the entities must be prepared for future progress. However, we must ensure that such progress is constructive and desired by all parties and do everything possible to avoid progress precipitated by the financial problems of one of the entities concerned, as has been the case this time. With regard to the form and organization of these negotiations, we wish to highlight the work method adopted and the concessions made in order to conclude the agreement.

The work method applied during the negotiations was criticized on more than one occasion. Despite the avowed intention to achieve transparency and rigour, financing mechanisms continue to be extremely complicated, which leads to opacity in debate, directed by technicians instead of political representatives, an effect reinforced by the urgency of debate. A consequence of this urgency is that the effective implementation of the special act is not always possible or is insufficiently defined.

In our capacity as economists, we also deplore that a large part of the reforms is closely scrutinized from a legal standpoint but that the fiscal, budgetary and economic repercussions are not subject to thorough evaluation. These are questions that affect the daily lives of citizens.

The second conclusion, pertaining to form, concerns the price paid by the federal government and taxpayers to reach agreement. We note that the federal government systematically saves the agreements as soon as fixed budget transfers come to the fore and the “loser” blocks the negotiations. The federal government then offers the loser financial compensation and an equivalent financial transfer is granted to the winner. The discrepancies between the parties concerned thus remain the same, but the federal government does not come out of the process unscathed. This was true of the Saint-Éloi agreement and the definition of changes in the “negative term”. We question the soundness of this method.

Taxpayers risk bearing increased administrative costs stemming from the decentralization of certain taxes. If decentralization has the advantage of drawing the government closer to the citizen, it nonetheless engenders higher costs since it cancels out economies of scale and denies certain rules of efficiency (such is the case with the calculation of the real estate tax and personal income tax). Such costs will inevitably be reflected in the amount of tax due and there is no guarantee that such costs will be offset by gains in efficiency related to decentralization.

Our analysis has highlighted the need to closely monitor the use to which are put the regions’ broader fields of jurisdiction and the new financial means acquired by the communities. Above all, we must avoid, on the eve of the next round of negotiations, finding some of the interlocutors in such a financial stranglehold that they may not allow themselves any other demand. Therefore, it is essentially a question of ascertaining in a timely fashion the possible detrimental effects of tax competition and making provision for adequate responses and solutions thanks to efficient fiscal management tools. If all entities have such management tools, our federalism could evolve from an antagonist era to a more constructive era between different but mature entities, voluntary cooperation being a possible result of it.

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<sup>73</sup> See Lambert, Tulkens *et al.* (1999).

<sup>74</sup> De Bruycker (2001).

<sup>75</sup> See the article by W. Bourton in *Le Soir* of July 14, 2001 concerning the Brussels region.

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## APPENDIX 1

**SUMMARY TABLE OF VARIOUS AGREEMENTS ORGANIZING THE FINANCING OF FEDERATED ENTITIES**

<b>Accord</b>	<b>Date</b>	<b>Primarily concerns, from a financial standpoint</b>
<b>La Hulpe</b>	1990	Solidarity among French-speakers: joint financing of the Brussels-Capital region and the Walloon region for certain fields of jurisdiction of the French-speaking community
<b>Saint Michel</b>	1993	Revision of the financing mechanism pertaining to the communities and the regions (special act of July 16, 1993)
<b>Saint Quentin</b>	1993	Solidarity among French-speakers: transfer of the exercising of fields of jurisdiction of the French-speaking community to the Walloon region and Cocof (Decrees I and II of July 5 and 19, 1993, French-speaking community)
<b>Saint Éloi</b>	1999	Revision of the allocation criterion between communities of the VAT transfer (act of May 23, 2000)
<b>Ilbis decree</b>	1999	Solidarity among French-speakers: financial assistance from the Walloon region and Cocof for the French-speaking community (Ilbis decree of December 16, 1999)
<b>Sainte Thérèse Sainte Perlette Lambermont I Lambermont (II) Saint Polycarpe</b>	October 2000	Created the foundation of the Lambermont or Saint-Polycarpe agreement
<b>Lombard</b>	January 2001	Refinancing of the communities, extension of the regions' jurisdiction over taxation, transfer of fields of jurisdiction to the communities and regions (two special acts of July 13, 2001)
<b>Saint Boniface</b>	April 2001	Functioning of Brussels institutions, in particular, financial assistance for the community commissions and communes (special act of July 13, 2001 concerning refinancing)
	June 2001	Solidarity among French-speakers: bolstering of financial assistance from the Walloon region and Cocof for the benefit of the French-speaking community and determination of the future use of funds obtained by the French-speaking community in the wake of the Lambermont agreement

## APPENDIX 2

**CONVERSION IN EURO FOR TABLES CONTAINING PROJECTIONS FOR THE FUTURE  
BUDGETARY EFFECT OF THE LAMBERMONT AGREEMENT ON THE VAT TRANSFERS OF THE FRENCH-SPEAKING  
AND FLEMISH COMMUNITIES**

(in EUR)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
French-speaking community									
Prior to VAT transfer	4.173,3	4.269,1	4.373,3	4.480,0	4.589,3	4.701,3	4.816,0	4.933,5	5.053,9
After VAT transfer	4.249,6	4.411,1	4.575,1	4.827,9	4.987,7	5.205,6	5.429,6	5.659,3	5.883,1
Difference VAT transfer	76,3	142,0	201,8	347,9	398,4	504,3	613,6	725,8	829,2
Flemish community									
Prior to VAT transfer	5.551,6	5.664,6	5.787,9	5.913,9	6.042,6	6.174,0	6.308,3	6.445,5	6.585,7
After VAT transfer	5.665,9	5.879,7	6.099,8	6.463,0	6.685,2	7.006,5	7.345,7	7.703,9	8.093,9
Difference VAT transfer	114,3	215,1	311,9	549,1	642,6	832,5	1.062,1	1.258,3	1.508,2

Source: Davidson (unpublished article).

**ESTIMATE OF THE LOSS OF EARNINGS FOR A REGION FOLLOWING A TAX REFUND**

(in EUR)

	Estimated loss of earning for a tax refund				
Year	2002	2003	2004	2005	2006
Walloon region	85,7	89,6	93,9	98,4	103,2
Brussels region	26,6	27,6	28,6	29,7	30,9
Flemish region	187,2	196,6	207,1	218,2	229,8

Source: FUNDP projections.

## THE FUNDING OF AUTONOMOUS COMMUNITIES IN SPAIN

By Pere Galí

The Spanish Constitution has intentionally avoided establishing a clear, precise model for distributing the resources that citizens contribute to the State among various public administrations, the central government, the governments of each autonomous community and local governments.

Title 8 of the Constitution is open, indeterminate and vast. It allows, in its interpretation, the transfer of taxes from the State, not to mention transfer of their collection and including transfer from the tax agency.

Catalonia's autonomous status reflects this situation and broadens it by making it more concrete and leaving the model open for subsequent concretion.

These two basic forms favour periodic review, for which provision was subsequently made with the *Organic Law on Financing the Autonomous Communities* of 1979 (LOFCA), which developed Title 8 of the Constitution. Every five years the model has been reviewed for the five subsequent years.

Over 22 years have passed since the edification of the State made up of autonomous communities. Jurisdiction has been apportioned among the various autonomous communities and has been transferred and the role played by each administration is now much clearer and more precise. However, the funding system has been elaborated based on the actual cost of the services transferred and with successive adaptations and the incorporation of the modifications made during the last two revisions, in 1991 and 1996.

The system in force until this year has partially attained its objectives and, while successive modifications have achieved significant progress, it now displays major discrepancies and shortcomings, which imply for the autonomous communities a limitation on their financial autonomy, economic deficiencies and an inevitable process of indebtedness.

It was, therefore, necessary to define in respect of the future model that would fairly and in an integrated manner structure the distribution of public resources a model that grants the citizens of Catalonia what they have been demanding for years, i.e. financial autonomy within a transparent framework of solidarity.

Allow me, before I turn to the most interesting point in the report, to give a few examples of shortcomings in the existing system:

- ◆ Communities with similar jurisdictions receive different per capita amounts of resources.
- ◆ The system, based on expenditure updating criteria, does not allow for all administrations to experience a positive impact on their finances when the economy is thriving.
- ◆ It makes no sense for health to be separated, as is the case, from general funding. Moreover, the apportionment of resources is not adapted to the genuine needs of the population being protected, e.g. aging, immigration, new drugs.
- ◆ Some opaqueness prevails with respect to solidarity in certain autonomous communities in relation to the others, with the result that the fiscal balances of the autonomous communities are not published.
- ◆ The Advanced Scientific Research Centre (CSIC) has just acknowledged that Catalonia has a fiscal deficit in respect of the State of 1 billion pesetas (US\$5.5 million).
- ◆ The Economic Analysis Institute of the CSIC recognizes that between 1990 and 1997, Catalonia contributed, on average, over US\$5.5 million.
- ◆ In relative terms, this amount represents 50% of the Catalonia Government's budget.
- ◆ It should be noted that, because of its specific nature, Catalonia has not received funds from the European Structural Funds, the Inter-territorial Compensation Funds of the central government, or direct investments from the State in Chapter 6 of the budgets.
- ◆ We may pay taxes (capital tax) and participate in the collection of other taxes (income tax), but the central government maintains legislative power.
- ◆ The tax collection system falls under the jurisdiction of the State and is not linked to each territory, with the result that the autonomous communities are unable to assume joint responsibility for taxation.

In 2001, the funding model for the autonomous communities is being reviewed. For this reason, it was necessary to develop a new model that offsets the shortcomings of the existing model and is accepted by all political forces in the Spanish State (consensus) in order to ensure that it endures. This model should be based on the principles of economic self-sufficiency, financial autonomy, joint responsibility for taxation and solidarity and draw us closer in its economic concretion to the models for the economic agreement in force in the two autonomous communities, called “Forales,” of the Spanish State (the Basque Country and Navarre), in order to rebalance the existing differential in economic flows between the State and Catalonia (fiscal balance).

On October 18, 2000, the Parliament of Catalonia approved a resolution (257/VI) respecting a new system of funding by the Generalitat de Catalogne. In this resolution, the government has been asked to negotiate the establishment of a new funding system that takes into account the criteria mentioned.

In this way, under a mandate from Parliament, the Government of Catalonia, headed by Francesc Homs, Advisor for Economic Affairs and Finance, has taken the initiative for and assumed the entire process of negotiating the new model with the central government and the autonomous communities. Mention should be made of the characteristics indicated below.

### **1. A MODEL BASED ON THE DISTRIBUTION OF REVENUES AND NOT ON THE UPDATING OF EXPENDITURES**

The revenues of the Generalitat de Catalogne must depend on the taxes paid by the citizens of Catalonia to Catalonia, the essential, underlying principle that inspires and guides the existing agreement model in the Basque Country and Navarre and the most modern models of neighbouring countries. This factor is basic and strategic in the new pact.

### **2. INCREASE FINANCIAL AUTONOMY THROUGH THE INTRODUCTION OF THE CRITERION OF DIRECT PARTICIPATION IN A TAX BASKET**

From which the Generalitat will participate in 11 of the 13 taxes paid by Catalans. This factor alters the breakdown of participation in the Generalitat de Catalogne’s revenues: in 1982, only 16% of revenues came directly from taxes paid by Catalans. Now, under the new model adopted, this proportion will reach 86%. The remaining 14% of the Generalitat’s revenues are transfers from the State and provide leeway for future modifications.

Clearly, provided that the country and its economy develop in a positive manner, revenues tend to increase proportionally to the higher revenues derived from the taxes that are part of the tax basket mentioned earlier, which means that the Generalitat’s revenues are not tied to expenditures and changes in the latter.

In previous reviews, in 1991 and 1996, officials succeeded only in establishing participation in a single tax, i.e. income tax. Today, the tax basket includes:

- 33% income tax
- 35% VAT (value added tax)
- 40% tobacco tax
- 40% alcohol tax
- 40% hydrocarbon tax
- 100% energy tax
- 100% vehicle registration tax
- 100% succession duties and gift tax
- 100% capital tax
- 100% patrimony transmission tax and tax on documented legal acts
- 100% gambling tax

### **3. INCREASE IN THE SUFFICIENCY OF RESOURCES (ECONOMIC SUFFICIENCY), WHICH REDUCES THE FINANCIAL DIFFERENTIAL IN RELATION TO THE STATE**

First, when the model was negotiated, all of the autonomous communities obtained more extensive resources from the central government.

Second, from the standpoint of changes in the tax basket, additional resources are obtained every time that changes in the basket exceed nominal GDP.

Third, increased resources were obtained with respect to participation in specific health funds, to offset expenditures stemming from temporary illness-related work stoppages and expenditures in respect of displaced and non-resident persons and the possibility of implementing the retailer phase on fuels with a finalistic character for health.

Fourth, the funding of jurisdictions in the realm of security (autonomous police), which did not obtain sufficient funds with the transfer of jurisdiction, was reviewed.

The overall enhancements for the period 2002-2006 will generate additional revenues of US\$4.3 million.

#### **4. BROADER JOINT RESPONSIBILITY FOR TAXATION INCREASES THE CAPACITY OF THE PARLIAMENT OF CATALONIA TO LEGISLATE IN RESPECT OF TAXES PAID BY CATALANS AND THE ACTIVE PARTICIPATION OF THE AUTONOMOUS COMMUNITIES IN THE MANAGEMENT OF THE TAX AGENCY.**

The new funding agreement maintains the legislative power that existed prior to 2002 and broadens it in terms of the taxes transferred and attributes new legislative power governing all of the taxes in which it is starting to participate.

The transfer to the autonomous communities of legislative power over the new taxes transferred and the broadening of such power with respect to the taxes already transferred means the recognition of an autonomous sovereignty that allows the communities in question to regulate tax revenues and to engage in active fiscal policies for the social, cultural or economic promotion of each region or nationality. The transfer of jurisdiction over legislative power is being integrated into the European model while complying with the harmonized directives of the European Union, whose objective is to make intra-State transactions more efficient and increase transparency between member States.

The Generalitat de Catalogne has proposed, on its own, the transfer of the tax agency, that the Generalitat act as the sole administration in Catalonia with regard to taxation and that it collect all of the State taxes paid to Catalonia. The proposal is constitutional and statutory. The Basque and Navarre economic agreements apply it.

Although the demand has not been fully met, the establishment of two new councils has led to unquestioned participation:

- ◆ The Superior Management Council of the State Tax Administration Agency, with State representatives, six representatives from the autonomous communities and the president of AEAT;
- ◆ The Catalonia Territorial Tax Management Council, with three representatives of the State government and three representatives of the Generalitat, chaired by the special delegate.

This first step must enable us to move in the future toward the objective of full participation.

#### **5. REVIEW OF SOLIDARITY MEASURES**

Solidarity is one of the principles underpinning the new funding agreement. The following mechanisms are available to concretize such solidarity:

- ◆ adequacy fund: based on population distribution;
- ◆ specific health funds: for health cohesion and lower spending in respect of temporary illness-related work stoppages;
- ◆ relative revenue fund: for communities with lower per-capita income;
- ◆ allocation of minimum levelling of public services (health and education);
- ◆ inter-territorial compensation fund.

In the procedure overall, a principle of institutional loyalty is established, implying the adoption of a procedure that makes it possible to determine the necessary economic compensation in respect of legislative or administrative decisions adopted by the State that lead to higher spending for the autonomous communities, especially in the realms of health, education or justice.

## **6. FISCAL BALANCE**

Fiscal balance reveals the difference between the revenues that Catalonia contributes to the central government and the expenditures assumed in Catalonia.

Since per-capita revenue in Catalonia exceeds the average for the Spanish State, the revenues contributed exceed the expenditures assumed and the fiscal balance is negative.

The latest study on Catalonia's fiscal balance covers the period 1995-1998 and reveals that for 1998, Catalonia had a 1.3-billion peseta fiscal deficit (216,000 pesetas/inhabitant and 8.4% of Catalan GDP).

During the period analysed, the deficit increased, from 5.8% of GDP to 8.4%. This deterioration stems in part from a thriving economy, since during periods of prosperity positive revenues increase more than expenditures and the fiscal deficit thus grows.

The new model remedies the situation that arises because the autonomous communities do not participate in fiscal enhancement during prosperous times and, consequently, it tends to reduce the fiscal deficit.

# THE FINANCES OF DECENTRALIZED AUTHORITIES AND FINANCIAL RELATIONS BETWEEN AUTHORITIES AT DIFFERENT LEVELS IN FRANCE TRENDS AND OUTLOOK

By Guy Gilbert

## 1. INTRODUCTION

France's image on the international scene still seems so heavily marked by its past as a nation structured around the crushing power of a unitary-central State that one expects in a symposium such as this one devoted to "fiscal imbalance" the place reserved for French experience to be at best that of an extreme, indeed, simply exotic case.

I do not think so, since it strikes me that the *de jure* and *de facto* exercise of public financial power in France is (or at least, was, until recently) much more decentralized than in many other unitary countries, including in the European Union. The French public finance "model" undoubtedly primarily reflects the model described by Richard Bird in 1993 as "multi-unit finance" or "fiscal federalism," in which the central State is the principal and sub-central authorities are the agents. However, there is more than that in the play between the central State in France and the authorities that would compel us to consider a more diversified model in which, without going as far as the "multi-principals game" of "federal finance" defined by R. Bird, account would be taken of strategic interactions that are more complete than those underpinned by the principal-agent model.

In anticipation of the conclusion of this presentation, I also believe that the attempts to put public finances in order in the EMU pose a genuine threat to local financial autonomy in France and are giving the central State the idea of financial recentralization, because of which the existing system is subject to growing tension stemming from the adaptation of our public finances to the demands arising from the signing of the Maastricht and Amsterdam treaties. Such tension is so high that the future of the existing structure is in danger and, as a final paradox, France's entry into the "common European house" could serve as a pretext for a (re)centralization of the public finance system.

The first section is devoted to the paradoxes of the structure of public finances at several levels of authority in France. The second section describes in detail institutional facets of local finances and intergovernmental financial relations to explain the current state of decentralized finances. The final section will focus on future prospects in the form of two opposed scenarios.

## 2. PARADOXES OF THE FRENCH "MODEL" OF DECENTRALIZED PUBLIC FINANCES

A historic perspective suggests presenting France as an archetypal nation with a unitary, highly centralized government. Under the circumstances, local authorities would only obtain a subsidiary place, always dependent on the centralized authority. In other words, local autonomy, especially financial autonomy, would only be stingily counted and always fragile.

Applied to France, this commonplace is largely inaccurate. The financial autonomy of French local authorities is extensive, effective, strongly supported by decentralization, and guaranteed by the political weight wielded by local elected representatives in the parliamentary deputation. This autonomy is considerable both from the standpoint of the mobilization of resources (taxes, transfers and borrowings) and the use to which resources are put. Compared with the situation of authorities in other European Union member countries, such autonomy is, indeed, exceptionally strong (Gilbert 2000; Gilbert and Guengant 2001a; Gilbert, Guengant and Hespel 2001).

### 2.1. French local authorities enjoy extensive financial autonomy

France is a country in which local authorities enjoy considerable fiscal flexibility (it ranks second, after Sweden, and ahead, in particular, of the other countries of northern Europe). The same is true of borrowing, since local authorities enjoy extensive latitude, i.e. prior authorization is not required to borrow, except for borrowings denominated in currencies other than the franc and the euro. The only constraints concern control over legality, control over budgetary balance and the registration of debt repayment, and compliance with certain prudential rules.

However, overall, these rules do not go beyond the requirement that borrowings be amortized financially. In particular, they do not compel the economic amortization of public capital (to this end, it would be necessary for the balance of the operations section to be realized following the inclusion in expenditures of the economic amortization of local public

amenities and not according to the existing rule that only obliges authorities to pay off debt related to amenities). The authorities, in particular, the biggest ones, which maintain their treasury at the minimum possible level, readily optimize the obligation to deposit free funds with the Treasury.

The close link formerly imposed between obtaining loans and subsidies and the characteristics of the amenities funded has been loosened. Most of the subsidies and allotments that the authorities now receive are comprehensive and are paid as a lump sum.

Broadly speaking, French local authorities now enjoy significant financial autonomy in comparison with their counterparts in most EU member nations. However, striking differences separate member countries in which local authorities enjoy considerable autonomy.

France is the only member of the group where there is significant local autonomy and local spending accounts for a modest proportion of GDP. While the spending of highly autonomous local authorities in Sweden, Denmark and Finland accounts for between one-quarter and one-third of GDP, the equivalent figure in France is only 9%. However, in all other member countries, except the Netherlands, the weight of the local public sector is hardly different from that in France but the degree of fiscal autonomy is smaller. There is no clearly positive relationship between local financial autonomy and the spending power of the local sector (Chart 1).

## ***2.2. Fiscal autonomy is strong despite extreme territorial fragmentation***

The second distinctive feature of the situation in France concerns the relationship between local fiscal autonomy and territorial fragmentation. It may be thought that it is easier to grant considerable fiscal autonomy to local authorities all the more so as local expenditures are moderate and the authorities are small in terms of population. This is true in France, although it is not the case in the northern European countries, except the Netherlands, where strong local autonomy is combined with limited territorial fragmentation. Generally speaking, there does not appear to be any clear relationship between the degree of territorial fragmentation and local financial autonomy in the European nations (Chart 2).

All things considered, the situation in France is paradoxical in that there is strong financial autonomy and such autonomy is exercised in highly fragmented, overlapping territories. Territorial competition is exercised between very unequal authorities from the standpoint of financial wealth, an inequality that is exacerbated by the weight of local taxes and distorted by the distinctive features of the local taxation system.

## **3. INSTITUTIONS IN THE FRENCH “MODEL” OF DECENTRALIZED PUBLIC FINANCES**

### ***3.1. The map of local authorities is ... fragmented and overlapping***

- ◆ The map of local authorities encompasses three levels, or even four if account is taken of the intercommunal level.
- ◆ As of January 1, 1999, metropolitan France (with a population of 60 million), had 36 564 communes, 96 departments and 21 regions (plus Corsica).
- ◆ There are an additional 215 communes, four departments and four regions in the French overseas departments and territories.
- ◆ Communal linkage is exceptionally refined. The 36 communes with 100 000 or more inhabitants account for 15% of the population; the 841 communes with 10 000 or more inhabitants account for 49.5% of the population. Symmetrically, the 35 710 communes with fewer than 10 000 inhabitants, of which ... 28 183 have fewer than 1 000 inhabitants, account for 16% of the population. The average size of French communes is thus small, the lowest in the EU member countries, i.e. 1578 inhabitants.
- ◆ The regional division is also atypical in the European context. The French regions are very disparate in terms of population, i.e. 10.6 million in the Île-de-France region, 5.3 million in the Rhône-Alpes region, 4.3 million in the Provence-Alpes-Côte d'Azur region, 4 million in the Nord-Pas-de-Calais region, and, in contrast, 0.7 million in the Limousin region and 0.25 million in Corsica.
- ◆ Communal fragmentation makes necessary the voluntary grouping of basic authorities with a view to jointly managing amenities or elaborating economic development and urban planning projects on a more relevant scale than the communal level.
- ◆ Voluntary groups of communes can take an associative or federative form.
- ◆ In an associative group, the communes (municipal councils) transfer to the group decision-making and executive power in respect of the jurisdictions transferred in exchange for a financial contribution and levy additional taxes to this end. In 1999,



there were 18 051 intercommunal syndicates (14 614 syndicats intercommunaux à vocation unique (SIVU), 2221 syndicats intercommunaux à vocation multiple (SIVOM), and 1216 mixed syndicates. Under the federative formula, funding for intercommunal public establishments comes from substitutive taxation levied at a single rate throughout the intercommunal zone. This is true of the nine syndicats d'agglomération nouvelle, 305 districts, 12 communautés urbaines, 1348 communautés de communes and five communautés de villes.

- ◆ Groups have developed regularly since their creation. The total number of groups has risen from 10 636 in 1972 to approximately 20 000 today. The pace of establishment of the groups has been uneven over time, according to the formulas proposed by legislators, and in geographic terms (intercommunal groups are more common in the western part of France than in the southern and eastern parts). Since 1992, the federative formula, which is the most integrative, has enjoyed the greatest success.
- ◆ As of January 1, 1998, a total of 17 760 communes had grouped together, equivalent to 48.4% of the population. One commune in two belongs to a group of communes with its own taxation, whether in urban, near-urban or rural areas.

### 3.2. *The jurisdictional map is no ... “French formal garden”*

- ◆ Legislation attributes to local authorities a number of compulsory jurisdictions. The authorities are free to assume other jurisdictions.
- ◆ Legislation governing decentralization and jurisdictions adopted in 1982, 1983, 1984 and 1986 has organized a “rational” redistribution of blocks of jurisdictions, which reality has hastened to complicate.
- ◆ The **regions** have been assigned jurisdiction over land use planning and development, regional planning, assistance to businesses, ongoing vocational training and apprenticeship, river ports and navigable waterways, fishing fleets and aquaculture, construction and the maintenance of high schools.
- ◆ The **departments** are responsible for social action and health, maritime ports and aquaculture, non-urban school transportation, the maintenance and construction of colleges, and assistance in respect of rural amenities.
- ◆ The **communes** are responsible for urban planning (documents, planning and authorization to use land), general jurisdiction over local urban services, the construction and maintenance of nursery and primary schools, libraries, occupational health and general health services, sports facilities, urban public transport, and jurisdictions exercised on behalf of the State, e.g. civil status and voters' lists.
- ◆ All communal jurisdictions may be transferred to **intercommunal groups** (except for police powers). The groups manage a wide range of services that has continued to grow over the years (ranging from two jurisdictions, on average, in the case of groups with additional taxation powers, to eight for groups with integrated taxation). Some jurisdictions are compulsory for certain types of intercommunal groups, e.g. the new communautés d'agglomération established by the law of July 12, 1999.

The following table indicates the division of key jurisdictions.

<b>Jurisdiction</b>	<b>Authorities</b>
Education:	
Construction and maintenance	State, communes, departments and regions
Staff remuneration	State
Social action	Departments and communes
Management of hospitals	State
Water, garbage	Communes and intercommunal groups
Road maintenance	State, regions, departments and communes
Public transportation	Regions, departments, communes and intercommunal groups
Economic development	State, regions, departments, communes and intercommunal groups

### 3.3. *Decentralized authorities are democratic authorities*

Since the adoption of the laws of 1982-1986:

- ◆ all of the authorities, except public intercommunal establishments, have deliberative assemblies elected by universal suffrage for six years through various methods, e.g. majority vote, mixed majority/proportional vote in respect of the municipal councils of the communes, depending on size, majority votes with respect to the county council in the departments, and a proportional vote in the case of the regional councils;
- ◆ the executive body is elected within the deliberative assemblies, i.e. the mayor and assistants in the communes, the president of the county council or the regional council and the vice-presidents in the departments and regions, respectively. The region also elects an economic and social council.

### 3.4. *The acts of decentralized authorities are controlled ex post*

- ◆ The acts of various authorities have been controlled ex post since 1982.
- ◆ As soon as they are adopted, the acts of the authorities are submitted to a representative of the State, i.e. the prefect of the department or region, as the case may be, who may have recourse to the administrative tribunal or the Chambre Régionale des Comptes (CRC). Except for specific cases, the act remains in force until such time as it is cancelled.
- ◆ **Budgetary acts** are subject to specific constraints (Gilbert and Guengant 2001b).
- ◆ First, they must comply with common presentation rules that tend to be aligned with private accounting rules (reforms have been undertaken recently).
- ◆ Local budgets are presented in the form of general budgets and subsidiary and autonomous budgets in the case of specific public services.
- ◆ The operating section budget records as expenditures all operations pertaining to the authority's current needs, e.g. salaries, maintenance expenses, supplies and operating expenses, and financial expenses such as interest on borrowings and self-financing. It records as revenues operating allocations and other transfers received, fees for services provided, the proceeds from local taxes, proceeds from State property, and various own resources.
- ◆ The investment section records capital-related operations; as expenditures, acquisitions of movables and immovables, capital-construction projects and the repayment of capital on borrowings; as revenues, gross savings, borrowings, and subsidies and allocations for amenities received, in particular, from the State.
- ◆ The budget must be voted in principle prior to January 1 of each year and, in fact, prior to March 31.
- ◆ It must be voted in "real" balance. In other words, the balance of the operating section must be sufficient to allow the authority to cover the repayment of capital on borrowings for the fiscal year (cf. infra "Borrowings and debt").
- ◆ Budgetary acts are controlled ex post. In order to be binding, the budgets must be submitted to the prefect, who may refer them to the CRC. In small communes with fewer than 200 inhabitants, the prefect directly regularizes the accounts. The CRC, which is made up of independent magistrates, monitors the accounts, usually by reference to the prefecture, in four instances only: voting on the budget beyond the deadline, failure to record compulsory expenditures (debt due and expenditures made compulsory by law), the absence of genuine balance in the budget section by section, and the absence of a vote or imbalance in the administrative account. In principle, the CRC judges the legality, not the advisability, of the employment of funds.

### 3.5. Local taxation overlaps and is specialized

- ◆ The financial resources of local communities include taxes, fees, various forms of aid paid by the State, by Europe or by other local communities, to which are added proceeds from borrowings and gross saving for the financing of investments. The French system is characterized by the prominence of local tax resources, their great variety and the considerable complexity of the rules governing the apportionment of State funding.
- ◆ Taxation predominates in local budgets and accounts for nearly two-thirds of operating revenues. There are over 40 local taxes of varying importance. Local authorities have at their disposal several optional tax es, e.g. an electricity tax and a visitors' tax, and may grant temporary exemptions.
- ◆ The taxation system centres on overlapping and specialization.
- ◆ The four most important direct taxes overlap, i.e. the communes, departments and regions independently vote on the tax rates that apply to the same taxation base, without the deductibility of taxes collected at a lower level. This is true of the property tax on undeveloped property (TFNB), the property tax on developed property (TFB) and the housing tax (TH), which are based on cadastral values that are supposed to represent the revenue from the property in question. However, the bases have not been subject to general review since 1970 and are simply reassessed homothetically each year in light of the failure to implement the review effected in respect of 1990. The housing tax, of which the regional share has just been eliminated, is subject to keen criticism because of its regressivity in relation to income.
- ◆ The fourth and final local direct tax, the business tax (TP), constitutes (or rather, constituted) a high-yield tax. Until recently, this tax alone accounted for nearly half of the tax revenues of local authorities. It was very unevenly distributed and was the principal cause of the very great disparity in tax wealth between local authorities. Based on salaries (18% of the total payroll until 1999) and the rental value of fixed assets (investments), it is very poorly tolerated by businesses, which call into question the anti-economic bases and distortions in rates between local authorities, although contributions are capped in relation to the establishment's added value.
- ◆ The last category of overlapping taxes includes additional transfer taxes and taxes related to urban planning.
- ◆ **Specialized** taxation can, by and large, be broken down as follows:
  - in communes and groups of communes:
    - garbage collection taxes
    - payments to fund public transportation
    - electricity tax
    - additional transfer taxes
    - taxes related to urban planning
  - in the departments:
    - vehicle stickers (largely eliminated in 2000)
    - tax on property publicity and registration fees
    - electricity tax
  - in the regions:
    - tax on registration certificates
    - tax on driver's licences.
- ◆ Broadly speaking, local authorities do not **control tax bases**, which are established for remuneration by the State's taxation services on behalf of local authorities. However, the local authorities may grant relief, the nature and conditions of which are governed by legislation. The State adds its own tax relief to that of the local authorities, which gives rise to financial compensation (cf. infra.).
- ◆ In principle, the local authorities vote freely on tax **rates**, although this freedom is, in fact, considerably limited even though it is more extensive than in many EU member countries.
- ◆ As for the business tax, minimum and maximum rates are levied, which apply not to the tax base but to added value (3.5% to 4% depending on the size of the business). The rate of the business tax may not vary more rapidly than the rates of taxes borne by households under the same authority. In the case of the housing tax or property taxes, no other rate tunnel is adopted but a taxation threshold is defined by legislation (housing tax).
- ◆ Intercommunity taxation has undergone various major reforms, the most important of which is sanctioned by the law on intercommunal cooperation of July 12, 1999. Two intercommunal tax systems must be distinguished. In the case of intercommunality accompanied by additional taxation, the Établissement Public de Coopération Intercommunale (EPCI) votes on a rate that applies to the direct taxes (TFNB, TFB, TH and TP), which makes intercommunality the fifth overlapping level of taxation. As for intercommunality accompanied by own-source taxation (single urban business tax), the EPCI votes on behalf of the communes that are part of the intercommunal structure the single business tax rate that will

apply to all of the members, thus avoiding intracommunal tax competition. Since 1999, the community business tax rate may not vary freely in relation to household tax rates, which continue to be set by the member communes of the EPCI.

- ◆ Proceeds from local taxes are paid monthly (through advances) to local authorities.

### 3.6. *The structure of State financial aid to local authorities is complex*

- ◆ State financial aid to local authorities stood at nearly 300 billion francs in 2000. This amount is considerable, equivalent, for purposes of comparison, to nearly three-quarters of personal income tax revenues, although it does not reach as a relative proportion the amounts from which local authorities benefit in the United Kingdom or Germany, for example.
- ◆ Overall, such aid is highly complex, although the principles governing its structure and development are very similar to those found in many countries. In this instance, the weight of history is decisive.
- ◆ After a lengthy period in which State aid often took the form of conditional subsidies, most of the aid is now comprehensive, i.e. it is not allocated or conditioned by a specific use.
- ◆ The financial stakes are high since territorial fragmentation in France and the predominance of a high-yield local tax in respect of businesses is exacerbating disparities in fiscal capacity between local authorities and, consequently, the need for equalization.
- ◆ Since 1996, aid has been divided between budgeted (rationed) and non-budgeted (non-rationed) aid. The entire array of rationing measures was included in two successive contracts between the State and local authorities, i.e. the Pacte de Stabilité Financière, between 1996 and 1998, and the Contrat de Croissance et de Solidarité, between 1999 and 2001 (cf. infra.).
- ◆ Transfers from the State to local authorities fall into four categories: operating aid and grants, aid and grants covering amenities, aid covering transfers of jurisdiction, and compensation for tax exemptions and legislative abatements.
- ◆ **Operating aid and grants** (126 billion francs in 2000) include:
  - overall operating aid (DGF) for the communes and **groups**, comprising “lump sum aid” (70% of the total) that includes basic aid, equalization aid, compensation aid, a supplement in respect of road works, a minimum guarantee, and “special aid” for central cities and tourist communes. The amount is set in relation to the amount that the commune received under the old system (1993) adjusted to the commune’s population evolution since that time. From one year to the next, it incorporates changing prices (roughly half) and half of growth by volume in GDP. The DGF also includes “development aid”, comprising the DGF of groups of communes with own-source taxation (the amount of this DGF is high in order to encourage the creation of intercommunal bodies with own-source taxation); urban solidarity aid (DSU) derived, in particular, from a contribution from the Région Île-de-France. It benefits communes with over 10 000 inhabitants with limited fiscal capacity and is apportioned in light of “costs and resources” (fiscal capacity + social housing + APL + revenue). Urban solidarity aid benefits central boroughs and communes with fewer than 10 000 inhabitants, apportioned according to fiscal capacity and population (in the of central boroughs).
  - The **overall operating aid of the departments** follows the same principles but is simpler.
  - The regions do not receive any DGF, except the Région Île-de-France until 1995.
  - The **business tax national equalization fund (FNPTP)** receives part of the proceeds from the business tax of the communes in which are located big establishments and through contributions from the State and, occasionally, big companies (the post office and France Telecom).
  - The **national equalization fund (FNP)**, established in 1995, is intended for communes with limited fiscal capacity and a considerable tax effort and is funded by means of the surplus of the FNPTP and State contributions.
  - **Special aid for teachers** offsets the costs borne by the communes to house teachers.
- ◆ **Aid and grants for amenities** (34 billion francs)
  - **Overall aid for amenities (DGE)** is a project-based subsidy granted to communes with fewer than 20 000 inhabitants and to groups of communes with over 20 000 inhabitants. It takes the form of an aid fund and changes in keeping with the price of the GFCF of administrations.
  - The **VAT compensation fund (FCTVA)** approximately compensates the VAT paid by local authorities on their capital equipment purchases.

◆ **Compensation aid for the transfer of jurisdictions** (25 billion francs)

Since 1982, transfers of jurisdictions from the State to local authorities have been funded either by means of tax transfers from the State or through aid:

- **General decentralization aid (DGD)**, aid for occupational training and aid for Corsica change in the same manner as the DGF and benefit the regions, departments and communes.
- **Regional aid for school facilities (DRES)** and **departmental aid for college facilities (DDEC)** benefit the regions and departments, respectively, and change in the same manner as the price of the GFCF of the administrations.

◆ **Compensation for administrative exemptions and abatements**

The State imposes constraints on the fiscal choices of local authorities, e.g. the ceiling on the business tax, the business tax abatement for companies that invest or hire, the abatement or exemption from the housing tax for low-income earners, and so on.

To compensate local authorities that consequently have lower fiscal capacity, the State has at its disposal two budgeting techniques, abatements and compensation.

In the case of abatements (60 billion francs in 1998), the State takes the place of the local taxpayer in respect of whose tax it provides relief and fully compensates the local authority for the fiscal shortfall regardless of the rate that the authority has voted. Against a backdrop of this “moral hazard,” the communes have every interest in increasing the rates since the State will supplant the local taxpayer. The budgetary risk for the State is also apparent as it is contending with a fiscal subsidy (an “open tax expenditure”).

In the case of “exemption compensation,” the State funds the fiscal shortfall by paying monetary compensation that is added to the taxes levied by the local authority. The amount of such compensation is independent of the tax rate voted by the local authority, e.g. the compensation is calculated according to the tax base of the exempted taxpayer multiplied by the rate in effect at the time the compensation was implemented. In this way, the State protects itself against the “rate risk.” In some instances, it even protects itself against the “base risk” by freezing the amount of the compensation calculated on the tax base and the rate in force the year the measure was introduced. This technique makes it possible to transform the corresponding tax expenditure into a “closed-ended” subsidy.

◆ **Macroeconomic management of State aid**

En 1995, the French government committed itself to ensuring that a portion of the financial aid paid to local authorities, i.e. 160 billion of roughly 250 billion francs, would increase between 1996 and 1998 at the same pace as inflation in order to maintain the purchasing power of the allocations and thus avoid destabilizing local budgets. This stability pact expired in 1998.

A growth and solidarity contract replaced the pact for the years 1999 to 2001. In addition to the indexing based on inflation found in the pact, the contract added gradual indexation based on growth in GDP (0.15%, then 0.25%, and 0.33% in 2001). Behind their apparently favourable appearance the two pacts reveal a formidable mechanism for adjusting the State's grants (see Section IV). Nearly 110 billion of the “budgeted” 160 billion francs concern overall operation aid (DGF), which, as we have seen, increases in relation to inflation plus 50% of growth in GDP, while the budget allowance increases by the inflation rate alone. In order to simultaneously respect both conditions, it is necessary for (and sufficient that) another form of budgeted aid be used as an adjustment variable, which is true of the business tax compensation aid, which has thus declined markedly each year since 1996.

### **3.7. Legislative framework governing debt and borrowing**

Since the adoption in 1982 of legislation governing decentralization, French territorial authorities, i.e. communes, departments and regions, have enjoyed almost total freedom of access to capital markets, at least to finance their capital investments. The possibility of borrowing, subject to the allocation of the funds, requires neither prior approval nor a priori control by national authorities. The authorities responsible are free to choose the amount, rate, duration and lending agency. Comprehensive loan applications are submitted to banks for the investment program overall, not on a project-by-project basis. Consequently, borrowing represents a temporary, global, non-specific resource.

The banking sector accounts for virtually all of the credit available, i.e. approximately 70 billion francs in 1997, outside of national planning. However, bond issues on the financial market are scarcely developed, i.e. on the order of 5 billion francs in 1997. The dominant position of intermediated credit stems from the keen competition between offerers from the standpoint of rates and management facilities. In comparison, debt issues seem more costly, overall (with the attendant fringe expenses) and, above all, more rigid. The Crédit Local de France controls roughly 40% of the market, followed by the Crédit Agricole and the savings banks, which are the main lenders.

The freedom to borrow accorded the territorial authorities is, however, accompanied by a corollary in the form of an obligation to achieve a balanced budget, a constraint aimed at guaranteeing the timely repayment of debt and protecting the lenders' interests, but also of protecting local authorities from the risk of debt overload. Moreover, the loan guarantees provided by the authorities are also monitored. They are only accepted if the cumulative total of yearly loan repayments exceeds half the authority's actual operating revenues. In addition, the amount of the annual repayments guaranteed in respect of a given debtor must not exceed 10% of the commune's total guarantee capacity. Annual provisions equivalent to 2.5% of the guaranteed annual repayments that remain to be covered must cover such guarantees.

Each year, the State representative verifies compliance with legal provisions and, in the event of failure to comply, approaches the *Chambre régionale des comptes*. Control focuses both on the budget estimate (preliminary budget) and the actual budget (administrative account). The authority's balance depends, by and large, on its level of savings, i.e. the outcome of the fiscal year, in conjunction with depreciation expenses and provisions. However, legal protection offered by the legislation no longer guarantees, under all circumstances, the solvency of decentralized administrations. Budgetary control has a twofold temporal and spatial bias. Consequently, annual balance no longer corresponds to multi-year balance, in other words, to durable solvency (Gilbert and Guengant, 2001b).

#### **4. RECENT CHANGES IN LOCAL FINANCES: ARE LOCAL AUTHORITIES "RISK-FREE PLAYERS"?**

##### **4.1. *A growing macroeconomic weight (Table 2)***

Overall, the APULs now account for between 5% and 10% of GDP, depending on whether account is taken of their consolidated added value (400 billion francs in 1996 in relation to a GDP totalling 8 000 billion francs) and their budgets are added up without consolidation (450 billion francs for the communes, 150 billion francs for groups, 250 billion francs for the departments, and 100 billion francs for the regions). The trend is the same in both instances. Since the early 1970s, the weight of the APULs in GDP has risen by one-third but such growth is slowing gradually, with a marked drop during the economic crisis of the 1990s, which strongly tightened up local budgetary constraints.

##### **4.2. *Budget control achieved at the cost of reduced investment***

Local budgets, which, overall, are balanced, do not lead to macroeconomic risks.

Operating revenues, which grew in volume by 8% a year between 1970 and 1977, have barely risen by 3% since the beginning of this decade, since the increase in rates does not offset the erosion of the tax bases.

Given that operating expenditures, especially personnel expenditures and social action expenditures, continued to climb steadily (2 points higher than GDP in volume), the management surplus of local authorities gradually diminished. The surplus is certainly comfortable and now stands at more than 25% before interest expenses are charged, but it did reach a record level of 32% in 1989.

This sound budgetary performance could only be sustained at the cost of slower growth in capital expenditures, which are more malleable than operating expenditures. Thus, until the early 1980s, for each additional franc of operating revenues, three-quarters were earmarked for current expenditures (excluding interest) and the remainder to self-financing and debt service. Between 1983 and 1989, balance was gradually restored between the two components, which reached 50/50 in 1990 (Charts 3 and 4).

Starting in 1990, the division once again became unbalanced under the combined effect of the reduction in cash flow and the high level of real interest rates. Today the ratio stands at 90/10 in favour of operating expenditures. Since real interest per franc borrowed is now constantly higher than real savings per franc invested, the leverage effect becomes negative, thus reducing loan requests (Chart 5).

It is readily apparent why the indebtedness of local authorities is now well under control. Several convergent indicators confirm this observation: the debt/current funds ratio has been remarkably stable since the early 1970s, i.e. between

16% and 17%. Growth in annual loan repayments has roughly kept pace with increases in reportables (the first figure is equivalent to between 50% and 60% of the second one). The portion of savings mobilized for debt service is now lower than it was in the early 1970s and the local debt/GDP ratio has been stable for some time, i.e. between 8% and 9% (Chart 6).

The ability of local authorities to get out of debt (debt/gross savings) is markedly lower than the average contractual duration of portfolio loans, i.e. five years and eight to 10 years, respectively. The finance requirements of the APULs, which was 1% of GDP in the early 1970s and virtually disappeared in 1989 (0.16%), subsequently reappeared but remained highly limited (10 billion francs in 1997) in relation, for example, to that of public administrations overall (290 billion francs in 1997) (Chart 7).

To conclude, the “financial fundamentals” of the local authorities are, overall, satisfactory. The overall budget share is becoming stable. Budgetary balance and solvency are satisfactory and indebtedness has been contained, although financial risks certainly do persist. The fiscal slippage of a number of cities and the financial problems of certain departments are well known, although they are highly localized and attributable more to situation factors than to widespread problems.

## **5. WHAT FUTURE IS THERE FOR THE FRENCH LOCAL FINANCE “MODEL”? LOCAL FINANCIAL AUTONOMY IS CALLED INTO QUESTION**

The flipside of recent changes in local finances is less pleasant. Over the past 30 years, the strong dynamic of the budgets of territorial authorities has been achieved at the cost of heavier local taxation, equivalent to over three points of GDP during that time, and a financial effort by the State that has hardly slackened. Various transfers to local authorities increased from 15% of the State budget in 1980 to over 19% in 1999, although most of the transfers are tied to the decentralization of jurisdictions.

This situation raises two basic questions. The first concerns the future of local taxation and the second, the ultimate sustainability of the process of dividing aid paid by the State to local authorities.

The archaic nature of the local tax base, the disparity in rates and the unfair nature of local taxation have been noted repeatedly. The government’s inability to promote a reform of the tax bases, given the transfer of expenses associated with such a reform, has led to a complete deadlock, which is reflected at present in the renationalization of the resources of local authorities.

*How has the deadlock occurred in the system of funding territorial authorities?*

The growing assumption of responsibility for local taxation under the national budget does not stem from more or less Machiavellian initiative of the dominant “player,” the central State, alone, which has finally succeeded in imposing on the decentralized authorities an elaborate, longstanding political strategy that it has patiently implemented, a strategy that is ultimately aimed at the disappearance of all territorial financial autonomy.

Observation of past change reveals that the situation marks, instead, the outcome of the “game” played by the players, i.e. the State and the local authorities, each of which has at its disposal strategic resources. In some respects, the decentralized authorities may seem to have lost the game, although not all of them in the same way. Financial “recentralization” has scarcely affected the many authorities that have “vested rights” and that have been able to obtain for their own benefit a large portion of the transfers distributed by the State. The others have weathered with greater difficulty the transition and have been constrained, in order to finance their development or, indeed, to simply ensure their survival, to negotiate the opening of new rights and new outlets on the margins of the main forms of aid.

The reforms of territorial taxation proposed in the wake of legislation governing decentralization have all failed, whether they were introduced by the State (the business tax) or the local authorities (the departmental income tax).

In light of resistance to head-on treatment of the “crisis” in local taxation, the only way to respond to growing opposition, especially from the business community, has been to increase the tax relief offset by the national budget.

However, the explosion in the budgetary cost of tax relief has led the State to at least partially shift this cost to the local authorities, through the standardized budget allocation procedure.

The growing “institutional risk” confronting local taxation is heightened by France’s participation in Euroland. In conjunction with the euro, budgetary convergence is entrusted to the central government, which is responsible as a last

resort for deficits and the debt of central and local public administrations and social security agencies. The conjunction of the financing needs of the three categories of agencies, especially from the standpoint of the financing of health and retirement spending, will make the budgetary exercise especially arduous, apart from the fact that inflation will for a time displace these strategic factors. Moreover, with regard to debt, a shift in economic conditions would certainly raise the question of the division of access to borrowing by the three categories of players. Even more directly, France's participation in the European Union will ultimately pose the question of the place of local authorities in community institutions and that of the role of local finances in community public finances overall. According to what comprehensive mechanism will the public finances of the member states be managed? What principle of unanimity or majority rule will be adopted? Will tax competition be limited or, to the contrary, encouraged? Will European financial equalization be established?

Broadly speaking, local French finances are at the crossroads. The reform of local financing will be a key budgetary issue in the coming years. Not only is the content of the reform uncertain but also its very occurrence. The window of opportunity for a reform of local taxation is undoubtedly very narrow and the coming years will be decisive for the future of financial decentralization. Against this uncertain institutional backdrop, forward thinking is essential.

Two alternative forward-looking scenarios illustrate in a deliberately highly contrasted manner the issues at hand, i.e. the pursuit of "fiscal recentralization" and the restoration of fiscal decentralization.

### ***5.1. The pursuit of "fiscal recentralization" (Diagram 1)***

This scenario centres on two hypotheses. First, no agreement between the State and territorial authorities is reached on basic reform of direct local taxation. Second, the Constitutional Council is not opposed to the gradual elimination of local fiscal autonomy. The progressive nature of the assumption by the State of local taxes hides the breach to the principle of "free administration."

In the realm of taxation, the scenario stipulates that repeated local direct tax crises would be defused, as in the past, through the accumulation of premium relief funded by the State. Opposition from businesses would lead to the gradual removal of the business tax base, only the property investment component of which would remain, which would ultimately be incorporated into the property tax on developed industrial and commercial properties and thus form the second bulwark of direct local taxation of fixed assets. The first one would centre on the inhabitants, the second one on businesses. The rates of the two taxes on developed properties would now be differentiated but continue to "co-vary" according to the privity rule.

The housing tax would benefit from growing relief. The tax would disappear, first of all at the regional level (since 2000), then the departmental level and finally, the communal level. The only measure of fiscal freedom left to territorial authorities would centre on the property tax on the developed properties of households and businesses.

However, by dint of relying excessively on taxes and delaying the revision of cadastral assessment, now nearly 50 years old, the final bastion of direct local taxation would become increasingly precarious.

In the realm of State aid, the principle of a three-year pact would be renewed with a division between budgeted and non-budgeted aid. The State would intervene more and more extensively through compensation relief and would eliminate abatements, which would engender a steady increase in budgeted aid and a corresponding decrease in non-budgeted aid. Budget allotment indexing rules would play a growing role in light of growth in the volume of the funds concerned. They would adjust to the macroeconomic situation, growing tighter during economic slumps and looser during economic upswings. However, public finance macroeconomic management constraints (Maastricht) would diminish the importance of the indexing criterion. The loss of purchasing power of budgeted aid would become more pronounced and to facilitate acceptance of it by local authorities, a redistribution mechanism would be attached to grants in lieu of taxes. Non-budgeted aid would be concentrated on the VAT compensation fund (FCTVA). Broadly speaking, the development of equalization would be presented as compensation for the loss by local authorities of financial autonomy.

From the standpoint of expenditures, two sub-scenarios can be distinguished depending on the dynamics of local investment.

The first sub-scenario adopts the hypothesis of slower growth in investment and overall control over spending. The slowdown in capital expenditures would apply to development investment. The inventory of local public amenities would, of course, be maintained as it is and, if need be, brought up to standard, but it would cease to grow in volume. Consequently, recurring operating expenses would be controlled by volume and, therefore, staffing levels. However, salaries would continue to rise under the effect of burgeoning fringe benefits, regardless of control over investments.



Operating expenses would generally continue to drift according to an exogenous trend despite the curbing of capital investment.

The second sub-scenario adopts the hypothesis of an upswing in local development investment. The local authorities would readopt a policy of growth with respect to their inventory of amenities. Operating expenditures would increase through the costs engendered by new investment, in addition to the exogenous effect of the increase in the cost of labour (retirement effect).

Changes in the debt would, naturally, depend on the scenarios adopted with regard to investment. Real interest rates are supposed to fall. However, the local authorities would not be able to take full advantage of the return of favourable financial leverage because of the loss of the fiscal leeway they previously enjoyed. (The potential for local mobilization of resources would now depend solely on developed property and user fees.) The local authorities would not be able to carry out the debt reduction policy initiated in the early 1990s, for want of sufficient savings. The upswing in investment would engender growth in the need for financing partly covered by the increase in the VAT compensation fund and partly by an increase in the debt. However, the possibilities would be limited in the latter domain because of constraints imposed by Maastricht-based management of the deficit and debt. Under the circumstances, local authorities would find it harder to gain access to the borrowing market. A return to the system of prior authorization for borrowing would even be conceivable should a conflict arise with the State respecting the division of the authorized debt margin.

The dynamics of operating expenditures would lead to a substantial increase in developed property rates. Since the bases would not be subject to any thorough revision of the cadastral assessments, a crisis would develop both with respect to household and also to businesses. The last bulwark of local taxation would collapse and the State would take charge of the proceeds from the only remaining local tax.

*The centralization of local tax resources is complete.*

## **5.2. The restoration of fiscal decentralization (Diagram 2)**

The scenario concerning the restoration of fiscal decentralization assumes the conclusion of an agreement between the State and the local authorities on a sweeping reform of direct taxes, which would automatically terminate the policy of tax relief funded by the State. It would also lead to the reform of financial equalization, whose implementation is intended, in particular, to rectify fiscal capacity unevenly distributed among the local authorities.

Tax reform would focus at once on tax bases, rules governing the setting of rates, and the map of fiscal divisions. The State and the local authorities would share the considerable political cost. Local authorities would benefit from the broadening and modernization of the tax bases, but in exchange, would agree to twofold control over their leeway with respect to the setting of rates: each local authority would now only be able to freely set the rate of a single tax (the principle of fiscal specialization) and, if need be, within an authorized range (the principle of the rate tunnel).

From a territorial standpoint, the progress of specialized intercommunal taxation would be spectacular and the fiscal consolidation of the territories would accelerate. It would be accompanied by a broadening of jurisdictions. The communes would survive despite rising intercommunal power but they would accept the reduction in their budgets and fields of activity. Under the hypothesis adopted, the departments and regions would maintain their jurisdictions and financing.

The overhauling of fiscal decentralization would depend, first and foremost, on the modernization of the tax bases. The property tax system and real estate tax legislation are centred on the market value of properties or, at the very least, on property and real estate bases that change over time, much as market values do. The housing tax would be eliminated and local authorities would receive the proceeds from a broad-based local income tax, such that the one point of CSG would essentially be equivalent to the loss of revenues resulting from the elimination of the housing tax. As is true of the housing tax, the base of this income tax represents a reasonable and convenient approximation of the scale of consumption by residents of local public services (most econometric studies confirm that consumption income elasticity approaches 1, Guengant, 1988). The business tax would be maintained but its base would be reformed and now coincide with added value assessed at factor cost and at the place of production.

Next, the overhauling of local taxation depends on the principle of fiscal specialization. "Marginal" specialization would be adopted. The tax resources of each level of authority would continue to depend on various taxes (equalization of basic risks) but the capacity to increase or decrease the rates on a given tax would be granted to only one category of authority. This "marginal fiscal specialization" would thus combine the advantages of the security provided by a composite fiscal resource and that of democratic transparency.

The establishment of a rate tunnel is intended to temper the (non-cooperative) strategic use that certain local authorities would be tempted to make of the taxation weapon. The rate tunnels are narrower if the elasticity of the localized base to the tax rate is high and if these bases are narrow in relation to the expenditures to be financed. They are all the more readily accepted when, at the outset, the modernization of the tax bases has made it possible to further harmonize the rates within the territory, especially as regards the business tax and the developed property tax of businesses.

The reform introduces the decoupling of local taxation (communes and intercommunal groups) and the taxation of intermediate authorities (departments and regions), a solution that should facilitate the reorganization, indeed the possible elimination, of one level of intermediate authority.

When these principles are combined, local taxation would be reorganized as indicated below.

- ◆ **The communes** would set property tax rates and also benefit from a broad-based, local income tax, but at a moderate set rate.
- ◆ **At the intercommunal level**, the single business tax applicable to an urban area would become widespread. Fiscal coordination between communes and intercommunal groups would be achieved, first of all, by means of a legal relationship centred on the covariation of household and business rates. Second, a decisive institutional reform would round out the French territorial reform that has been under way for half a century. Democratic legitimacy and most local jurisdictions would be transferred to the intercommunal level, which would have a deliberative assembly elected by direct universal suffrage; municipal councils, which would continue to be elected by direct suffrage, would become components of community political organization. The ceiling and the vertical link between the rates would be maintained in respect of the business tax. The linkage between household and business taxation would guarantee the coordination of communal and intercommunal fiscal strategies and rule out the risk of fiscal inflation. Financial equalization between the basic authorities would adapt to this new context of community management of local budgets.
- ◆ In order to finance social aid expenditures, in particular, the **departments would be** empowered to modulate the rate of a departmental income tax centred on a broader base in a narrower rate tunnel.
- ◆ The definition of the fiscal specialization of the **regions** would be harder to define. Various observers would agree to recognize the major economic role that the regions will be called upon to play in the future. Some options, such as a TIPP, a VAT on petroleum products and a tax on local loopback telecommunications, would be eliminated successively. A mixed solution, i.e. the allocation of a portion of taxes on polluting activities and the modulation of rates within a narrow tunnel set by Parliament, and sharing with the State of a national fiscal resource would, in the final analysis, appear as a compromise that reflects the regions' role in the realm of sustainable development and one that is likely to allow the regions to benefit from a "base effect" when economic conditions and the success of regional development initiatives allow for it.

Broadly speaking, the thorough reorganization of local taxation would depend on specialization combined with coordination. The taxation of households and businesses would be linked at the communal and intercommunal level. The taxation of the departments and regions would be decoupled from local taxation in a narrow sense. These authorities would obtain broad bases and their power to set rates would be partially amputated in aid of greater clarity for the citizen.

As for **State financial aid**, the reform of local taxation would, first and foremost, reduce the need for relief and thus, automatically, the corresponding transfers. Second, the broadening of the tax bases would widen the differences in fiscal capacity between authorities because property values would be taken into account with respect to property and real estate taxes, but would reduce them because power would be vested at the intercommunal level to differentiate the rates of the business tax and through monitoring of leeway in respect of rates. The second effect would undoubtedly be more important than the first, since differences in per-capita fiscal capacity between communes would be 85% attributable to local taxes paid by businesses alone (developed property and business tax) (Guengant, in Gilbert 1997). In any case, the map of the fiscal capacity of the territories would be profoundly altered. The system of financial equalization between the State and local authorities must be reformed, whether from the standpoint of criteria giving entitlement to subsidies, budgeted amounts or the type of authorities benefiting from equalization.

The reform of the financial equalization system depends on the notion of "real fiscal capacity." Equalization seeks to promote "territorial equity" by reducing the differences between authorities in "fiscal capacity less costs." The reform of local taxes would restore to fiscal capacity a legitimacy that it lost in the past. Correlatively, the place of fiscal capacity in equalization mechanisms must be redefined in order to finally introduce the notion of "expenses."

Broadly speaking, the reduction in the State's financial expenses would allow the latter to subject local authorities to less drastic conditions than in the past in the context of the three-year contractualization of budget allotments. In this way, the State would accept more generous indexing. The DCTP would regress less rapidly and its elimination would be avoided.

The need for financial equalization would be for a constant budget allotment, better satisfied. In addition to this compulsory vertical equalization achieved through State aid, there would be a voluntary equalization all the more probable as it depends on the development of intercommunal groups.

The departments and regions would withdraw from communal and intercommunal equalization in order to concentrate on their own fields of jurisdiction. Joint financing would decline without disappearing altogether.

The two sub-scenarios are identical to the preceding scenario. The ultimate crisis in local finances would be avoided. Through the restoration of financial decentralization, local authorities would achieve greater autonomy and obtain more flexible resources that would allow them to reduce their indebtedness or better control growth in their debt. In both instances, conflict over the debt margin with the State would be avoided.

## **6. CONCLUSION**

1. The two preceding scenarios describe extreme paths. Between the two, numerous other avenues are possible, depending on the ability of territorial authorities to defend their fiscal autonomy and the capacity of the national budget to pursue the assumption of local taxes. Consequently, while the first scenario is not wholly certain, the second one is even less so. The likelihood of undertaking a sweeping reform of direct local taxation seems relatively remote. Between the complete disappearance and the restoration of financial autonomy, the future course of direct local taxation is likely to follow numerous intermediary paths.

Two compromise dynamics could mitigate the rigour of the recentralization scenario in respect of the territorial authorities without leading to the genuine restoration of fiscal decentralization. The first avenue, which is closer to the recentralization scenario, would lead to the nationalization of tax (the solution would consist in gradually lowering the business turnover threshold required to take advantage of the “ceiling” on the value-added business tax, and tightening the “rate tunnel,” which would result in a value-added business tax for all). The second avenue, which is more in keeping with the decentralization alternative, assumes the maintenance of the location of collection within broader fiscal divisions.

In contrast to the two preceding scenarios, a third scenario is based on the maintenance of the location of the tax. Fairly unanimously preferred by a vast majority of local elected representatives, the preservation of the local nature of the business tax, or at least the residual fraction of the bases, is no longer automatically guaranteed since the reform of 1999. A purely defensive strategy would probably be doomed to fail.

2. The local authorities will not be able to regain genuine financial autonomy unless, aside from the freedom to spend and borrow, they are also empowered to freely set the tax rates on the tax bases allocated to them. Such fiscal autonomy demands that the tax bases be modernized. It is hard to imagine in France the definition of the tax base coming under the jurisdiction of an authority other than Parliament. However, once Parliament has clearly defined the bases underpinning the revision, its implementation could, as the Mauroy report suggests, be spread over time and be subject to the approval of the authorities concerned. It would be desirable to maintain a deadline and for the reform to apply simultaneously to a sufficiently large relevant geographic area to avoid any detrimental economic distortion and preserve a minimum of clarity with regard to the taxpayers.
3. The guarantee of the maintenance of the fiscal autonomy of local authorities does not make any less necessary the maintenance of transfers from the State, both for reasons of economic efficiency and because of the absence of congruence between changes in expenditures and tax revenues, by level of local authority. The development of intercommunal groups would considerably reduce the need for financial equalization.
4. If the scenarios elaborated here suggest that there is a possibility of saving the necessary fiscal autonomy of the local authorities while avoiding a conflict with the State on questions of financing, we must, however, emphasize the overall constraints of the undertaking, stemming from our commitments under the Maastricht Treaty. The avoidance of conflict over the debt margin between the State and local authorities is only possible insofar as the “fiscal boundaries” between these authorities and, indeed, social agencies, are modified. The strategic interplay between social agencies, local authorities and the State for access to the two broadly rationed “resources,” i.e. the budget deficit and debt, has only two outcomes (Guengant and Josselin 2001). One outcome, which would be negotiated, would lead to a voluntary division between the players of constraints and frustrations. The other outcome would lead to one player, undoubtedly the State, since it alone is unquestionably responsible for compliance with the budgetary and financial criteria associated with international treaties, imposing on other organizations and public authorities a strict financial and budgetary framework. However, there are no examples in which this strategy of the hierarchical transmission of constraints does not lead either to changes in the internal institutional framework, or to less perennial or visible bailouts that indirectly change these “hard” budgetary constraints into “softer” constraints, to use the expression currently used (Wildasin 1997, Rodden 1999, 2001).

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## APPENDIX: TABLES, CHARTS AND DIAGRAMS

TABLE 1

THE FINANCIAL AUTONOMY OF LOCAL AUTHORITIES IN EUROPEAN UNION MEMBER COUNTRIES, AROUND 1995				
Member country	Spending by local authorities (as a % of GDP)	Degree of local fiscal autonomy <sup>1</sup>	Number of basic local authorities	Average number of inhabitants per authority
Denmark	33	49	275	19100
Sweden	28.7	60	286	30900
Finland	23	43	455	11200
The Netherlands	19.1	8	572	24500
Italy	13.7	25	8104	7000
Spain	12 / 7.2 <sup>2</sup>	30	8082	4800
Austria	12	5	2353	3400
Luxembourg	11.7	32	118	3400
Germany	10	20	16121	5000
United Kingdom	10	14	- <sup>3</sup>	ns
France	9.2	54	36559	1600
Belgium	7.4	35	589	17200
Ireland	5.4	16	- <sup>3</sup>	ns
Portugal	3.7	7	275	34200
Greece	2.1	-	5922	1800

**Notes:**

<sup>1</sup> The degree of financial autonomy is ascertained by means of the *taxation/total revenues excluding borrowing* ratio.

<sup>2</sup> The first figure refers to the autonomous communities and the second, to the communes and provinces.

<sup>3</sup> Not significant: the occasional recoveries of structures do not make it possible to calculate an average size in respect of the basic units.

**Sources:** Dexia (1997), Gilbert and Guengant (1998a), based on the national accounts.

CHART 1

FINANCIAL AUTONOMY OF LOCAL AUTHORITIES AND SIZE OF THE LOCAL PUBLIC SECTOR  
(EU member countries, around 1995)

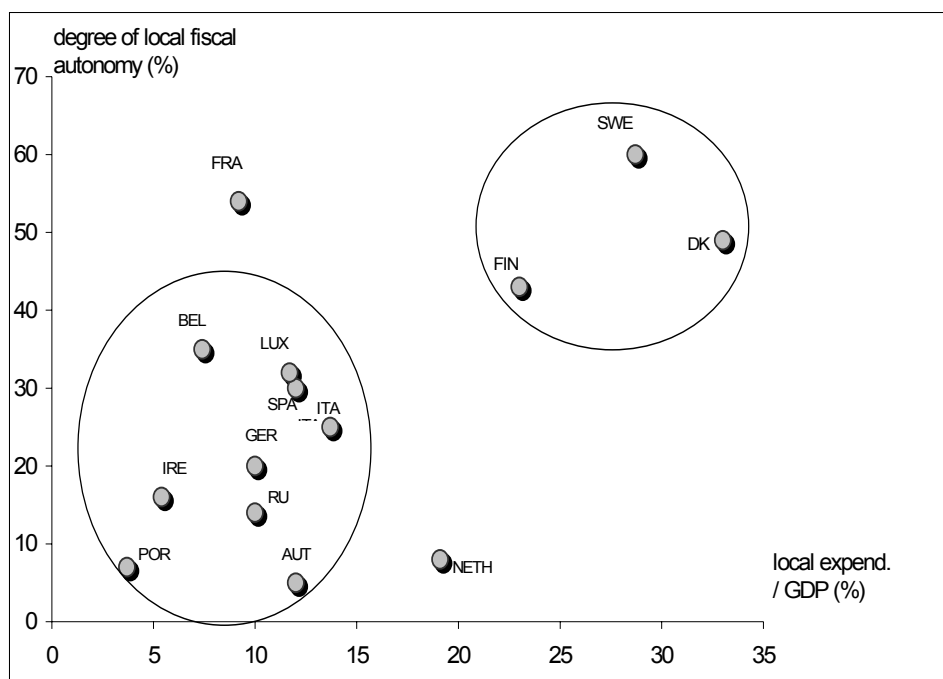
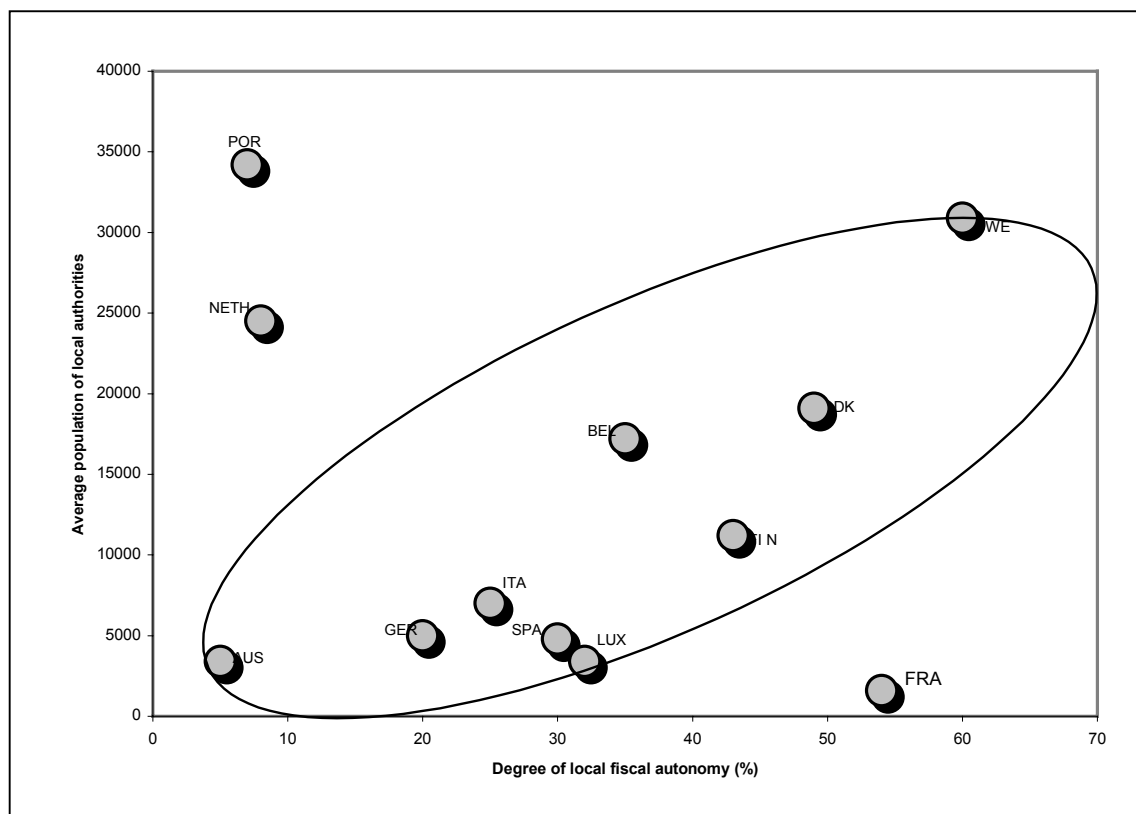


CHART 2

LOCAL FINANCIAL AUTONOMY AND TERRITORIAL FRAGMENTATION  
(EU member countries, around 1995)



**TABLE 2**

**WEIGHT OF THE STATE AND LOCAL AUTHORITIES (REGIONS, DEPARTMENTS, COMMUNES AND INTERCOMMUNAL GROUPS),  
FRANCE, 1998 (AS A % OF GDP), SEC DATA**

	Central public administrations	Local public administrations	
<b>Total expenditures</b>	<b>23.7</b>	<b>9.8</b>	
Intermediate consumption	1.6	2.2	
Compensation of employees	7.3	2.7	
Interest on the debt	2.6	.5	
Benefits and social transfers	3	.8	
Other transfers:	8.5	1.3	
Incl.: investment	1	.3	
assistance			
subsidies paid	.8	.4	
current transfers between administrations	5.5	-	
GFCF	.5	2.	10.8% of GFCF, all of France, and 66% of GFCF of the APUs.
<b>Total resources</b>	<b>20.6</b>	<b>10.2</b>	
Taxes:	18.2	4.8	
goods + imports	11.4	3.8	
income and property	6.3	.9	
capital	.5	-	
Other resources	2.4	5.3	
Proceeds of operating subsidies	.8	1.6	
Current transfers between administr.	-1.1	2.8	
<b>Financing need (-) or capacity (+)</b>	<b>-3</b>	<b>+0.3</b>	
<b>Added value</b>	<b>n.a.</b>	<b>4.3</b>	
<b>Market output (water, purification, transportation, and so on)</b>	<b>0.7</b>	<b>n.a.</b>	
<b>Total employment</b>	<b>2.2 million</b>	<b>1.6 million</b>	

CHART 3

# LOCAL PUBLIC INVESTMENT OF PUBLIC ADMINISTRATIONS, IN VOLUME, AT GFCF PRICES

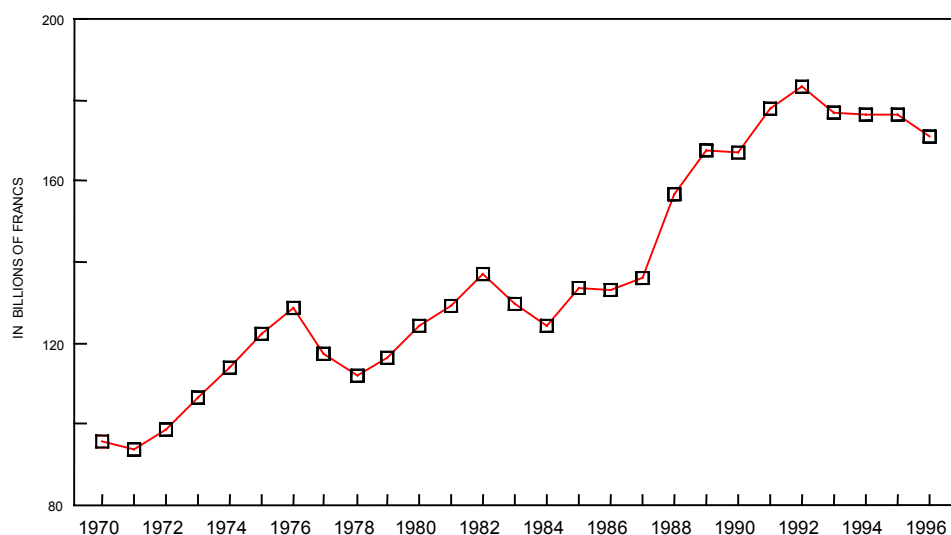


CHART 4

# FINANCING OF INVESTMENT EXCLUDING DEBT REPAYMENT

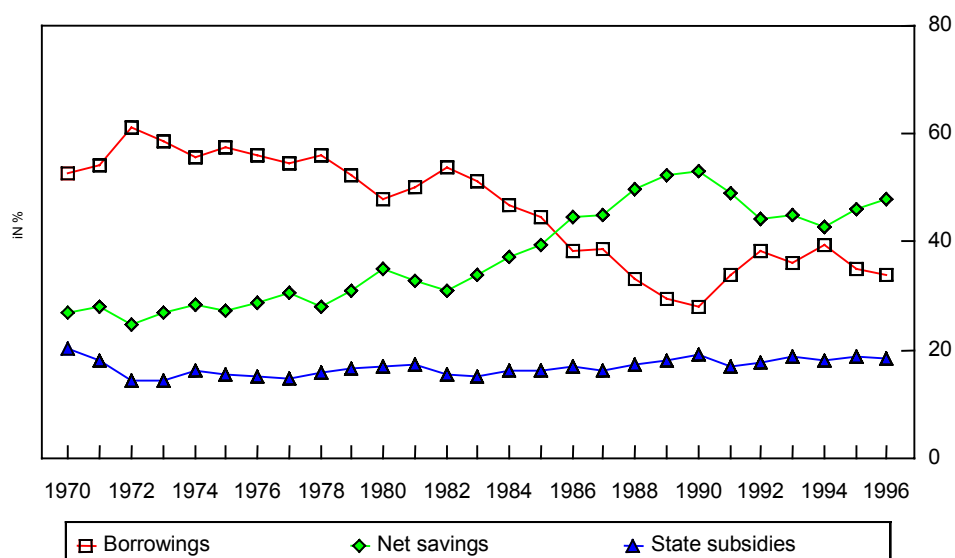




CHART 5

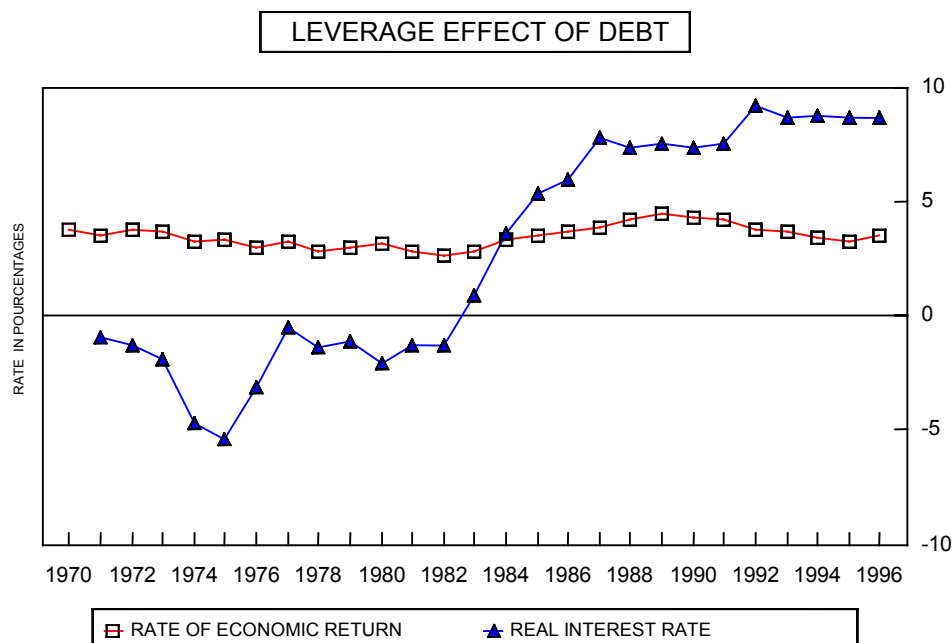


CHART 6

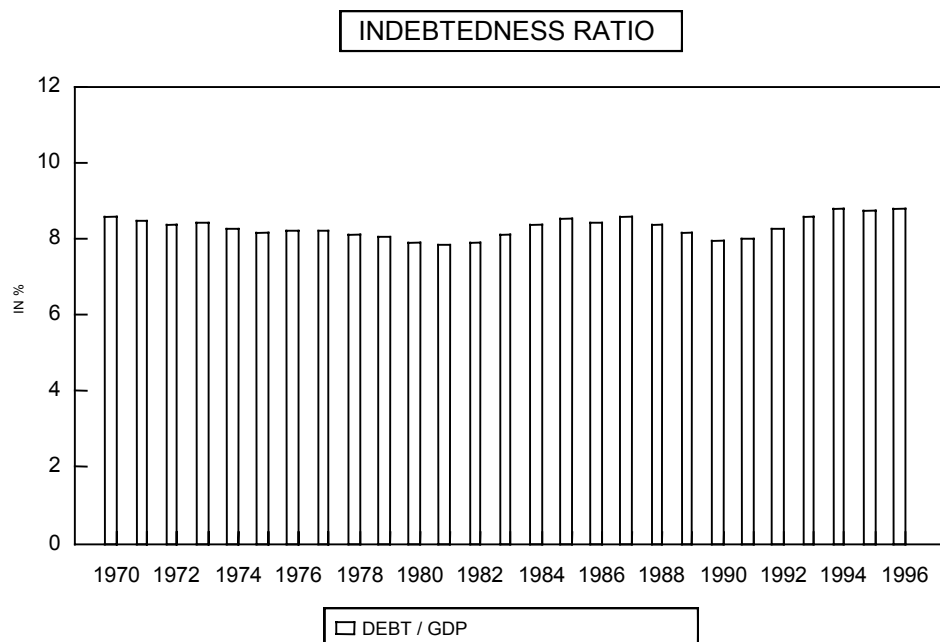


CHART 7

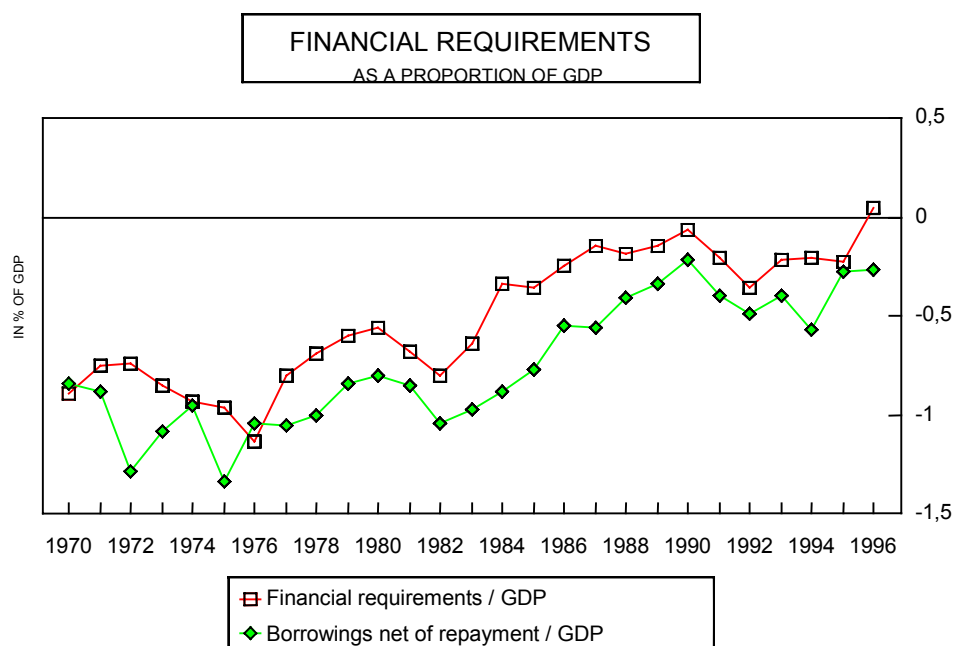


DIAGRAM 1

SCENARIO CALLING FOR THE “PURSUIT OF FINANCIAL RECENTRALIZATION”

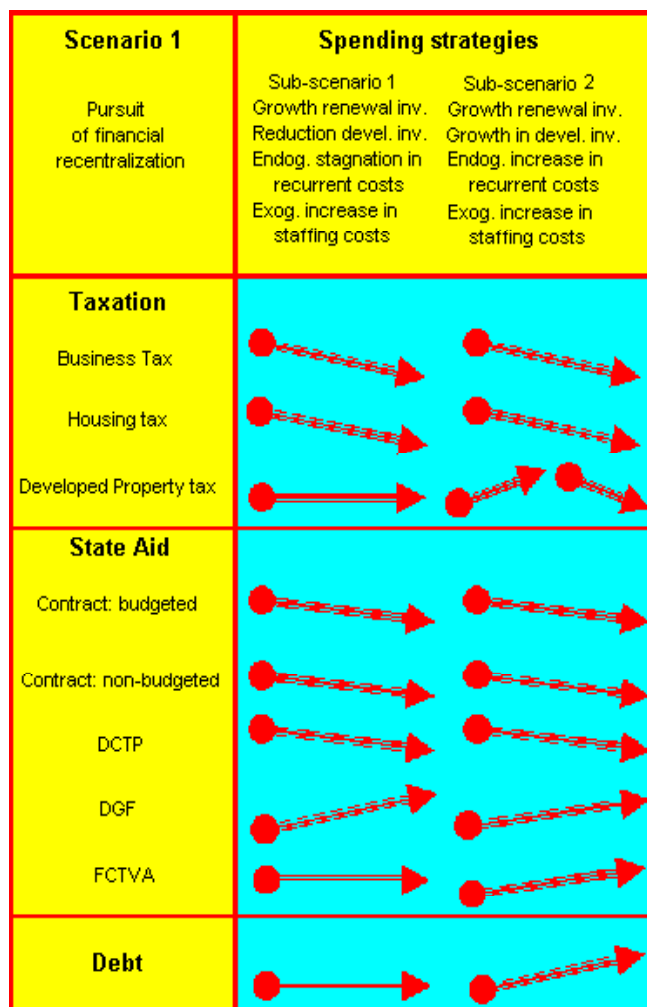
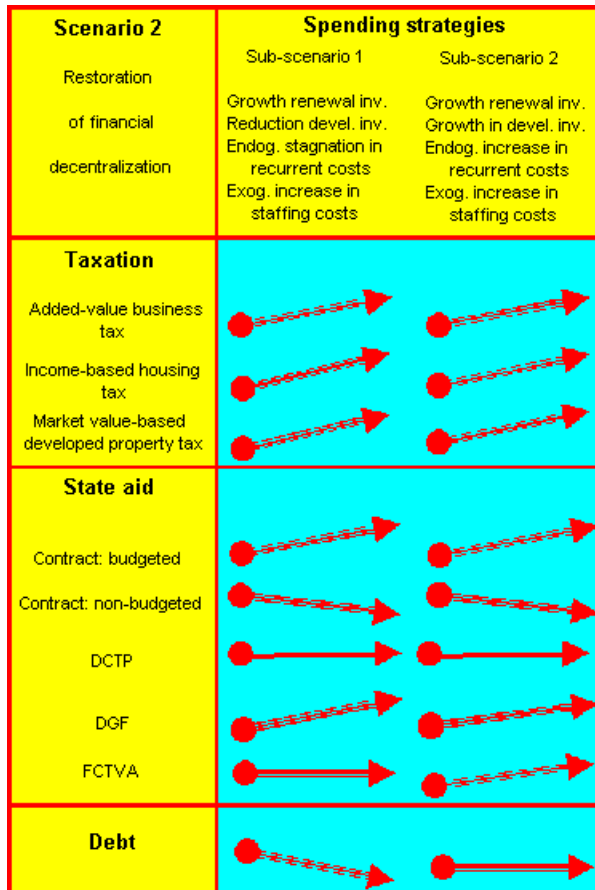


DIAGRAM 2

SCENARIO CALLING FOR THE “RESTORATION OF FINANCIAL DECENTRALIZATION”



## **THE PROCESS OF DECENTRALISATION IN ITALY: A FOCUS ON REGIONAL GOVERNMENTS**

*By Laura Raimondo*

### **1. OVERVIEW**

Notwithstanding the very strong historic tradition of great and prosperous municipalities, the democratic season of Italy after fascism was based fundamentally on a centralized State. During the post-war reconstruction period and the economic miracle of the sixties Italy concentrated on recovering from the II World War, reducing the industrial gap of the country, providing credible economic answers to the demands that the generation born in the thirties was making of the new republic and democratic State. The Constitution of 1948 had introduced among its fundamental principles (art.5 and Titolo V and art.117) an initial roadmap towards larger local autonomies, defining on the one hand those competencies of the central State that could not be transferred or delegated, and on the other competencies that had a regional nature or that could be totally decentralized. It was on these latter that public action, based on territorial and regional perspectives, should be designed and carried out.

The Constitution allowed for the creation of regional governments through legislation. Up until the early 1970s, however, only five "special regions" (Regioni a Statuto Speciale) were created (Sicilia, Sardegna, Valle d'Aosta, Trentino-Alto Adige and Friuli). The introduction of the remaining "ordinary" regions required specific legislation and was delayed until 1975-77. The "special regions" benefited from a much more autonomous status, at least as far as the legislative power and competencies were concerned. Numerous contradictions characterised the structure of powers, functions, competencies and resources at different levels of government operating on the whole territory. While regional governments were granted legislative powers in important fields provided by the Constitution, the inconsistency between taxing authority and spending authority limited regional autonomy and accountability.

It was only in the nineties that the roadmap towards decentralisation was effectively implemented. Act 142 of 1990 dealing with the system of local autonomies gave new powers to municipalities and provinces to adopt their own statutes and to define their organisation. The act also clarified the role and functions of mountain communities and instituted metropolitan areas connected to the principal national poles of urban aggregation. These centres were given territorial planning and network service functions and tasks related to economic development.

The main political project towards a decentralized State is however contained in Act 59/97 which, using an wide interpretation of the Constitution, redefines and wholly re-organises the State in all its administrative functions, transferring or attributing to the "right" territorial and administrative level the competency for administrative functions and the autonomy on expenditure decisions. At the same time Act 59 and, even more, its implementation decree n.112/99 consider not only the competencies that the Constitution had attributed to the central or regional level but deal also with the devolution of functions to "functional autonomies" (for examples Universities), to municipalities or to the private sector with the idea of completely redefining the public sector, in order to identify the entity best able to offer a public service both through decentralisation and privatisation.

In the 1990s, the criteria for managing local public services were modified by the introduction of market-oriented principles. New forms of production were provided for, with the constitution of special companies, third party concessions, and the institution of mixed private-public companies. Most local utilities are now incorporated and the entire sector is undergoing a process of privatisation.

The administrative reform consists also of a series of other acts, approved during the nineties, which introduced simplification and organizational procedures, reorganized the central government, introduced a new personnel management system and reformed the budget process. The aim was to achieve a long overdue modernisation of the P.A., which had been characterised by inefficiency ever since the birth of the democratic State. New instruments for governance have been introduced, linked to the development of strong institutional partnerships, both horizontal and vertical, social partnerships, and the implementation of administrative models inspired by the principles of New Public Management. Contracts signed by both parties (Intese Istituzionali di programma) regulate the joint action of the central and regional governments on investment expenditures, initiating a cooperative approach to territorial development where central and regional governments have the same decision-making power and pool their resources to achieve an agreed objective.

Though on the expenditure side, within the framework of the current Constitution, the Italian State is far more decentralized than it used to be in the seventies and the Regions in particular are acquiring more and more

competencies and decision-making power on a significant number of funds, the level of decentralisation on the revenue side has proceeded more slowly, and it is only lately (mainly since 1997) that the issue of fiscal decentralisation has been put forward. At first it was a political stance and only later did it become a matter to be discussed in order to build a coherent governance model which gives careful consideration to the cost and benefits of such a new model both from a national and regional perspective.

During the last five years words like federalism, fiscal autonomy and devolution have become part of the political jargon, very often losing their original meaning. All political parties have accepted or even strongly supported as flagships such words, sometimes without clarifying, either in the political arena and in front of the electorate, what these slogans really meant. These attitudes have not contributed to develop a serious collective thinking on the model Italy wants to adopt to change from a centralized State to a decentralized one, taking into consideration our own history, culture and social dimensions. Nor do ordinary citizens have the correct information to understand the impact of any proposal on their revenues and on the capability to access services.

There are four factors that should be borne in mind when evaluating the pattern of the Italian decentralization process and discussing which level of decentralisation, or even federalism as some propose, is suitable for Italy:

- ◆ first, Italy is still a dualistic country characterized by a large area, the so-called Mezzogiorno that, even if some positive developments have been witnessed during the last three years, accounts on average for only 67 % of the average per capita gross national product; the gap with the Centre-North and Europe was slightly reduced in the late eighties to increase again in the mid nineties; the data suggest that we are not talking of *territorial differences* within a country but of a deep structural dichotomy;
- ◆ secondly, Italy entered the European Monetary Union and agreed to abide to a Stability and Growth Pact that put forward strict budgetary conditions; under these conditions fiscal federalism can be more difficult to achieve, especially if the entities (regions and to a lesser extent municipalities in the Italian case) benefiting from fiscal autonomy are experiencing a new governmental phase;
- ◆ thirdly, there is no shared knowledge of the benefits and costs of transforming a centralized State into a decentralized or even federal one. The northern areas of the country which are demanding profound reforms often seem to consider federalism as a way to enter Europe without bringing with them the less developed areas of the South, forgetting that in any federal system important equalization mechanisms work to counterbalance territorial disparities in income and perform a transfer of funds from richer to poorer areas;
- ◆ fourth, Italy is going through a wide administrative reform process which is modifying rules and objectives of the public administration in accordance with the New Public Management approach. It has renewed the rules of the electorate system for Municipalities and Regions, introducing the direct election of the City Mayor (1993) and of the President of Regions (2000) allowing in the latter case for a majority premium to ensure political stability. These new rules have reinforced regional and local autonomy. In 1997, a broad programme of "delegation", deregulation and simplification was launched. The administrative and institutional process of reform is under way but not yet finalized and it will be possible to evaluate results only in the next years. Their aim was however to increase the efficiency of the administrative action and the effectiveness of government.

In the next section of the paper a brief description of the level of decentralization of Italy is provided. Paragraph 1 makes a summary of the distribution of competencies on the expenditure side between the central and the regional level. A few data are provided on the share of resources attributed to different layers of government and the ex-post distribution of expenditure resources both by sector and economic category. The second paragraph deals with the level of decentralisation from the revenue side and describes briefly the changes which have taken place in the nineties from a system where local and regional finance were mainly dependent upon state transfers, mostly earmarked, to the greater fiscal autonomy introduced in 1999 and 2001. The third paragraph tries to picture the actual level of financial autonomy of the regions. The fourth highlights some of the limitation we encounter as part of a union. The fifth paragraph deals mostly with the same issues seen from a different angle, that of the Mezzogiorno, or so-called Objective 1 Regions in the European terminology.

We describe an important experiment of actual decentralisation of expenditures being carried out in the last three years, the theoretical approach that was chosen to overcome the "gap" between the two areas of the country, financial arrangements being used to transfer European and National funds to Objective 1 Regions and the balanced co-operative and competitive model applied to regions to spur on the one hand their capacity to link and develop common projects and increase the competitiveness of their territories and, at the same time, expose them to competition and "market" incentives.

## 2. REGIONAL AND LOCAL DECENTRALISATION: THE EXPENDITURE SIDE

The definition of a new system of competencies was introduced with Act 59/97, better known as "Bassanini I". Without modifying the Constitution, Act 59 used all the space available to implement by ordinary law a large decentralisation of functions. Indeed it reverses the traditional approach inherited from the Constitution of defining the competencies of Regions, by defining on the contrary the competencies of the central state, leaving all other competencies to local autonomies. The principle of vertical subsidiarity was fundamental: public activities were to be carried out by higher levels of government only where they could not be carried out by lower levels (for example, due to managerial efficiency or the impact of externalities). In relation to the distribution of functions among regions and local authorities, reference was made to the "principle of differentiation, in which functions are allocated taking into account different characteristics --associative, demographic, territorial and structural-- of the local authority".

Matters of explicit national interest remained within the sphere of the State (external affairs and trade, defense, public order and safety, justice, university and scientific research, large network infrastructure and heritage). Its implementation decree (Decreto Legislativo 112/98) transfers around 40% of the administrative functions from the Ministries to the Regions, Provinces and Municipalities. In particular, with regard to the promotion of local development, functions related to industry were transferred to the regions which were to manage incentives, while the central administration retained functions relating to the general orientation of industrial policy. It took two years and 100 Prime Ministerial decrees to transfer assets, equipment, resources and personnel from the Ministries to the other level of administration.

The Bassanini I Act is considered by many to be an anticipation of the constitutional reform towards federalism that should have been produced by a bipartisan work carried out by the "II Commissione Bicamerale" formed of representatives of both branches of the Parliament, under the D'Alema Government. No agreement was reached at that time and only at the beginning of 2001 (under Amato's Government) was a new constitutional law approved by the Parliament. This law will be submitted to confirmation in a referendum to be held in October 2001. The law integrates the principles of administrative decentralisation introduced by ordinary law and recognizes legislative, financial and administrative autonomy to regions and local autonomies. It assigns to the State the responsibility of implementing equalisation of financial resources in order to ensure, over the whole territory, the access to the same level of essential services related to social and civil rights. It is also stated that an equalisation fund would provide for the resources necessary to co-finance (together with local resources), the public functions attributed to the sub-central levels in areas of lower fiscal capacity.

**TABLE 1**

**Expenditure of the central state, regions and local governments as a percentage of public spending**  
(absolute values in current billion liras)

Years	GDP	Public expenditure (1)	State		Regions		Local governments	
			% GDP	% Public expenditure	% GDP	% Public expenditure	% GDP	% Public expenditure
1990	1,306,833	493,401	21,6	57,3	8,7	22,9	7,5	19,7
1995	1,772,254	653,190	21,3	57,7	8,9	24,2	6,7	18,1
1997	1,993,850	642,882	17,4	53,9	8,4	25,9	6,5	20,1

(1) State, Regions, Local Governments, net of intergovernmental transfers and, for the State, net of debt service

Source:

Buglione E., elaboration on data from *Relazione generale situazione economica del Paese*, Ministry of Economy and Finance

Data are not yet available to calculate the indicator reported in Table 1 for more recent years using the same territorial partition (in particular referring to local governments). While decentralization is proceeding fast the official government documents do not yet contain data of a nature to allow the measurement of the level of decentralization. As we can see, public expenditure as a percentage of GDP decreased by more than 4 points during the 1990-97 period, highlighting the first results of the budgetary maneuver to contain deficit and debt, as required to meet the Maastricht parameters. On the contrary, the same aggregate remains stable for regions and local governments. At the same time, the share of public expenditure kept at the central level decreases by 3.5 points and increases by the same amount in Regions and local government, mainly privileging the former.

By the end of 97 the share of public expenditure (using both transferred and local resources) of sub-central level of governments represented around 46% of total public expenditure.

Unfortunately it is not possible at the moment to provide data reflecting the impact of all the reforms that took place during the nineties on the expenditure side since the decrees transferring personnel, goods and resources were completed only at the beginning of 2001. At the same time such decrees do not yet implement some of the new changes introduced with the constitutional law approved in March 2001.

**TABLE 2**

Table 2 - Expenditure by functional category and by territorial partition - dati di competenza - percentage - 1999

Regions	Administr ation	Education	Health and social services	Agriculture	Industry, commerce and tourism	Transportati on	Housing and other infrastruct ure	Other	Total
Total	7,1	3,9	53,5	4,7	2,6	5,4	6,8	15,9	100
Special Regions - Total	17,2	5,6	33,8	5,5	4,8	3,4	6,5	23,3	100
Ordinary Regions - Total	3,8	3,3	60,2	4,4	2,0	6,1	6,8	13,5	100
Northern ordinary regions	3,2	3,2	63,8	2,1	1,8	5,7	4,2	15,9	100
Central ordinary regions	3,1	4,1	59,0	4,5	1,7	7,5	10,0	10,0	100
Southern ordinary regions	5,3	3,0	55,6	7,8	2,2	5,5	8,1	12,6	100

Source: CNR, Istituto di studi sulle regioni

Expenditure pattern vary according to the different status of "special" and "ordinary" regions in Italy. Ordinary regions devote 60% of their current and capital spending to health and social services while "special" regions have a much higher incidence of administrative expenditure which reflects their different status.

A new constitutional law is going to be submitted to the Parliament for approval in Fall. The draft proposal contains the provision for attributing exclusive legislative power to regions in matters such as health, education (as far as regional educational interest are concerned) and local police. Industrial policies and incentives, which are attributed to the regions by the constitutional law of March 2001 are not considered part of regional competencies within the draft proposal. The proposal also provides for the nomination of regional representative in the Constitutional Court. Until now Constitutional Court members are nominated by the President of the Republic, by the Parliament and by the Magistratura (Corps of judges).

The proposal eliminates mention to common minimum health services as a denominator for all regions and as an objective to be guaranteed by the central state, through equalisation funds. It also introduces exclusive legislative power for education but only limited to matters considered of regional interest while the central state keeps the competency on defining national curricula, programs and standards. The content of the proposal is still under discussion within the governmental coalition and it is early to foresee any definite result.

### 3. REGIONAL AND LOCAL DECENTRALISATION: THE REVENUE SIDE

The main steps in regional decentralisation took place in 1992 with the attribution to the Regions of health service contributions and automobile taxes; in 1995 state transfers were abolished excluding those for the health fund, for natural disasters and for purposes of major national interest, and they were offset by the assignment to the Regions of a share of the excise tax on petrol and the institution of an equalisation fund. Another step towards fiscal autonomy was made by the Regions in 1997 with the attribution to the regional level of a new tax on productive activity, known as IRAP, and of a personal income tax surcharge.

The major change however took place in 1999 with Law 133, which abolished health fund transfers and assigned to the Regions new shares and surcharges of central government taxes, in particular VAT and income taxes. This was accompanied by the redefinition of rules regulating the financing and utilisation of the equalisation fund. These rules are based on revenue raising capacity and on needs that, in a first transition phase, are mainly health service needs. The way in which the share of VAT is distributed among regions is influenced by the capacity of regional government to



satisfy health service needs with the share of VAT produced by their regional territory. Such needs are quantified on the basis of parameters regulated at the central level by the National Health Plan agreed by all level of government. The equalisation mechanism is ensured by horizontal transfers from regions which produce higher VAT receipts to Regions that produce lower VAT receipts for the amount necessary to cover the estimated needs.

Even if the model under construction seems to be characterised by vertical co-operation, the VAT reform introduced a different pattern, which recognises the amount of resources produced by each geographical area and makes clear which region is transferring funds and which region is benefiting and by how much. There is at the moment an intense debate among researchers, and unfortunately less among public opinion, about the definition of the parameters for defining needs and for identifying the concept of minimum service, stated by the Constitution. Richer regions may push in the long run to reduce the content of minimum service in order to free resources to finance their own priorities.

The autonomy of local governments was also enhanced in 1992 with the institution of the municipal real estate tax and in 1993 with the reorganization of minor taxes. In 1997 some previously existing municipal taxes were abolished and offset by a share in IRAP and the institution of a municipal surcharge on personal income in 1998.

In 2002, with the implementation of the municipal surcharge on personal income tax, the share of regional and local receipts, estimated at around 19 per cent of total national revenues, will be significantly higher than the current OECD average (13% in 1998).

**TABLE 3**

<b>TAX RECEIPT AND CONTRIBUTIONS – PERCENTAGE</b>			
<b>Administrative level</b>	<b>1996</b>	<b>1999</b>	<b>2002*</b>
Supranational level	1.2	0.8	0.8
Central administration	55.3	57.6	51.4
Local administrations	8.0	12.2	19.4
Of which:			
Regions	4.9	9.1	15.5
Provinces and municipalities	3.1	3.1	3.9
Contributions	35.4	29.4	28.4
<b>TOTAL</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source : Ministry of Economy and Finance

**TABLE 4****Table 4 - Regional own revenues- projection by ordinary region for 2001** (billion liras)

Ordinary Regions	Own revenues					Own revenues/Total revenues
	IRAP	Petrol, gas excise	Income tax share	Automobile tax	Total own revenues	
Piemonte	5.709	538	900	768	7.915	76,2%
Lombardia	15.102	1.065	2.138	1.710	20.015	98,6%
Veneto	6.110	586	871	891	8.458	79,9%
Liguria	1.688	192	299	251	2.430	55,7%
Emilia -Romagna	5.911	550	888	805	8.154	81,6%
Toscana	4.271	501	642	633	6.047	69,0%
Marche	1.602	185	225	260	2.272	67,0%
Umbria	782	106	122	167	1.177	53,9%
Lazio	7.212	647	796	847	9.502	78,1%
Abruzzo	1.018	143	151	208	1.520	48,6%
Molise	216	27	30	45	318	36,9%
Campania	3.198	396	459	534	4.587	36,6%
Basilicata	371	46	52	81	550	36,9%
Puglia	2.280	341	362	308	3.291	38,2%
Calabria	995	174	133	228	1.530	30,8%
Total	56.466	5.497	8.070	7.735	77.768	68,4%
Tax or excise receipt/ total receipts	72,6%	7,1%	10,4%	9,9%	100,0%	

Source: Own calculation from P.Giarda , 2000

Regional and local authorities can borrow and issue bonds. Borrowing is regulated by the so-called golden rule, which has an indirect ceiling fixed by law (debt service cannot exceed 25% of total own revenues, and borrowing to finance current expenditure is prohibited). Very frequently, as happened very recently with regional health deficits, the central government covers year-end deficit overruns.

The data reported in Table 1 and 3 suggest that the emerging institutional and financial arrangement being established in the Italian model reveals a comparatively high degree of decentralisation both on the expenditure and the revenue side. However regional and local government revenues are experiencing a higher sensitivity to the economic cycle than it used to be in the past when most transfers were earmarked and derived from general central state resources. Constraints on indebtedness are however relatively lax in particular if one considers that such arrangements have to be looked at within the framework of the observance of the European budget rules agreed under the European Stability and Growth Pact.

#### 4. FISCAL AUTONOMY OF REGIONS

As mentioned in the previous paragraphs, many changes took place during the nineties, both on the expenditure and the revenue side. In order to appreciate the dimension of these changes and also measure the current level of financial autonomy of Italian Regions, it is possible to compare data referring to the revenue structure and to the expenditure structure in year 1990 and 1999.

During the reference period considered here the attribution to regions of higher resources was counterbalanced by the reduction of transfers from the central government to Regions. Furthermore, transfers that were earmarked before were substituted by resources not linked to specific uses. Therefore both fiscal and expenditure autonomy should have occurred. As can be seen from the data reported in Table 7 this phenomenon did indeed occur, and it testifies to a very

significant change towards financial autonomy of regions. However there are a few considerations that need to be made in order to interpret realistically and properly such data.

TABLE 5

## FISCAL AND EXPENDITURE AUTONOMY

<i>Fiscal autonomy</i>	1990		1999	
	<i>Spec. Regions</i>	<i>Ord. Regions</i>	<i>Spec. Regions</i>	<i>Ord. Regions</i>
A) Own revenues	149	1,536	8,812	69,018
B) Total current revenues	28,824	65,793	42,059	120,332
A/B x 100	0.5	2.3	21.0	57.4
<i>Expenditure autonomy</i>				
	<i>Spec. Regions</i>	<i>Ord. Regions</i>	<i>Spec. Regions</i>	<i>Ord. Regions</i>
C) Unconditioned funds	20,060	9,210	38,673	78,569
D) Total revenues net of loans	33,318	80,925	45,788	130,871
C/D x 100	60.2	11.4	84.5	60.0

Source: E. Buglione, 2001

Own resources represented in 1990 only 2.3% of total regional revenues. Notwithstanding the wider competencies and large attributions of special regions, their fiscal autonomy was even lower, amounting only to 0.5%. At the same time the expenditure autonomy of regions, referring to the resources for which regions can autonomously decide the destination on the total amount of resources of the regions, was also limited (11.4%). On the contrary the expenditure autonomy of special regions was already substantial. They had complete autonomy in deciding upon 60.2% of their resources which, it is important to remember, were totally transferred from the Central Government. This situation was heavily criticised, since the asymmetry between autonomy of expenditure and dependency on transfers reduced responsibility and accountability of local and regional governments and contributed heavily to feed the Italian public debt, which reached its peak at the beginning of the nineties. This criticism applied even more to "special" regions which benefited from a privileged position. In 1990 per capita resource transfers amounted to 3.7 million liras in "special" regions as against 1.6 million liras in "ordinary" regions.

Overall, at the beginning of the nineties, even if regions were already competent in a number of matters, their autonomy was limited by the possibility, given by the normative framework, of the central state to decide, sometimes in detail, the way in which regions had to exercise their competencies and use the transferred funds, overemphasising the role of co-ordination and orientation attributed to the state by the Constitution and primary laws. As far as health expenditure in particular was concerned, the separation between expenditure competencies and revenue collection led to a system where needs were always determined by regions in the absence of budget constraint since it was impossible to understand if the systematic budget overruns were due to an underestimation of the needs or to the lack of control of the regions and the low efficiency of hospital and health facilities and services in the use of the transferred funds.

With the administrative and fiscal reforms implemented in the nineties and at the beginning of year 2000 the revenue and expenditure structures look very different. Fiscal autonomy increases from 0.5% in 1990 to 21% in 1999 in "special" regions and from 2.3% to 57.4% in 1999 in "ordinary" regions. At the same time, expenditure autonomy increases from 11.2 to 60% in ordinary regions and from 60% to 85% in "special" regions. Taking into consideration also the last fiscal reform for "ordinary" regions which devotes 38% of VAT collected resources to "ordinary" regions (D.lgs 56/2000), their fiscal autonomy increases further to 68% (see Table 5); furthermore their expenditure autonomy will be increased starting from 2003 by removing the obligation to use a share of VAT funds for health fixed investments.

The data reported in this chapter show an increasing level of decentralisation and a considerable level of financial autonomy. Some caution however needs to be used in considering budget data: the picture emerging from this data may overemphasise the level of autonomy currently being attributed to regions. The issue refers to the way in which IRAP (tax on productive activities) and the regional share of IRPEF (personal income tax) should be considered. They are both classified in the budget as regions' own resources. However it is only recently (2001) that regions have become able to modify the tax base rate fixed by state law and attributed to them.

## **5. DECENTRALISATION, FINANCIAL AUTONOMY AND THE EUROPEAN STABILITY PACT**

Because of the agreements signed at the European level, and considering the current level of decentralisation, in 1999 a domestic stability pact was signed and became effective. The domestic stability pact is designed to involve Regions and other local authorities in the effort to attain the objectives agreed by the central government in the European Stability and Growth Pact. The domestic pact requires local bodies to reduce deficits and their stock of debt. The target for the first three years of the domestic pact, beginning in 1999, is the annual reduction in the total deficit of local governments equal to at least 0.1 per cent of GDP. The local governments' accounts will be monitored for consistency by the State-Region and State-Municipalities Conferences.<sup>1</sup> No sanctions for non compliance are provided while, if Italy is sanctioned under the excessive deficit procedure; fines will be proportionally levied on the bodies that fail to meet their targets.

Without going into the details of the domestic agreement, what is important is that the domestic stability pact is the first attempt to answer the issue of rendering coherent the commitments taken in the European Growth and Stability Pact and the internal behaviours of regional and local governments in particular in those countries which have a high degree of decentralisation like Italy. It is true that the European Growth and Stability Pact entails an internal asymmetry between responsibilities laid down at the national and regional/local level within a member state, which all influence the good performance of each country vis-à-vis its budget target, and the de facto responsibility of the central government to be answerable to the E.U. Such asymmetry can create free-riding among local governments, as has been highlighted by many European researchers. Internal stability pacts are an initial answer to this and other issues raised by the European pact but, as in the Italian case now, they rely for effectiveness mainly on the cooperative attitude of local and regional governments and do not provide incentives or conditionalities to assure its attainment, or tools to react to cyclical effects by which local entities are now significantly influenced.

What is important to highlight here is the difficulty of reconciling full achievement of the advantages of fiscal decentralisation (both allocative and political) with full exploitation of the advantages offered by complying with E.U. commitments.

## **6. AN EXPERIMENT OF NEW CENTER-LOCAL RELATIONSHIP : STRATEGY AND RULES OF THE 2000-2006 OBJECTIVE 1 DEVELOPMENT PROGRAM**

The 2000-2006 objective 1 planning process governing the use of European structural funds to less developed areas gave the Italian government a chance to shift towards a more adequate policy approach, designed to increase the territorial competitiveness of the Mezzogiorno; this came after a period of regional policies which were designed to compensate competitive disadvantages of lagging-behind regions with a sectorial, top-down approach, based mainly on incentives to the private sector.

The significant amount of resources (around 50 billion Euro of European and national public resources) for investments, the possibility of designing a new set of rules conditioning their use, and the constraints in terms of accountability and credibility of results requested by the European co-financier, made it possible to put into action some lessons learnt in the last decade, when profound changes occurred in the economy and society of Italian regions, despite the significant decrease of public investment since 1992.

In the Nineties, a very lively entrepreneurial climate in some areas of Mezzogiorno led to an increase in the turnover rate of non agriculture firms and in local firm agglomerations, in exports and inward flows of foreign tourists. Local partnerships between private and public actors based on the definition of common projects, financed by the central government (territorial pacts), proved to be an effective instrument to foster private investment and local relations. The reform of the municipal electoral system, which increased responsibility and accountability of mayors by empowering them through a direct election, made possible the resurgence of some urban areas. The experience of the Nineties showed that significant changes can take place in the Mezzogiorno if a proper institutional design is devised and if responsibility is increased at a local level.

The plan therefore aimed at enhancing the positive signs registered in the Nineties, through the definition of a strategy and of a set of rules which focused on the lasting objective of increasing territorial competitiveness of the Mezzogiorno and attracting increasingly mobile capital, turning the challenge of Monetary Union into a major asset.

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<sup>1</sup> These are bodies formed the first by the Ministerial council and the President of the Regions, the second by the ministerial Council and representatives of mayors. They oversee all matters potentially of interest to the Regions and municipalities. They provide non compulsory and compulsory comments to law and decree drafts, to official documents and to decisions taken by various governmental, inter-ministerial and other institutional Committees.

The rationale of the strategy lies in the idea that Southern Italy is endowed with significant natural, human and cultural resources, which lie largely idle and could be better used to produce a significant social and economic return. Proper economic exploitation of idle resources and the enhancement of relational capital within clusters, together with reduction of barriers to mobility and competition and the strengthening of communication, were chosen as policy priorities to create positive supply externalities and to reduce current diseconomies which negatively affect both expectations and investment productivity of private investors. This would induce, through positive expectations on growth rates, an increase in private investments and consequently a steady increase of employment rates.

To succeed, this strategy needed to be implemented within an adequate institutional design. Moreover it had to be credible in order to convince private investors to make their investments before programme effects on territorial competitiveness became fully visible. The success of the strategy requires a general upgrading of public investment and Public Administration.

The governance of the programme was therefore based on a set of rules aimed at reaching this objective by supporting at the same time competition and cooperation between different levels of government (central, regional and local government), but also within the same government level (among regions or municipalities). Competition was induced by implementing, within the framework of structural funds responsibilities, the allocation of clear responsibilities at different government levels as regulated by Bassanini I; by introducing a mechanism of rewards and sanctions previously agreed among regions; by defining clear operational targets; and by strengthening monitoring and evaluation functions. Partnership, both institutional and social, was necessary in order to allow the transfer of knowledge between different government levels and among private and public actors. Unlike responsibilities, it cannot be easily transferred from one level to the other via formal protocols. This asks for informal interactions among actors to be developed and encouraged.

This new institutional model of public investment management was strengthened by the definition of a medium-term financial plan and the ex-ante determination of resources available to regions. This included the identification of the overall volume of available resources for 2000-2006 (budget funds, special domestic funds for lagging areas, European structural funds and national co-financing) and full disclosure of the criteria for distributing resources between regions. The criteria chosen to allocate European structural funds and domestic funds for lagging areas took into consideration variables as population and surface as dimensional variables and per capita revenue, unemployment rate and infrastructure gap as corrective factor for allocation purposes.

The plan allocates most of the funds (de facto 72 per cent) and the responsibility for selecting projects to the 6 Objective 1 regions (Campania, Basilicata, Calabria, Puglia, Sicilia and Sardegna) and to 1 phasing out region (Molise). The central government is directly responsible only for some operational programmes (communication, research and development, education, enhancing law enforcement). It also acts, through the Ministry of Economy and Finance, as a co-ordinating authority, with the task of setting general rules and guidelines for monitoring and evaluation.

The increased responsibilities allocated to regional governments are the outcome of the political choice, made during the nineties, to decentralise as described in the previous paragraph, and are justified by the fact that regions are in the best position to involve local private and public actors, who possess much of the knowledge needed to enact the Plan. On the other hand, regional governments are traditionally inclined to prefer several small and scattered investment projects with more immediate and visible effects, rather than more integrated projects which are necessary to implement the strategy of the plan. Furthermore complex programming and high-quality project selection require a profound and rapid modernisation of Region's administrative structure.

In order to guarantee the quality of planning and the actual implementation of the strategy at the regional level, it was thus first intended to set conditions for the use of resources. The latter were agreed upon during a long and complex partnership process, where all institutional and social actors involved contributed to fix common priorities, objectives, targets and define common implementation rules ensuring the quality of investment in each CSF priority axis.

That was not considered enough, however. Appropriate incentive devices had to be set so as to pressurize Regions into implementing administrative reforms and pursuing high quality projects. Similar devices were designed to apply also to central Administrations. The performance reserve foreseen by Regulations<sup>2</sup> was considered as an opportunity to hasten the upgrading of managing authorities and reach higher quality standards. The Commission proposal was therefore strengthened (with the addition of a 6% national reserve) and turned into a reward system whose criteria and implementation mechanisms embody the main principles of the Plan.

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<sup>2</sup> Regulation n. 1260/99 article 44

The following sections aim at showing how the performance reserve system was adapted to the plan strategy and governance rules.

### **6.1. The performance reserve criteria and indicators and the upgrading of Public Administration**

The two reserves (4% and 6%) are based on the same general principles. They are thought to be complementary in addressing a complex set of objectives all aiming at upgrading the effectiveness of public administration action and quality of public spending. As provided for in Regulation n.1260/99, the performance reserve of 4%<sup>3</sup> is assessed against financial, management and effectiveness criteria.

The Italian system, approved by the Commission, rewards those who reach a benchmark set exogenously and which is common to all programmes, below which access to the performance reserve is denied.

A few indicators of the Commission proposal<sup>4</sup> have been substituted or integrated in order to make the Italian performance reserve mechanism more coherent to the model and the set of rules that govern the Italian CSF. The reward is obtained if at least 6 out of 8 indicators are satisfied.

The complete list of indicators of the Italian 4% reserve is presented in annex A. Most of the indicators are directly or indirectly linked to the effort of upgrading the quality of programming and screening public investments and deepening the capacity to interpret the socio-economic conditions of the territory on which those investments will perform. Expanding and improving the quality of public investment is the crucial factor which is expected to trigger growth rates in the economy of Mezzogiorno regions in the 2000-2006 period. The upgrading of the quality of public investment is the direct result of an overall effort of public action enhancement, in which a significant role is played by factors such as detailed knowledge of the functioning of the socio-economic system, a mechanism based on trust for the implementation of the public investment program, careful methods of investment selection (to choose only those investments which better enhance endogenous development factors).

The national reserve of 6%<sup>5</sup> is designed to create proper incentives to achieve conditions such as a) specific aspects of the modernisation of the Public Administration, which are deemed to be essential to reach the expected results and b) concentration of funds on a few priorities and integration of actions to reach defined objectives.

The mechanism design is different from the 4% and varies between the first and the other two blocks of indicators. The first block, relating to institutional enhancement, includes 10 indicators for Regions and 4 for Central Administrations, which measure the modernisation process of the P.A, the diffusion of institutional innovation and the degree to which reforms are being implemented in some of the sectors crucial to the achievement of the defined development objectives. The device rewards the Administration for each indicator reaching the minimum standard, which, as for 4%, is set exogenously. As for the other two blocks of indicators, integration and concentration,<sup>6</sup> they both include only one indicator. In this case, the mechanism is based on benchmarks resulting from the average of the performance of all regional administrations, so as to create a competition among them.

As for the choice of 6% reserve indicators, the complete list is presented in annex B, while some examples are given below for each block.

For institutional enhancement, among the different features of the administrative reform, the performance reserve mechanism rewards the transition from the former normative-hierarchical approach to administration functioning to a performance-oriented one where officials are delegated higher responsibilities and have to reach defined targets (see Annex B, indicator B.1.1) and where such elements are part of a monitored contract. Along the same lines is the reward for implementing an internal management control system (see Annex B, indicator B.1.2 ).

As highlighted previously, the success of the CSF depends also on the capacity of regional governments, to which the implementation of most funds is delegated, to screen and select the interventions which are most pertinent for their territory and to monitor and evaluate their impacts in terms of their contribution to improve supply externalities and

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<sup>3</sup> A complete and detailed description of Italian 4% reserve criteria and mechanism design is contained in the document agreed with the European Commission and approved by the first objective 1 CSF Monitoring Committee on November 7, 2000 "QCS Obiettivo 1 – 2000-2006; Criteri e meccanismi di assegnazione della riserva di premialità del 4%"

<sup>4</sup> The Commission proposal for the 4% reserve is contained in "Implementation of the performance reserve for objective 1, 2 and 3" – Working document 4 - Directorate General Regional Policy and Cohesion; Directorate G: Programme Coordination and Evaluation of Operations

<sup>5</sup> A complete and detailed description of Italian 6% reserve criteria and mechanism design is contained in the 2000-2006 Objective 1 CSF (§6.5 and annex D) and in the document "QCS Obiettivo 1 – 2000-2006; Criteri e meccanismi di assegnazione della riserva di premialità del 6%"

<sup>6</sup> The concentration criterion applies only to regional administrations.

intermediate objectives. A proxy for this is the indicator that measures the degree to which regional and central administrations have set up and implemented monitoring and evaluation functions and equipped the responsible units with sufficient qualified human resources to perform those functions (see Annex B, indicator B.1.4).

Increasing the competitiveness of southern regions cannot only be the result of the flow of qualified public investments, even though these are present in conspicuous amounts, but is conditioned by the contextual implementation of other policies which allow the Public Administration to provide good services. Competitiveness and market competition in southern regions are among those policies. In this context, the proposal rewards the implementation of sector reforms that spur competitiveness and market competition in public service provision such as in water and solid waste services (see Annex B, indicators B.1.8 and B.1.9). These are services that will benefit considerably from structural funds because they are expected to contribute significantly to the achievement of national program priorities. The indicators were defined to measure the degree of implementation of the reform and, at the same time, the capacity of local public administration to externalise or privatise some of their previous functions.

As for integration and concentration, both criteria are based on the underlying assumption that when resources are limited, as they always are, there is only a restricted number of objectives that can be achieved and that, for each objective to be reached, all pertinent interventions have to be implemented following both a logical and temporal integration path. Economies both of scope and agglomeration should materialise, providing for a higher return from those interventions. It is also assumed that regional governments, through negotiation with central institutions and social partners, will be able to identify the path which is most pertinent to meet growth and employment targets estimated to amplify convergence. The indicators suggested here capture both aspects only partially, and imperfectly measure the principles that the plan intended to push forward. They have to be accepted as proxies. They do require, in particular integration, the capacity of regional and local administrations to identify ideas and implementation rules that are precise and clear enough to give substance to territorial integrated projects.

## **6.2. *The performance reserve mechanism as a tool to foster competition and partnership***

The rules governing the implementation of the reserves aim at fostering both competition and partnership between different levels of government and within each managing authority (among different offices).

For both reserves competition generally occurs in the second round of the performance screening process. All programs judged efficient according to the set of indicators and benchmarks defined qualify for the reserve allocated to them. Only if a program is found to be inefficient is the reserve allocated to that program made available for redistribution to its successful rivals. It is a second-degree competition mechanism, which is activated only after having allocated the reserve to efficient programs.

As for the 6% reserve criteria of integration and concentration, a direct competition among administrations is already introduced in the first round by means of benchmark definition. For both indicators benchmarks are fixed on the basis of the average performance of all programs. In this case there will be, by definition, programmes that will not be allocated the full amount of the quota of the 6% reserve devoted to integration and concentration. Only those regional Operational Programmes which are ranked very close to the average will qualify for the allocation of a 0.8% for integration and a 0.6% for concentration, to which another 0.7% for integration and a 0.4% for concentration could be added if the programme performs better than the average<sup>7</sup>. Therefore, while the first benchmark could be reached by any Operational Programme, the second benchmark can only be reached by best performing programmes.

The Italian design is therefore meant to foster a higher degree of competition among administrations. Nevertheless, the second-degree competition rule and the introduction of “affordable” benchmarks allow for reducing the risk of excessively favouring those regions which, because of their history, tradition and dimensions can perform better than others. Moreover, the access to single portions of the reserve, as it is the case for the 6% reserve, can provide the right incentive even to the least efficient administrations to focus their efforts on a few indicators rather than on all, helping them to reach at least a few results.

The competition fostered by the reserve also affects local governments. At least one third of the listed indicators measure the performance of the regional territory and not necessarily of the regional institutions. Again, within the framework of decentralised responsibilities, it is the overall performance of the territory that can help meeting the benchmarks. The necessity to perform well for the 4% reserve system (for example in terms of financial and physical implementation) and the wide share of resources dedicated in the 6% reserve system to indicators for which local governments play an important role (integration, concentration, one-stop shop, implementation of the reform in water

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<sup>7</sup> In the case of central administration, for which only integration applies, those satisfying the first benchmark will be allocated a 1.4%, to which another 1% could be added if the second benchmark is reached.

and solid waste services) constitute incentives for regional administrations to set up an internal reverse reward system according to which those local governments that help in getting the reward, will in turn get a share of it. Indeed, some regional governments have already regulated and set up an internal reward system, and therefore reversed the incentive scheme towards local governments and bodies.

The incentive scheme is part of a system where institutional and social interactions among levels of government and actors play an important role in the definition of objectives and targets. The identification of patterns that are essential to the success of the program was carried out by sharing experience, analytical results and knowledge by means of a vertical and horizontal partnership. The main structure and indicators of both reserve proposals were discussed at least one year before the formal approval of the CSF. Local governments, regional and central administrations had therefore enough time to organise themselves and get their share of the reward. Because it was clear that it would have been onerous for some of the less efficient administrations to produce the expected results (strengthening effectiveness on screening, programming, monitoring, evaluating public investments and implementing them) a certain degree of flexibility was introduced in the 6% reserve.

A strong incentive system such as the one described here, built into a process of decentralisation and reform of the public administration, strengthens the exposure of regional and local administrations vis-à-vis their political market; it helps on the one hand to reduce the degree of uncertainty which still characterises the dialogue among different levels of government and on the other to assume clear responsibilities as compared to at least a limited set of objectives and targets.

The strength of the system is heavily dependent upon reducing the risk of renegotiating agreed rules and of tensions on the reserve allocation that would originate pressures to change rules. This risk does exist; however, some characteristics of the process leading to the definition of the rules make it less likely to occur:

1. The incentive device is the outcome of a partnership effort, which will accompany its implementation until the final allocation of the reserve resources;
2. The credibility of the process and the commitment of all the actors is ensured by having made the latter part of an intergovernmental agreement with a super-national partner, the European Commission;
3. Indicators, targets and reallocation rules were clearly defined from the beginning, while a monitoring device has been set to provide administrations with a feedback on how to improve their action to attain the benchmarks;
4. Italy has recently had a positive experience of competition among administrations. In the case of the allocation of 2000 Meuro to projects presented by regional and central administrations, 30% was allocated with a reward mechanism and there was no pressure to renegotiate rules.

As said before, we expect that the reserve system will help improving the effectiveness of public investments. Because the programming of structural funds was mainly based on a cooperative model, monitoring and evaluation of the reserve are designed so as to share fully information among all actors involved. A technical group will be appointed to monitor and assess every year the progress made by each administration against their benchmarks. The assessment will then be performed with the help of each management authority (central administration or regional one) and their evaluation unit. Every year, starting from 2001, each management authority will provide the technical group with a report on both reserves, stating the attainment of each indicator. On this basis the technical group will provide the CSF Monitoring Committee with a technical report assessing progress, bottlenecks and obstacles to implement the two reserve requirements. The CSF Monitoring Committee will then formulate specific recommendations to each administration. The deadline for final reports is the end of September 2002 for the 6% and the end of July 2003 for the 4%.



An effective monitoring and assessment system is crucial in order to provide the necessary information required to readdress or modify measures and actions being carried out to meet the reserve objectives. Therefore its outcomes will be immediately integrated into programming and implementation through a feed-back process. The sequence of properly collecting the data, monitoring, evaluating and feeding back administrations with relevant recommendations and advice is expected to be effective in internalising evaluation results and allowing all administration to satisfy as many indicators as possible. The feedback system is deemed to work because of the power of incentives.

## **7. CONCLUSIONS**

The process of decentralisation is under way and it has already deeply changed the nature of Italian governance structure. Regions have now higher competencies and financial autonomy and much higher responsibility for policy design, evaluation of investment opportunities and risks, monitoring expenditure management and enhancing efficiency of service provision.

Institutional fragmentation is still very high, 58% of municipalities have less than 3,000 inhabitants and the provision of high quality services will require enhanced management and technical capacities but, above all, cooperation among institutional levels.

The economic and structural gap which characterizes the territorial differences between the centre-north and the south need to be reduced in order to allow for decentralisation and fiscal federalism to produce the expected benefits and minimize the undesired costs.

Intergovernmental arrangements and equalisation mechanism are not fully designed yet and they do not respond to a clearly defined model of federalism. Though southern regions have the same demand for higher decision-making power on expenditure and higher fiscal autonomy they cannot compete yet on a level-playing field with northern regions.

A model stressing horizontal federalism and geographic competition may delay or reduce the chance of Mezzogiorno to fill the gap with Europe. However an incentive-based system where cooperation and competition among levels of government are carefully mixed and public investment policies properly targeted and where an equalisation mechanism counterbalances lower fiscal capacity may create the proper conditions for the Mezzogiorno to improve accountability vis-à-vis its constituencies, public administration efficiency and enhance the quality of service provision.

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## ANNEX A

CRITERIA AND INDICATORS FOR THE ALLOCATION OF THE 4% RESERVE	
CRITERIA AND INDICATORS	DESCRIPTION
<b>A1. EFFECTIVENESS</b>	
A.1.1. Basket of outputs	Comparison of actual and planned outputs for some measures (covering at least half of the value of the programme)
<b>A.2 MANAGEMENT</b>	
A.2.1 Quality of the Monitoring System	Introduction of a system of indicators and of monitoring procedures responding to national agreed standards and guaranteeing the availability of financial, physical and procedural data from January 2001
A.2.2. Quality of Financial Control	Upgrading of the control system to the model proposed in the CSF
A.2.3 Quality of Project Selection Systems	Application of selection procedures based on feasibility studies and on criteria favouring environmental sustainability and equal opportunities (for a significant amount of projects measured in terms of % of total financial commitments)
A.2.4 Quality of the Evaluation System	Appointment of the independent evaluator by October 2001 and definition of terms of reference responding to national standards
A.2.5 Quality of the labour market analysis system	Set up within the managing authority of a system of analysis of the most significant aspects of labour market and of employment effects of interventions; diffusion of results
<b>A.3 FINANCIAL MANAGEMENT</b>	
A.3.1 Financial absorption	Attainment of 100% of declared expenditure in relation to planned expenditure in the financial plan for 2000 and 2001
A.3.2 Public-private partnership	Implementation of at least 4 public-private partnership schemes for the financing of projects

## ANNEX B

### CRITERIA AND INDICATORS FOR THE ALLOCATION OF THE 6% RESERVE

CRITERIA	INDICATOR
<b>B1. INSTITUTIONAL ENHANCEMENT</b>	
Implementation of the national legislation fostering the process of public administration reform and procedural slimming	B.1.1 Delegation of managerial responsibilities to officials (legislative decree n. 29/93)
Design and implementation of organizational and administrative innovation to accelerate and make effective structural fund spending	B.1.2 Set up and implementation of an internal control management unit
Carrying out of measures aiming at the implementation of sector reforms	B.1.3 Implementation of one back-stop shop
	B.1.4 Implementation of employment services
	B.1.4. Set up of regional and central administration evaluation units
	B.1.5 Development of the information society in the P.A.
	B.1.6 Preparation and approval of territorial and landscape programming documents
	B.1.7 Concession or management by a private-public operator of integrated water services (L.36/94)
	B.1.8 Choice of management mode and its implementation for urban solid waste within optimal service areas
	B.1.9 Set up and operational performance of regional environmental agencies
<b>B.2 INTEGRATION</b>	
<b>For regional administrations</b>	
Implementation of territorial integrated projects	B.2.1 Incidence of commitments of integrated territorial projects on the total amount of resources budgeted for integrated territorial projects in the operational programme
<b>For central administrations</b>	
Degree of integration of national operational programmes with regional planning	B.2.2 Share of commitments of the investments programmed within a programme framework agreement (Accordo di programma quadro) or any other negotiated agreement between central and regional administrations over total commitments
<b>B.3 CONCENTRATION</b>	
Concentration of financial resources	B.3.1 Concentration of financial resources within a limited amount of measures

## **DECENTRALIZATION IN SOME NON-FEDERAL COUNTRIES: THE CASE OF THE UNITED KINGDOM**

*By David Heald*

### **1. INTRODUCTION**

The United Kingdom differs from many of the countries discussed at this symposium because it is a unitary state characterized by Executive-dominated Parliamentary government and a highly centralized system of public finances. Nevertheless, it is embarking on a process of asymmetric internal devolution at exactly the same time as European Union (EU) developments are raising far-reaching questions about future economic, monetary and fiscal arrangements.

Inevitably, this paper cannot be fully comprehensive in its coverage.<sup>1</sup> However, it seeks to explain and analyze contemporary UK developments. The paper is structured in the following way. After this brief Introduction, Section II sets the context. Section III describes the devolved funding system in 2001. Section IV considers real and imagined problems. It sets out possible developments, paying particular attention to current policy debates about the present funding system and about fiscal autonomy (regarding which there was much coverage in Scotland during the 2001 UK General Election). Section V discusses similarities and differences between the United Kingdom and Canada, with regard to territorial public finance. Section VI provides brief conclusions.

The focus of this paper is upon the fiscal implications of devolution for the United Kingdom as a whole, as much as upon the devolved territories of Scotland, Wales and Northern Ireland. Given that such devolution has been in place for only two years, predictions about the wider implications for the United Kingdom must necessarily be tentative. In these circumstances, it is appropriate to note that the present author has been a longstanding proponent of devolved government, particularly – but not exclusively – for Scotland. As such, he has been a participant observer for more than a quarter of a century.<sup>2</sup>

### **2. CONTEXT**

A brief setting of context inevitably involves over-simplification and matters of interpretation which are themselves controversial. Nevertheless, this Section is vital to establishing the political and constitutional context of the technical financial arrangements.

Firstly, there are matters of geography. In the initial symposium programme, this paper was titled “Grande-Bretagne” or “Great Britain”; the paper itself now carries the correct title of “United Kingdom” (“Royaume-Uni”). A publication by the Foreign & Commonwealth Office (2000, inside cover) contains the following clarification: ‘The term “Britain” is used informally to mean the United Kingdom of Great Britain and Northern Ireland. “Great Britain” comprises England, Wales and Scotland’. It is hardly surprising that there is confusion when Great Britain is smaller than Britain! More seriously, there is resentment and touchiness in Scotland, Wales and Northern Ireland at the way ‘England’ is often used to describe the whole.

Secondly, history is important and influences attitudes and governmental arrangements. Wales was conquered in 1277 and its incorporation into England was fully completed by the Laws in Wales Act 1535. Scotland’s history was different: the Union of the Crowns occurred in 1603, when James VI of Scotland assumed the English throne as James I. This was followed, more than a century later (and after a brief union under Oliver Cromwell), by the Acts of Union 1707, when the two Kingdoms came to be governed by a single Parliament in one Kingdom, with the same monarchy and succession, and equal trade and economic rights. Ireland was conquered in 1649 but not fully incorporated until, following a major rebellion in 1798, the Act of Union (Ireland) 1800 created the United Kingdom of Great Britain and Ireland. The Government of Ireland Act 1920, which provided for separate devolved Parliaments in Belfast and Dublin, was implemented only in the north. The south of Ireland seceded in 1922 as the Irish Free State (and changed its name to the Republic of Ireland in 1937), being formally recognized as an independent Republic by the United Kingdom in the Ireland Act 1949. Northern Ireland remained part of what had therefore become, in 1922, the United Kingdom of Great Britain and Northern Ireland. There was devolved government in Northern Ireland from 1921 to 1972, when civil disorder brought about direct rule from Westminster.

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<sup>1</sup> The pre-devolution and post-devolution arrangements are explained, respectively, in Heald (1994) and Heald et al. (1998).

<sup>2</sup> See, for example: Heald (1976, 1980, 1990) and Heald and Geaughan (1996).

Thirdly, since the election of the Labour Government in May 1997, constitutional reform has received much attention. Devolution is just one aspect; others are the incorporation of the European Convention of Human Rights into Scottish and then English law, and the removal of much of the hereditary element in the House of Lords (the upper chamber of the UK Parliament). In 2001, Scotland has a devolved Parliament with legislative and some tax-varying powers; Wales has an Assembly with executive powers and responsibility for secondary legislation, but not for primary legislation or taxation; and Northern Ireland has a devolved Assembly with legislative but not taxation powers. There have been many fewer developments in England, though London (itself a region for statistical purposes) now has an elected Mayor with executive responsibility for, *inter alia*, strategic planning and transport, supported by an elected Assembly. Significantly in a UK context, all these bodies have been elected by a form of proportional representation. Overall, there has been a significant injection of a democratic element accountable to territorial electorates; these reforms have largely built upon and modified existing territorial structures of government.<sup>3</sup> An important point – to which attention will return – is that, long before recent devolution, Scotland and Northern Ireland exhibited distinctive features of governance and civil society which indicated that they had not been fully assimilated to the English model.

Two aspects of the UK political system also merit comment. First, UK citizens seem to expect that they can have EU levels of public service provision at US levels of taxation. Among the consequences of this illusion is that genuine policy failures go unaddressed and evidence of success is dismissed as data manipulation (eg improved school exam performance is attributed to exams being easier). Second, the United Kingdom combines a highly centralized fiscal apparatus dominated by the Treasury with a substantial degree of expenditure decentralization to local authorities.<sup>4</sup> However, central government has long dominated local government, which is heavily dependent on transfers from central government and operates under its direction in many areas. This was exacerbated by the taxation and expenditure limitation measures of the 1979-97 Conservative Government.

Though still big spenders, UK local authorities suffered a loss of confidence and own revenues<sup>5</sup> during this period, a trend unlikely to be reversed under the centralizing tendencies manifest in 'New Labour' at the UK level.<sup>6</sup>

Asymmetric devolution is, in part, a response to the inherent asymmetry of the United Kingdom. First, 84% of the UK population live in England, and this preponderance is likely to increase. Second, there has long been asymmetrical machinery of government, with the Secretary for Scotland (upgraded to Secretary of State in 1926) and the Scottish Office dating from 1885. These increasingly undertook, especially after the Second World War, functions separately from the 'UK' Ministers and Departments. Northern Ireland has been distinctive at least since 1921 (when it secured devolved government under the Government of Ireland Act 1920); and Wales has tended to follow Scottish developments with a long lag. These governmental arrangements have played as much a part in sustaining separate senses of identity, as have the separate religious, legal and educational systems which Scotland maintained after 1707. Leruez (1983) perceptively titled his book on Scotland: *Une Nation Sans État*.<sup>7</sup> In practice, distinctive arrangements perceived to be important in Scotland were hardly noticed in London. Those now deploring asymmetry in devolution should recognize that symmetry never existed; full integration into the English administrative system was never attempted with Scotland, though it was much further advanced for Wales.

Third, there is deep ambiguity about Scottish attitudes towards the Union. This was recognized by John Mackintosh, Professor of Politics, Labour MP and a major figure in the failed 1970s' devolution campaign; not least, the decline of the British Empire, which had offered many opportunities, made the Union seem less relevant (Mackintosh, 1969). Since that period, the semi-detached status of the United Kingdom within the EU has encouraged the periphery, especially Scotland, to become pro-European, in part as a weapon against the then UK Conservative Government, though probably also against UK centralism more generally. Speculatively, one would expect a higher pro-Euro vote in the territories<sup>8</sup> than in England should there be a referendum. Nevertheless, the conflicting pulls on individual Scots are clear: whether to concentrate on running Scotland or to play in the bigger field that the United Kingdom constitutes.

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<sup>3</sup> Full information on powers and responsibilities is available from the respective websites: <http://www.ni-assembly.gov.uk>; <http://www.scottish.parliament.uk>; <http://www.assembly.wales.gov.uk>.

<sup>4</sup> In 2000-01, local authorities accounted for 24.7% of Total Managed Expenditure (TME), the Treasury's principal control aggregate (Treasury, 2001c). King (1999) analyzed the structure, functions and financing of local authorities in Great Britain.

<sup>5</sup> Local governments in England, Wales and Scotland may only raise a domestic property tax (council tax), and then only within parameters set by central government. Non-domestic property taxes (Non-Domestic Rates), although still collected by local governments, are set centrally; and the revenue is remitted to the central authorities, who redistribute them as part of the transfers but not on the basis of derivation.

<sup>6</sup> For an interim assessment of the 1997-2001 Labour Government, see Seldon (2001).

<sup>7</sup> There is a substantial political science literature on 'stateless nations', with Catalonia, Québec and Scotland being cited in this category (Keating, 1997). Further discussion on Scotland can be found in McCrone (1992) and McCrone et al. (1998).

<sup>8</sup> There is much political sensitivity concerning how Scotland, Wales and Northern Ireland are described: nation; country; region; and many loaded terms specifically used in respect of Northern Ireland. For that reason, this paper usually adopts the Treasury's bland terminology of 'territories', understood to refer to Scotland, Wales and Northern Ireland (which have had territorial Secretaries of State and now have devolution), but not usually to England (which is managed by London-based departments which have a mixture of UK, GB and English responsibilities).

London's dominance over all aspects of British economic, political and cultural life reflects its role as business, commercial, financial, governmental, political and scientific capitals; this combination of roles in a single city is one of the differentiating aspects of the UK case.<sup>9</sup>

Nevertheless, it would be a fanciful view that contemporary developments represent a 'long march of historical inevitability' towards Scottish devolution or restored independent statehood. In reality, recent history might have turned out quite differently (Taylor, 1999). For example, until the death in a car accident of HRH Princess Diana on 31 August 1997 took over the news agenda, the Yes campaign in the Scotland referendum was looking vulnerable on the second question of whether voters supported the proposal that the Scottish Parliament should have tax-varying powers (the 'tartan tax').<sup>10</sup> Moreover, the carrying of the Labour Government's proposals for Wales was still in doubt right up until the declaration of the last local authority, in the referendum deliberately held one week after Scotland's. Several of the technical problems identified in this paper are much more easily understood if this context is taken into account.

### 3. DESCRIPTION OF THE DEVOLVED FUNDING SYSTEM

There are many complexities to the UK devolved funding system, but the basic outline can be readily explained. First, the devolved bodies are financed through an unconditional block grant ('assigned budget') from the Treasury paid via the territorial offices (the Scotland Office, Wales Office and Northern Ireland Office) which, as UK departments, account to the Westminster Parliament for the total. Accountability for the spending of the assigned budget rests with the devolved Executives, accountable to the devolved Parliament and Assemblies, with the audit being undertaken by the public official (Auditor General for Scotland, Auditor General for Wales and Comptroller & Auditor General for Northern Ireland) who heads the respective territorial audit offices. Subject to the qualifications below, the devolved Executives do not control budget size, but have total discretion over expenditure composition.

Second, changes to the levels of the assigned budgets are determined primarily through the mechanism known as the 'Barnett formula', established in 1978.<sup>11</sup> This formula operates only on increments, not on the base, allocating to each territory a population-based percentage of the increase in comparable expenditure in England. Heald (1990) set out the advantages of using a broad-brush formula such as Barnett, in the traditions of the Goschen formula (announced in 1888 and of which some use was still made in the late 1950s). There are powerful arguments against drawing the territories into a UK-wide annual needs assessment exercise, such as that used for the distribution of Revenue Support Grant in England. In the territorial context, needs assessments should be periodic, and then used to inform the calibration of the territorial formula for the next period. This pre-devolution mechanism has so far survived the transition from being an internal mechanism within one government to being the basis of transfers between governments. There has not been any formal equalization scheme across the United Kingdom, though highly complex systems exist, for example, for National Health Service funding allocations and Revenue Support Grant distribution to local authorities within each territory.

Applied systematically, the Barnett formula would bring convergence to the UK average per capita level of public expenditure (ie expenditure relatives converge asymptotically on 100).<sup>12</sup> Figure 1 provides a representation of this process, with the initial relatives for each territory being estimates of the position circa 1981. In Figure 1's simulation, it is assumed that the original 10:5:85 proportions reflected exact population shares, and relative populations remain unchanged. Crucially, the speed of convergence depends upon the nominal increase of public expenditure.

<sup>9</sup> This observation is not new. Davies (1999, p. 689) refers to the complaints of Sir Andrew Fletcher of Saltoun, who vigorously opposed the passage of the Act of Union through the Scottish Parliament: 'Fletcher was clearly in favour of an equitable balance between England, Scotland, and Ireland. He did not believe that an equitable solution could be found in a centralized state inevitably dominated by the strongest of the three partners. "That London should draw the riches and government of the three kingdoms to the south-east corner of this island", he wrote, "is in some degree as unnatural as for one city to possess the riches and government of the world"'. Fletcher thought of Wales as part of England just as did Lord Goschen, Chancellor of the Exchequer, when announcing the Goschen formula for territorial expenditure allocation in 1888.

<sup>10</sup> The Labour Government's plans for Scottish devolution were tested in a pre-legislative referendum held on 11 September 1997; the second question, (about the tartan tax), was carried by 63.5% to 36.5% on a 60.4% turnout (Heald and Geaughan, 1997)

<sup>11</sup> Briefly, the non-statutory formula provides that increases in public expenditure in Scotland and in Wales for specific services within the territorial blocks would be determined according to the formula consequences of changes in equivalent expenditure in England. Initially, Scotland received 10/85ths and Wales 5/85ths of the change in England. A parallel formula allocated 2.75% of the change in equivalent expenditure in Great Britain to Northern Ireland. The essential distinction is between base expenditure, whose current levels are carried forward, and incremental expenditure, which is determined by the formula (Heald, 1994). Under this arrangement, block expenditure relatives would in the long run converge on the UK per capita average. However, the intention was to seek a better alignment of expenditure and needs relatives, not full convergence (Mackay, 1996). It was understood that a territorial Secretary of State would have the right to call for a Needs Assessment should convergence go 'too far'. In practice, convergence has been substantially frustrated by formula bypass, and in Scotland by relative population decline. In 1992, the formula was recalibrated (10.66:6.02:100.00 and Northern Ireland 2.87%) in recognition of the results of the 1991 population census. In 1997, it was announced that the population figures would be updated annually. The effects of annual upratings of population are likely to be minimal, as these will affect only the increment. The significance of Scotland's relative population decline is that it offsets the convergent properties of the Barnett formula. Throughout this paper, an expenditure relative denotes the index for a particular territory or region of per capita expenditure relative to the UK per capita average.

<sup>12</sup> This is an oversimplification, as is noted in the discussion on relative population change. A mathematical analysis appears in Heald (1996).

Figure 2 breaks the assumption that the original 10:5:85 proportions reflected exact population shares, but keeps the assumption that relative populations are unchanged. In this case, the relatives converge to different values for each territory, though not far from 100. This result is less important, of itself, since the annual updating of population proportions was implemented in 1998. Nevertheless, it serves as a convenient reminder that, when population relatives do change through time, there are separate limits for each territory. On plausible assumptions about Scotland, Cuthbert (2001) proves this result mathematically for Scotland (which converges on a value above UK = 100).

Figure 3 shows graphically the automatic result that such a formula, which delivers equal per capita increments to each territory, delivers smaller percentage increases to those territories with highest starting values of the relative. In consequence, Scottish expenditure rises faster than Northern Ireland's expenditure, whilst it rises slower than English expenditure. Whilst Figure 3 makes the same assumptions as Figure 1, a comparable diagram can be produced on the assumptions of Figure 2. The Barnett formula is therefore a population-based mechanism to allocate increments of public expenditure, not a needs-based formula as it is sometimes described. Contrary to some claims, it was never intended to drive the territorial public expenditure relatives to 100: the territorial Secretaries of State understood that they could call for a successor needs assessment to that published in 1979 (Treasury, 1979), should they feel it necessary. Revealed preference suggests that they made a calculation that such a needs assessment would not be in their interests. Furthermore, the longevity of the Barnett formula, initially seen as a temporary measure, is to be noted.

Although there is now much more detail about the operation of the Barnett formula in the public domain (Treasury, 1999, 2000a), it is still not possible to replicate the calculations. The crucial point is that there are no published data for comparable English expenditure relative to the Scottish, Welsh and Northern Ireland assigned budgets. Because of different functional responsibilities, three separate series of data are needed. The Treasury takes a proprietary view of its public expenditure database and denies access to this even to the pre-devolution territorial departments and the post-devolution Executives. There has been so much recent change to the definition and measurement of public expenditure aggregates that do-it-yourself calculations are likely to be misleading.

Third, the formula-driven assigned budget is the major, but not sole, part of the funding available to the devolved Executives. Figures 4, 5 and 6 refer to Scotland, Wales and Northern Ireland, respectively. These Figures show that there is a common structure to the funding system in the three territories. Moreover, they are also useful as lists of the kinds of functional expenditure which are devolved. These are broadly the same, though with some important differences: for example, Scotland alone has 'Law and order' (though this could be devolved to the Northern Ireland Assembly should the security situation make this possible); and the Northern Ireland Assembly alone has responsibility for the social security system (though this is best seen as an agency arrangement, as there is no policy discretion).

What is also highlighted is how the devolved bodies are integrated into the UK public expenditure system.<sup>13</sup> When the devolution funding scheme was determined in 1997, it was not known that the Treasury would, in 1998, revamp public expenditure control aggregates or move to a biennial survey. Changes to the assigned budget are controlled by the Barnett formula, with the costs of running the territorial offices top-sliced in the case of Scotland and Wales. The assigned budget is classified as Departmental Expenditure Limit (DEL), as are certain other items of expenditure which, for various reasons, are not formula-controlled. Examples are Hill Livestock Compensation Allowances and Welfare-to-work (a programme financed out of the windfall tax on privatized public utilities). At the time of a Comprehensive Spending Review (CSR), namely in 1998, 2000 and 2002, DELs are set three years ahead. In contrast, Annually Managed Expenditure (AME) is set one year ahead, largely on the ground that these items are more difficult to control and forecast. Examples of AME are Common Agricultural Policy expenditure and Local Authority Self-Financed Expenditure (LASFE). If the Scottish Parliament were to levy the tartan tax, the expenditure funded in this way would be scored as AME.

Although there is greater transparency post-devolution about the system, largely thanks to the block rules guidance having been published (Treasury, 1999a, 2000a), there is not transparency about the numbers. In consequence, it is not possible to place values in each cell of Figures 4, 5 and 6. An indication of the predominance of Barnett formula-determined DEL is that, for 1999-2000 plans, this accounted for 79% (Scotland), 87% (Wales) and 84% (Northern Ireland).<sup>14</sup>

In the absence of better and more relevant data, interterritorial comparisons fall back on the figures for 'Identifiable General Government Expenditure' (GGE) published annually by the Treasury in a document now known as 'Public

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<sup>13</sup> The 1998 CSR saw the introduction of a new public expenditure control system, focusing upon Total Managed Expenditure (TME), itself composed of Departmental Expenditure Limits (DELs) and Annually Managed Expenditure. From 2001-02, government accounting has switched from a cash basis to an accruals basis, under the project known as Resource Accounting and Budgeting (RAB) (Treasury, 2001a).

<sup>14</sup> The calculation for Northern Ireland excludes social security benefits.



Expenditure Statistical Analyses' (PESA).<sup>15</sup> Taking data primarily from the 2000 issue (Treasury, 2000b), Figure 7 shows public expenditure relatives for Scotland, Wales and Northern Ireland, relative to England = 100 (rather than the published indexes with UK = 100). For each of these three territories, there is a line representing Identifiable GGE (solid line) and another representing Identifiable GGE excluding Social Security (dashed line). Although these are very imperfect proxies for devolved expenditure (data for which are unavailable), the striking point is that the relative (England = 100), when social security expenditure is excluded, is much higher for Scotland and Northern Ireland, but not Wales.

There have been longstanding complaints about the poor quality of expenditure data for the English regions, notably a large amount of expenditure identified to England but not to individual regions. There are better data in the 2001 issue of PESA for 1998-99 and 1999-2000, the latter of which are tabulated in Figure 8. When interpreting the relatives on individual programmes, attention should be paid to the UK weight, indicating the percentage of total expenditure accounted for by this programme. The entries for Totals in each column are weighted averages. These figures show marked variations in levels and compositions among territories and regions. Certain figures should be interpreted with great caution, as, for example, the figures for 'Housing' in some prosperous regions are clearly affected by the proceeds from council house sales being netted off. Much greater expenditure disaggregation is a precondition for analytical work on these differences.

Fourth, the UK Treasury controls, directly or indirectly, all borrowing on programmes controlled by the devolved Executives: they themselves can only borrow temporarily for timing reasons; and the 'consent' counterpart of (borrowing for) capital expenditure by local authorities is scored against the assigned budget. Total UK control of all borrowing would now be justified primarily in terms of UK commitments under the EU Stability & Growth Pact, though experience of past practices suggests that this would have happened in any case. One of the reasons why the Private Finance Initiative (PFI) - a Treasury programme to bring private finance and management into asset provision in transport, education and health - has been embraced in Scotland is that it is an approved route to evade borrowing restrictions. This is despite the fact that there remain ideological and Value-For-Money (VFM) doubts. The standard justification offered politically for the adoption of the PFI route is one of capital starvation and the non-availability of public funds; this sits uncomfortably with concerns that the Barnett formula will in future bring convergence.

Fifth, contrary to the purposes of various EU programmes of regional support to less prosperous regions, the award of funds from the European Regional Development Fund (ERDF) generally does not bring additional resources to the beneficiary UK territory or region. Despite EU pressure, the UK Government has consistently argued that there is additionality in aggregate, namely that public expenditure as a whole is higher than could have been afforded in the absence of ERDF receipts. The most politically dramatic event connected with devolution was when Alun Michael, having been parachuted into the Welsh Labour leadership by the Blair Government to stop Rhodri Morgan being elected First Secretary, had to resign because he failed to deliver extra money following the acquisition by West Wales (a strange geographic construction covering 63% of the area and 65% of the population of Wales) of Objective 1 status.<sup>16</sup> Subsequently, Rhodri Morgan became First Secretary; the Treasury allowed funding 'above Barnett';<sup>17</sup> and the minority Labour administration in Wales followed the Scottish precedent and went into coalition with the Liberal Democrats.

Sixth, the generation of revenues plays only a small role in the devolution funding system. Alone, the Scottish Parliament has the power to vary the basic rate of income tax, by 3p in either direction; this 'tartan tax' and the local authority taxation system is discussed in Section IV.

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<sup>15</sup> The data on identifiable expenditure should always be read with awareness about the impact of non-identified expenditure on services such as defence. Debates about the territorial pattern of defence expenditure are a telling reminder that political concerns are as often about inputs (hence employment effects) as about outputs. When the focus is upon both expenditure and revenue, tax expenditures (eg on owner-occupied housing) cancel out because regional revenue is correspondingly depressed. However, they do affect the comparability of expenditure measures.

<sup>16</sup> Objective 1 is the classification which brings eligibility for the highest level of European Regional Development Fund financing. On the role of EU funding in Wales, see Blewitt and Bristow (1999).

<sup>17</sup> This provoked outrage in the Scottish media, always keen to spot offence, until someone pointed out that an extension of this concession to Scotland (which was losing ERDF funds) would have meant a reduction in the Scottish Parliament's Budget.

## 4. REAL AND IMAGINED PROBLEMS

The new arrangements in the United Kingdom exhibit some real problems, whereas others are imagined. Notwithstanding that some of the problems which appear in public debate are imagined, this does not mean that they have no influence on the evolution of the system.

### 4.1. Lack of Transparency

There is a lack of transparency about both processes and data.<sup>18</sup> The territorial fiscal mechanisms originated in the context of the territorial deconcentration of UK central government, with the territorial Secretaries of State being members of the UK Cabinet. Typically, they were relatively junior members of that Cabinet, but acquired constrained autonomy over the operation of public policy in their territory, in part as a reward for their loyalty to the Prime Minister of the day. Neither the Treasury nor the territorial departments had any interest in transparency: the Treasury culture naturally disposes itself to secrecy; and the territorial ministries thought that they could best protect territorial interests behind a veil of secrecy (Midwinter et al., 1991). A continuing consequence is that UK territorial data are generally of poor quality, arguably deteriorating during the 1980s and 1990s when the Conservative Government categorically ruled out devolution. In the UK system, most official statistical work is geared to the needs of UK policy, and requests for data which might have been taken to imply support for devolutionary policies were suspect. These effects reach far beyond territorial public expenditure data; for example, Cameron and Muellbauer (2000, Abstract) noted that 'The historical unreliability of the Regional Accounts has implications for economic research on regional consumption and convergence and may have caused the poorest regions to miss out on EU Structural Funds'.

Given the technical problems of producing regional data, and the political context within which they are produced, all regional data are likely to be challenged politically. The best data about a constituent part of the United Kingdom appear in the series 'Government Expenditure and Revenue in Scotland' (GERS),<sup>19</sup> originally published by the Scottish Office and now continued by the Scottish Executive. However, this series is regularly abused by governments. Michael Forsyth, Conservative Secretary of State for Scotland, 1995-97, released one issue on the eve of a Scottish Conservative & Unionist Party Conference, at which he used its contents to denounce the devolution plans of the Scottish Constitutional Convention. Since 1997, Labour ministers, first at the Scottish Office and more recently at the Scottish Executive, use this document to pronounce unrealistic the SNP's plans for independence. In turn, the SNP attack the integrity of GERS, and always make reference to a celebrated written Parliamentary answer from 1997 given by the then Chief Secretary (William Waldegrave).<sup>20</sup> The media constantly recycle figures for Scottish fiscal deficits or surpluses relative to England, many of which reports are incompetent and/or malevolent. A classic error is to interpret the Scottish fiscal deficit as a measure of the subsidy from England, even when the United Kingdom as a whole incurs a fiscal deficit. Some of the inflammatory language is so outrageous as to be humorous.<sup>21</sup>

Although Scottish Executive economists must feel battered by this exposure, they deserve credit for persisting with GERS; no counterpart exists for Wales or Northern Ireland. In this political context, it will be quite difficult to achieve transparency and agreement upon regional flows of income and expenditure.<sup>22</sup>

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<sup>18</sup> Although it is not fashionable to have public doubts about the desirability of transparency, it is clear that attitudes in practice are ambivalent. There seems to be a presumption in some Finance Ministries, most notably in the New Zealand Treasury, that greater transparency will lead to lower spending. Moreover, it is difficult to take the UK Treasury's new-found enthusiasm for transparency at face value when there is so much pressure to use the PFI as a vehicle for off-balance sheet finance. Furthermore, the effect, so far, of the Comprehensive Spending Review has been to bring even more obscurity to public expenditure numbers. Some of the calls for greater transparency, whether with regard to interpersonal or interregional transfers, may implicitly or explicitly be calls for less redistribution or fiscal equalization. However, these observations should not be taken as a defence of fiscal opaqueness.

<sup>19</sup> The most recent issue of GERS relates to 1998-99 (Scottish Executive, 2000) and is available on the Scottish Executive's website at <http://www.scotland.gov.uk/library3/government/gers.pdf>.

<sup>20</sup> Historically, North Sea oil revenues (which are attributed to the UK Continental Shelf which is part of the United Kingdom but not part of any region) have been large. The Scottish National Party's argument that Scotland subsidized the United Kingdom by £28 billion during the years 1978-79 to 1994-95 is discussed in Heald et al. (1998). Whatever view is taken about the past, oil revenues have less significance for the future.

<sup>21</sup> One example is Heffer (1999): 'For the English...., the road to Scottish independence is paved with gold (p. 67).'; '... every English taxpayer and every English business will be better off if England no longer has to subsidise Scotland (p. 71); 'If the English can make a four pence in the pound tax cut out of Scotland's deciding to become independent, that is a cause for rejoicing rather than shame (p. 73)'. His calculations (p. 71) take the GERS measure of Scotland's fiscal deficit in 1994-95 as a subsidy from England to Scotland. Another example is the way in which the condition of the London Underground is routinely blamed on Scotland (McLean, 1998), a tactic which found much favour during the 2000 Mayoral election campaign in London. Before the referendum, there were suggestions that, unless it accepted the *status quo*, Scotland should be evicted from the Union (McLean, 1997a,b), in the manner in which it is claimed that Slovakia was evicted from the Czechoslovak federation.

<sup>22</sup> Recent discussion of the Scottish fiscal position goes back to McCrone (1969).

#### 4.2. Weak Fiscal Accountability

There is weak fiscal accountability, in part because of the extent of Vertical Fiscal Imbalance (VFI). However, public finance economists sympathetic to UK devolution have stressed that, in the UK context, attention should focus on fiscal accountability at the margin (Blow et al., 1996, Smith, 1996, Bell et al., 1996). This would allow devolved bodies to vary total budget size, as well as to vary expenditure composition. For the reasons explored elsewhere in this paper, there is not much likelihood either of full revenue decentralization or of a recourse to the principle of derivation (public expenditure in a region depends solely on taxes raised in that region). The twin dangers of blaming the devolved bodies, both for UK fiscal centralism and for the genuine constraints imposed by context, should be avoided.

Quite apart from the Labour Party's explicit electoral commitment not to use the tartan tax in the first term of the Scottish Parliament,<sup>23</sup> there have been other considerations pointing in the direction of caution. There was always a case for caution, in that the first step for the newly elected Parliament and Assemblies was to assess the expenditure situation, notably composition and the possibilities for greater VFM. Moreover, contrary to all expectations prior to devolution, the devolved Executives have been awash with money in financial years 2000-01 and 2001-02.<sup>24</sup> Rather than a shortage of cash, the problem has been mobilizing real resources, as manifest in high levels of underspend across both the devolved Executives and UK central government more generally (Treasury, 2001b).

A movement to greater fiscal accountability at the margin, if it occurs, is likely to be gradual. The combination of unexpected fiscal plenty<sup>25</sup> and expected political hesitation runs the risk that the tartan tax machinery, carefully developed between 1997 and 1999, will atrophy (Heald and Geaughan, 1997). There will be a long-term issue of how the tartan tax mechanism, whether restricted to Scotland or extended to Wales and Northern Ireland, interrelates with changes to central government taxes. After a period dating from the 1980s when considerable importance was attached by the Treasury to the stability of the personal income tax structure, the Treasury under Gordon Brown has engaged in a great deal of micro-management of tax bands, credits and rates. One such change considerably increased the potential yield of the tartan tax, but did this by taking its threshold lower down the income distribution, thereby making it more difficult to levy.<sup>26</sup> At the 1999 Scottish Parliament elections, there was a mistaken but widely accepted view that the tartan tax is regressive because it only applies to the basic rate, not extending to the higher rate.<sup>27</sup> The difficulty in using the tartan tax is essentially political, and there would be much manoeuvring regarding whether the Scottish Executive or the UK Government took the blame. One practical concern is that, given the Treasury's control over data and scoring, recourse to the tartan tax might be neutralized by a reduction in the assigned budget. However, transparency about the assigned budget calculations would be the best safeguard.

Perhaps one of the most significant aspects of the tartan tax is that this proposal explicitly linked the legislative and executive power of the Scottish Parliament to revenue raising. Although the referendum on the basis of two questions (one about the Parliament, one about the tartan tax) was widely interpreted as an attempt by the Labour Government to backslide on the revenue-raising power, the practical impact was to highlight the link in a way which had not previously been done, despite the commitment of the (Scottish Constitutional Convention, 1990, 1995) to this proposal. Subsequent to the referendum, some of those who had forecast dire economic consequences arising from a modest proposal then switched to a position advocating that the Parliament should raise all its own money.

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<sup>23</sup> This commitment, widely believed to have been imposed upon the Scottish Labour Party by the London leadership, was accompanied by a campaign against the SNP's 'Penny for Scotland' (ie the use of 1p of the 3p power), which forecast economic doom and mobilized business persons and celebrities (eg football managers), in a way highly reminiscent of the No campaign during the 1997 Referendum.

<sup>24</sup> In order to establish its economic credentials before the 1997 General Election, the Labour Party promised to hold to the pre-existing public expenditure plans for 1997-98 and 1998-99, which it would inherit from the Conservative Government. The public expenditure process was moved from an annual Survey (looking three years ahead on a rolling basis) to a biennial Comprehensive Spending Review (looking three years ahead, but with some reconsideration of the third year at the next CSR). The public expenditure settlements announced in July 1998 and July 2000 (Treasury, 1998, 2000c) were unprecedentedly generous, especially to public services such as health and education. These fed through the Barnett formula into the assigned budgets of the devolved bodies.

<sup>25</sup> Timmins and Beattie (2001a,b) reported that the Institute for Fiscal Studies has calculated that the Treasury has funds within its plans which would allow public spending in 2001-02 to increase by more than 10% in cash terms (the forecast GDP deflator is 2.5%).

<sup>26</sup> The March 1999 Budget restructured tax bands, replacing the existing 20% band (£0-£4,300 of taxable income) with a starting band of 10% (£0-£1500), with the net effect that the basic rate (23% in 1999-00, 22% in 2000-01) started at £1,500. Treasury (1999b, p. 99) stated: 'Effects on the Scottish Parliament's tax varying powers – statement regarding Section 7b of the Scotland Act 1998: After the changes..., a one penny change in the Scottish variable rate in 2000-01 could then be worth approximately plus or minus £230 million, compared with plus or minus £180 million prior to these changes. In the Treasury's view, an amendment of the Scottish Parliament's tax-varying powers is not required as a result of these changes'.

<sup>27</sup> The Institute for Fiscal Studies (1999) showed that, until the top decile, the tartan tax would be progressive. On the considerations which led to the tartan tax not being applied at the higher rate, see Heald and Geaughan (1997).

It is important not to underestimate the significance of the Scottish Parliament having full legislative control over local government structure, finance and taxation.<sup>28</sup> As shown in Section III, local government revenues implicitly finance a part of devolved expenditure. The positions are less developed in Wales (where the National Assembly for Wales controls the operation of the Welsh system but relies upon Westminster for primary legislation) and in Northern Ireland (where most local government functions were taken into central government under direct rule, and where the comparable taxes are lower); however, these positions might change. The constraint on change is political, not technical, echoing the earlier observation that UK citizens have more enthusiasm for public services than for paying taxes. The quickly reversed implementation of the community charge (ie poll tax) has accentuated political nervousness about local authority taxes, business as well as personal, and more specifically about differences between tax *rates*<sup>29</sup> in Scotland, Wales and England.<sup>30</sup> Two examples illustrate this point. Council (ie domestic property) tax valuations are still based on April 1991 values. In September 2001, there was newspaper coverage of business opposition to the intention of the Minister for Finance and Local Government in the National Assembly for Wales to go ahead with a proposal for a supplementary (ie local authority) business rate in Wales, even though such a proposal, discussed in a September 2000 Green Paper (Department of the Environment, 2000), has been abandoned in England.

Control of the entire local government financing system is a major asset for the Scottish Parliament, especially when it is noted that the Autonomous Communities in Spain are bypassed by the central government in Madrid which deals directly with local authorities. In contrast, central government taxation (here referring to the direct activities of the Scottish Executive) is not devolved, but central government charging policy is devolved.

The line between taxes and charges is an elusive one. Congestion-type taxes, such as motorway tolls, are those least likely to provoke a reaction from the UK Treasury, which may even like the idea of the devolved bodies taking the lead in such a policy area. Nevertheless, the withdrawal by the Scottish Executive of its own motorway toll proposals re-emphasizes the political sensitivity of these matters.

The 2001 UK General Election, the first to take place with devolution in place, was remarkably dull until enlivened by a fractious and confused controversy about 'fiscal autonomy'. The trigger was a letter urging fiscal autonomy (Cross et al., 2001), published in the Scotsman newspaper. The problem is that several meanings could be attached to this term. First, the meaning is clear if Scotland were an independent state, though that was not generally the context of this discussion. Second, fiscal autonomy could mean that the devolved Scotland would receive all the tax revenue collected by the UK revenue departments and identified as having emanated from Scotland, with there being no power to vary UK rates. In such a case, a crucial question is whether there would be fiscal capacity equalization and/or needs equalization; the letter itself condemned equalization as inefficient and unfair, and stated that the direction of transfer runs from Scotland to England. Third, fiscal autonomy could mean that Scotland would have power to vary all or some tax rates, in which case questions of whether there would be equalization of fiscal capacity and/or for needs, whether there would be separate tax administrations, and whether such rate variation would be admissible within a EU member state, all arise. It became apparent that those in the media and politics advocating fiscal autonomy in the second or third meanings included some, hitherto opposed to devolution and the tartan tax, who believed that such an arrangement would bring large and welcome reductions to devolved expenditure because of a revenue shortfall, as well as those who supported fiscal autonomy as a means of securing higher devolved expenditure.<sup>31</sup>

The focus in the United Kingdom should be upon fiscal accountability at the margin, not upon the proportion of expenditure which is financed from own resources. To concentrate upon the latter is to misjudge the UK fiscal system. Even without the traditionally centralized fiscal psychology of the Treasury and the desire of the present Chancellor of the Exchequer to micro-manage functional spending departments, the growing extent of international (IMF) and supranational (Ecofin) surveillance of general government-based indicators means that a high level of own resources would not be any guarantee of autonomy at the margin.

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<sup>28</sup> The limitations on this power were spelled out in the 1997 White Paper: 'Should self-financed expenditure start to rise steeply, the Scottish Parliament would clearly come under pressure from council tax payers in Scotland to exercise its [capping] powers. If growth relative to England were excessive and were such as to threaten targets set for public expenditure as part of the management of the UK economy, and the Scottish Parliament nevertheless chose not to exercise its powers, it would be open to the UK Government to take the excess into account in considering the level of their support for expenditure in Scotland' (Scottish Office, 1997, para 7.24). There is no guidance on what would constitute 'excessive' growth.

<sup>29</sup> Much less attention is paid to differences in valuation practices and levels.

<sup>30</sup> It is part of the received political mythology that the poll tax was Prime Minister Margaret Thatcher's revenge upon Scotland for its lack of enthusiasm for the policies of her Government, a view often now repeated by those sympathetic to her programme. In fact, the poll tax emerged as a Scottish proposal in response to a bitterly contested rating revaluation in 1985, and this was the reason why implementation took place in Scotland in 1989-90, one year ahead of England. This episode in GB fiscal history (the poll tax was never implemented in Northern Ireland) has been described as 'fiscal anarchy' (Besley et al., 1997).

<sup>31</sup> Another aspect of this debate is the proposal that the Scottish Parliament would take all revenues generated in Scotland and then pay the UK Government for the services it provided. Such a system in principle operated in Northern Ireland from 1921 to 1972, but in practice it quickly degraded and the payment became negative (Gibson, 1996). A practical issue is that such an arrangement would generate much controversy about non-devolved matters, with the Scottish Parliament being likely to object to certain components of such UK expenditure, definitely complaining about the geographical distribution of defence bases and perhaps threatening to charge rent for the location of the UK's nuclear capability in the Clyde estuary.

### **4.3. Policy Variation and Policy Leadership**

Leaving aside the issue of the relationship between expenditure and needs, the evidence indicates that per capita expenditure on devolved services is higher in Scotland, Wales and Northern Ireland than it is in England. Especially since the implementation of Barnett in 1981-82, the territorial offices had considerable scope to vary the composition of their expenditure from that in England, though the fact that the respective Secretaries of State were members of the UK Cabinet of a Conservative Government, with a well-defined policy agenda, limited how much deviation might be expected. During this period, the Secretary of State's expenditure-switching power within the block seems to have been used more for tactical public expenditure management than for policy variation. Nevertheless, even through the periods when the 1979-97 Conservative Government regarded reducing public expenditure as a priority, successive territorial Secretaries of State and their civil servants defended territorial programmes.

Under the devolved system, policy divergence seems more likely, as the factors which generated alignment are now much weaker. Midwinter (1997) has stressed that one of the reasons why the Treasury has not challenged the Barnett system is that any reductions of expenditure secured in the territories would spread very thinly over the much larger England. Moreover, the system allowed the Treasury to exercise control over the main Whitehall spending departments, and then quickly calculate the formula consequences which bore a predictable relationship to totals. Treasury staffing levels could not have coped with involvement in the particularities of territorial public policy (Thain and Wright, 1995), especially in cases where there was political leverage. Policy leadership, especially that which might be expensive, remained in London in Whitehall departments. Devolution changes this picture. From the Treasury's viewpoint, policy initiatives in the territories might now generate expensive policy spillovers to England<sup>32</sup> if there is pressure for matching policy.

Examples of this are now widely discussed. First, the Labour Government's UK reform of student finance began to unravel when the coalition Scottish Executive adopted a package involving the abolition of up-front student fees. This was substantially less expensive than the proposals of the Cubie Report (1999), which had been commissioned by the Scottish Executive as part of the coalition agreement between Labour and the Liberal Democrats. Subsequently, pressure has built up for policy changes in England which, because of relative populations, would be expensive for the Treasury.

Second, the Labour Government appointed a Royal Commission on the financing of long-term care for the elderly (Sutherland, 1999). To the Government's discomfort, the majority report favoured the government paying for personal care as well as nursing care for dependent elderly persons, irrespective of means. Although the proposals were initially rejected by the UK Departments and by the Scottish Executive, one of the first actions of the new First Minister was to announce that the majority report proposals would be implemented in Scotland. This was partly under pressure from the Liberal Democrats, but also to assert his independence from the London Labour leadership, which had become involved in the Scottish leadership election, occasioned by the death in October 2000 of First Minister Donald Dewar. Subsequently, pressure is building up for policy modifications in England. Moreover, the implementation of this policy raises financial issues concerning the way the non-devolved social security system interfaces with devolved expenditure; in this case, the devolved policy will bring savings to the UK programme.

A third example relates to teachers' pay, on which topic the Scottish Executive commissioned the McCrone Report (2000) which recommended considerable restructuring and substantial pay increases. Again, these Scottish developments have affected debates about teachers' pay in England (though there is some evidence that teachers' pay in Scotland has lagged behind that in England).

These Scottish initiatives have provoked much comment in England, largely to the effect that Scotland must be overfunded if these can be afforded from within the assigned budget. Several questions arise. First, there is the question of the respective merits of the Scottish and English policies, a topic well beyond the scope of this paper. Second, there is the question of how much these initiatives will cost, both in Scotland and then if extended to England. There are many figures in circulation about potential costs, though the basis of calculation, the original source and even the time period are often not made explicit. For example, with regard to Scotland, £800 million has been cited for the McCrone proposals; £110m a year for Sutherland; and £50m a year for Cubie. Moreover, a huge amount of media attention has been attracted by the mismanagement and cost overruns of the buildings for the Scottish Parliament at Holyrood and for the National Assembly for Wales at Cardiff Bay. These overspends have to be met from within the assigned budget. Third, even where a Scottish policy initiative does not involve future expenditure commitments, the method of funding via the assigned budget means that the way in which the Treasury scores particular transactions can be highly technical

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<sup>32</sup> This discussion refers to the financial effects of horizontal policy spillovers, not to vertical financial spillovers. The published rules (Treasury, 2000a) for operating the devolved financial system specify that there would be adjustments to the assigned budgets in cases where devolved policy, for example higher council taxes or higher council house rents, leads to higher benefit payments from UK funds.

and immensely important. There has been newspaper coverage, probably leaked to damage the new First Minister, regarding negotiations between the Scottish Executive and the Treasury as to how the transfer of Glasgow City Council's housing stock to a housing association will be scored.<sup>33</sup>

Nevertheless, policy spillovers do not all run the same way. First, pressure has been put upon the devolved administrations because of the headlining, particularly at the times of the 1998 and 2000 CSRs, of the percentage increases awarded to health and education in England. Because of the operation of the Barnett formula, the devolved administrations could not match these percentages, without massively distorting internal priorities within their assigned budgets. The so-called 'Barnett squeeze' has been measured as the amounts Scotland, Wales and Northern Ireland have not received because the same percentage increase as in England was not applied to their own expenditure base (Cuthbert and Cuthbert, 2001). Although there is something bizarre in such calculations,<sup>34</sup> the media and political attention they attract are undoubtedly causing problems for policy-makers in the devolved administrations.<sup>35</sup>

Second, there are considerable differences in the structure of government in the four territories of the United Kingdom, and in the conduct of central-local relations. Scotland now has a single-tier local authority system and, even before 1997, there has been considerably less conflict over education policy and schools management. Local government is highly marginal in Northern Ireland, with many functions, including schools, managed directly by the Executive or by quangos. In England, the highly centralized inclinations of the Department for Education and Employment (now Education and Skills) have combined with the desire of Westminster politicians to gain credit for 'new money', leading to the announcement of direct payments to schools which bypass the block grant local authority financing system. The knock-on effect, probably felt more intensely in Northern Ireland, where there seems to be more awareness of English developments, is that schools in Northern Ireland believe they have been missing out.

Thirdly, there is the curious situation when the Barnett formula is widely criticized, albeit for diametrically opposite reasons. It is primarily exceptionally high rates of nominal public expenditure growth which has brought the convergence issue on to the policy agenda in the territories. There has also been extensive media attention to changing patterns of relative GDP, usually focusing on Scotland moving much closer to the UK average and Wales dropping much further below. However, this focus on relative GDP is largely misguided, as the drivers relevant to differential needs for devolved expenditure are demography, geography and participation rates in publicly provided services such as health and education.

The so-called 'devolution backlash' has been relatively subdued. In part, this is because the territories receive little attention from the UK media. However, there is undoubted resentment, particularly in the North East of England (adjacent to Scotland), about the higher expenditure levels and greater policy autonomy of the territories, now much more widely known. So far, resentments have been fuelled, without there being real transparency in how the territorial expenditure system operates.<sup>36</sup>

Thus far, the expectation of many strongly supportive of devolution that the budget constraints would be highly restrictive has not come about, because of broader UK developments. A key issue is whether the system, which theoretically embodies a hard budget constraint, can withstand the inevitable political pressures when money becomes genuinely tight.

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<sup>33</sup> Traditionally, Scottish local authorities have owned a large stock of 'council housing'. Over the past 20 years, a substantial proportion has been sold to sitting tenants. Some local authorities, like the City of Glasgow Council, with a large proportion of its remaining stock in poor condition, see the transfer to a housing association as a means of renovating the stock. Housing associations, though heavily dependent on public funds, are treated by the Treasury as private sector bodies which can borrow in the capital market without that scoring against public expenditure aggregates. The technical issue is presumably that, at the time of the transfer, the local authority would seek a writing-off of that part of its debt relating to the now-transferred housing stock, with the Scottish Executive accepting responsibility for servicing that debt. However, newspaper coverage suggests that a write-off of housing debt across the United Kingdom at the time of transfer might avoid the Scottish Executive taking over this debt.

<sup>34</sup> These calculations imply that each territory should have the same percentage increase, irrespective of the present expenditure relatives and of relative needs.

<sup>35</sup> We have a formula that, every time a big headline increase is announced by the Chancellor in England, it can't actually be repeated here because our Barnett consequences don't give us enough. There are serious difficulties there. For every pound extra that has been announced for education, per school child in England, it's only 76p per pupil here' (Mark Durkan MLA, Minister for Finance in the Northern Ireland Executive, quoted in the *Belfast Telegraph* on 14 January 2001).

<sup>36</sup> Newspaper comment suggests that there is considerable resentment at the prominence in the UK Labour Cabinet of MPs representing Scottish constituencies: out of 23, five are Scottish MPs, and three others (one a member of the House of Lords, two representing English constituencies) were born in Scotland. An important factor behind this prominence was that Labour was much more successful in Scotland in 1983 and 1987 at retaining its seats. One of the provisions of the *Scotland Act 1998* is that, with effect from the General Election to be held not later than 2006, the number of Scottish MPs will be cut from the present level of 72 to a number based on the same population quota as applies in England. Gay (1997) calculated that a strict *pro rata* basis would give, out of 659 MPs, England 549 (presently 529), Scotland 59 (72), Wales 33 (40) (where there are no proposals for reduction), and Northern Ireland 18 (18).

#### 4.4. *Absence of Institutional Machinery*

UK government has been very top-down, with a hierarchical relationship between central government and local authorities, even before the 1980s saw a removal of functions, the imposition of compulsory tendering, and the diminution and restriction of revenue raising. Even within the territories, with their separate territorial administration, political authority came through the Secretary of State from the Prime Minister and the UK Cabinet.

On a constitutional level, devolution does not necessarily change this, because the Scottish Parliament was established by Westminster legislation, which any future government can repeal, and the funding basis is only contained in the devolution White Papers (Scottish Office, 1997, Welsh Office, 1997) and non-statutory Treasury guidance (Treasury, 1999, 2000a). There can be no such thing as a constitutional assignment of powers. Nevertheless, the political reality is quite different. Devolution 'all around' fundamentally alters the politics; between them, the three territories elect a considerable proportion of the UK Parliament. Withdrawing devolved powers is unlikely to be attempted by a UK Government unless it enjoyed significant support for this policy in that territory. Although the UK Government can exercise the power to suspend the Northern Ireland Assembly, it is far less likely that this could be done in the case of Scotland and Wales. There are now credible alternative political mandates, with devolved administrations looking to their own electorates who may behave differently in UK and devolved elections. A further complication arises from proportional representation to the devolved bodies, together with coalition government which is a likely consequence. In Scotland and Wales, this has facilitated a revival of the respective Conservative Parties, making UK commitments to roll back devolution highly problematic for a UK Conservative leader.

What is obviously lacking is institutional machinery within which intergovernmental relations can be conducted. The devolved Executives are remote from the UK level of decision-making, relying both on internal party links and on the operation of the Scotland and Wales Offices, whose heads at present retain UK Cabinet Minister status. There is no clarity as yet as to how this machinery might develop.

For example, the aborted devolution plans of the 1970s produced an Expenditure Needs Assessment conducted by an interdepartmental committee chaired by the Treasury (1979). This work provided the context within which the Barnett formula was adopted. Although nothing has ever been published, the Treasury has periodically updated its assessments of the relative needs of Scotland, Wales and Northern Ireland. Understandably, the devolved Executives do not trust either the Treasury's ownership of public expenditure data or the potential uses to which such calculations might be put. Such concerns will have been magnified by the Deputy Prime Minister's promise during the 2001 General Election campaign that there would be 'blood on the carpet' about the Barnett formula (Hetherington, 2001).

Given this context of suspicion and of poor data, only a body independent of the UK Treasury would command consent in the context of any future needs assessment. There is presently a remarkable amount of confusion about even basic facts, stemming in part from an apparent failure to understand the difference between relative and absolute changes. The Barnett formula is characterized in Scotland, Wales and Northern Ireland as a means of depriving them of equal percentage increases to those in England, whilst in England it is synonymous with feather-bedding of the territories. Territorial politicians and media work themselves up into a lather, sometimes about things which are unimportant or irrelevant. To what extent this is playing political games, and to what extent there is genuine ignorance, is sometimes difficult to assess.

What the United Kingdom will need is some kind of forum for minimizing areas of conflict over factual matters, and a mechanism for resolving disputes. Different federations deal with this matter in various ways: for example, the Australian Grants Commission plays an important role in the operation of fiscal equalization among the states, and the Supreme Court has regularly been involved in taxation disputes. In Germany, the Fiscal Equalization Law is currently under revision after the Federal Constitutional Court deemed certain aspects of the present scheme unconstitutional, in a judgement delivered on 11 November 1999.

Thus far, intergovernmental conflict over resources has been minimal, probably because of the lubrication of unexpected real expenditure growth. This is one of the factors which have, thus far, falsified Midwinter and McVicar's (1996a,b) apocalyptic predictions of conflict which would destabilize the Union.

Those supporting devolution recognized the strains on the Barnett formula-controlled assigned budget which might arise. These concerns operated at two levels. Firstly, a collapse of public service quality in some parts of inner London might take opinion formers and the middle class further out of public provision and reduce the need, and weaken political support, for the higher expenditure in England which generates formula consequences. Second, a fundamental

shift in UK policy towards tax expenditure support for private health and education would automatically mean that there were fewer formula consequences.<sup>37</sup>

## **5. COMPARISON BETWEEN CANADA AND THE UNITED KINGDOM**

Certain differences and similarities between Canada and the United Kingdom can usefully be summarized. Firstly, Canada became a federation in 1867 whereas the United Kingdom is not a federation, and probably never will be. Nevertheless, recent UK developments are quasi-federal in character and reflect the fact that, in both countries, there is a real possibility of break-up. Québec has had referendums on separation, and the break-up of the United Kingdom began in 1922. But for World War I, devolution might well have been implemented in Scotland in the 1910s when 'Home Rule All Round' was a vibrant rallying cry in the periphery. To a considerable extent, devolution, which had been strongly supported by the Labour Party, went off the agenda because Labour, both in office and in opposition at Westminster, attached great importance to the centralized UK welfare state. The existence of potentially insoluble conflicts, which federalism is seen as a way of managing, distinguishes both Canada and the United Kingdom from a federation like Germany, where federalism is more a governance concept than a mechanism for assuaging deep conflicts or facilitating marked policy divergence.

Secondly, in both Canada and the United Kingdom there are markedly different patterns of political support in different areas, a feature that has been accentuated by the first-past-the-post electoral system. Its effect was particularly pronounced during the 1979-97 Conservative Government, which relied upon majorities from England to pass legislation concerning Scotland and Wales. The Labour Party's revival in southern England in the 1997 General Election, sustained in 2001, has modified this picture, though provoking new complaints that New Labour's preoccupation with 'Middle England' is leading it to neglect its heartlands. The electoral system thereby amplifies fluctuations in political support.

Thirdly, Scotland often defines itself in relation to England, its much larger neighbour, which – for most of the time – is unconcerned about, and ignorant of, developments in Scotland. There are parallels in that Canadian nationalism is, in part, defined relative to the United States (Helliwell, 2001). There is some similarity between the economic pressures from the North American Free Trade Area (NAFTA) and those from the EU, though a bigger difference is to be found in that increased economic integration is not presumed to involve either monetary or fiscal integration. The fiscal history of Canada and, especially, that of the United States, where federalism has been explicitly viewed as a restraint on government size, has led to much less concern about the fiscal viability and health of sub-national governments (Riker, 1996). There is much more willingness to leave fiscal discipline to the capital market, rather than the surveillance which has been adopted by Ecofin.<sup>38</sup> Although the United Kingdom, unlike Canada, does not have a constitutional commitment to fiscal equalization, there is a deeply embedded political commitment to the principle of broadly equal standards of public service provision across the United Kingdom.<sup>39</sup> The differences in provision which are now attracting increased attention are partly a consequence of political compromises and partly a reflection that the UK fiscal system has been non-transparent. Whereas Canada exhibits a high degree of revenue decentralization (Boadway and Watts, 2000), the United Kingdom will remain highly centralized. Indeed, the UK Government will simultaneously resist EU pressures for tax harmonization (arguing the case for tax competition) and devolved pressure for modest measures of tax decentralization (arguing that these would be distortionary). Even without EU pressures for tax harmonization, the UK Exchequer's loss of revenue from tobacco and alcohol excises, together with the criminalization of parts of the distribution system, will lead to major reductions in excise levels, which are currently much higher than in the relevant parts of continental Europe. Distance provides less protection than in Canada for differentiated excise systems.

Fourth, the UK Government has no power to spend its own money on devolved functions, so that, in this respect, the devolved bodies are more effectively protected from UK government intervention than are the Canadian provinces, which have long complained about the Federal Government's use of its 'spending power' (Boadway and Watts, 2000) to override provincial policy preferences. An obvious caveat is that a UK government has control over the tax/transfer system and there might well be circumstances in which this could be used to override the policy preferences of devolved bodies.

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<sup>37</sup> This issue, of there being no English counterpart to generate formula consequences, already arises in the case of water and sewerage, privatized in England and Wales but not in Scotland and Northern Ireland.

<sup>38</sup> There has been considerable conflict between the UK Chancellor of the Exchequer (Gordon Brown MP) and Ecofin concerning the UK's conformity with the EU Stability and Growth Pact (which applies to the United Kingdom even though it is not a member of the Euro). The deficits and debt of sub-national governments are scored within the general government measures monitored by Ecofin.

<sup>39</sup> This manifests itself in unresolved tensions in public attitudes to centralization. First, territorial variation in cash benefits is deemed intolerable, even when strong cases could be made in terms of regional variations in the cost of living. Second, though centralized bureaucracies are viewed as suspect, attempts to decentralize public sector decision-making (eg purchaser-provider separation in health, with local determination of some priorities) quickly face bitter complaints about 'postcode lotteries'. Paradoxically, if devolution brings greater transparency about in-kind provision, this might revive pressures for uniform provision.



## **6. CONCLUSIONS**

In conclusion, four final observations will be made. Firstly, it is essential to recognize where the UK devolved system of government is coming from and not to criticize it on the grounds that it would not have been invented in that form had there been a clean slate. Devolved government in Scotland and Wales is only two years old and the restoration of devolved government in Northern Ireland, itself two years old, suffered a 24-hour suspension on 10 August 2001 for reasons unconnected with the subject matter of this paper. The start has undoubtedly been shaky, but the show is on the road.

Secondly, the conceptual framework of the economic theory of fiscal federalism is most helpful in constructing an analysis of a particular country in terms which resonate elsewhere. However, prescription ought to proceed with great caution. The mainstream literature on fiscal federalism has a strongly normative orientation, relating to the optimal tiering and spatial design of government. Much of its development predated the influence of public choice theorists, a factor which probably explains the relatively optimistic view of government characteristic of this tradition. Clearly, those who start with a Leviathan model of government are likely to reach different conclusions from those making more benevolent assumptions. Moreover, the trade-offs between efficiency, equity and broader political considerations (such as sustaining territorial integrity) will crucially depend on context. In some cases, the units of a devolved or federal structure are themselves open to negotiation, in others they are historically and culturally determined. Similarly, traditions about the extent of fiscal equalization can be deeply embedded.

Thirdly, one possible line of constitutional development would see Wales and Northern Ireland converge on the Scotland model, at the same time as the Scottish Parliament sought to expand its fiscal power. By far the greatest uncertainties attach to developments in England, where the Labour Government's commitment in principle to regional government did not produce much action between 1997 and 2001. In its 2001 General Election Manifesto, Labour undertook that elected regional assemblies could be established in those cases where a double condition was satisfied: there is majority support in a referendum; and there is a predominance of single-tier local government (a condition satisfied in the North East, North West, Yorkshire and Humberside, and, marginally, the West Midlands). A White Paper has been promised, though that would have to be followed by primary legislation to authorize such referendums. This leisurely approach is indicative of contrasting views within the Government, in relation to, *inter alia*: the interface with local authorities; the electoral system; the possible effect on the Government's centralized approach to public service delivery (perhaps the most high profile priority of its second term); and the interface with the business-led Regional Development Agencies (the highest profile English regional measure of its first term). It remains unclear whether the response to devolution in the territories will be a new emphasis on England as a unit, or a focus on at least some regions.

Fourthly, there is an urgent need for the United Kingdom to be open to learning from other jurisdictions, though this would be contrary to inclination and history. There is clearly relevant experience in countries such as Canada and Australia (where there is a shared institutional heritage) and Germany and Spain (where EU membership provides common context). As the literature shows, policy transfer and lesson-drawing are not simple matters (Dogan and Pelassy, 1990, Rose, 1993). However, that difficulty does not justify insularity. When commenting on a draft of Heald's (1980) monograph, the late Russell Mathews, a prominent figure in Australian policy and practice on fiscal federalism, observed that the British were characteristically obsessed with re-inventing the wheel. Fortunately, such attitudes will be more difficult to sustain in a more integrated world and with devolved institutions in place.

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## APPENDIX: FIGURES

FIGURE 1

**Figure 1: Block Relatives**  
10:5:85 as exact population shares

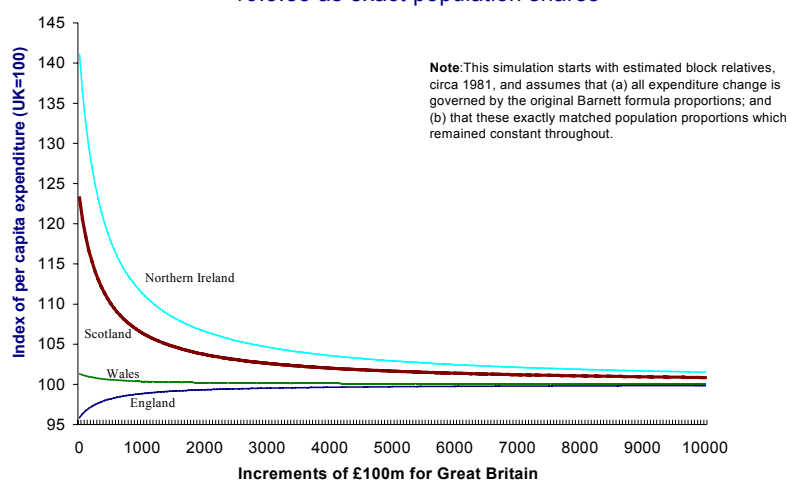


FIGURE 2

**Figure 2: Block Relatives**  
10:5:85 as rounded population shares

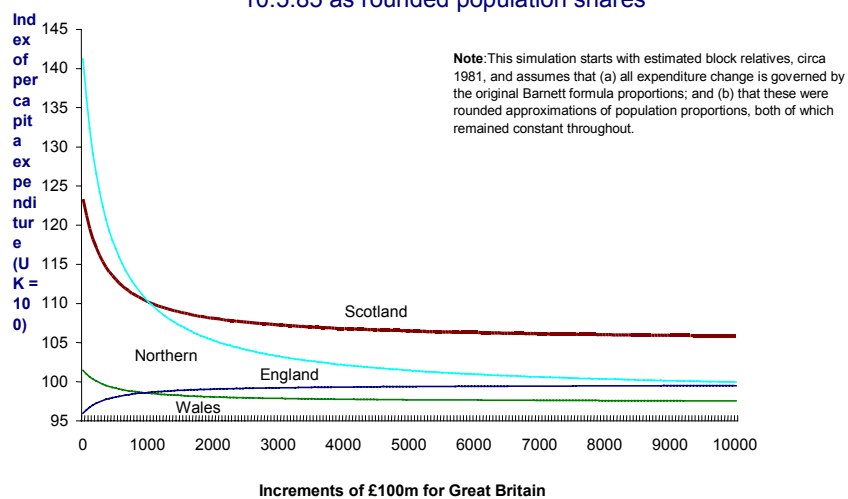


FIGURE 3

### Figure 3: Relative Block Growth Rates

10:5:85 as exact population shares



FIGURE 4

## THE CASE OF THE SCOTTISH PARLIAMENT

Public Expenditure Regime		
<b>1999-2000 onwards</b>		
<b>Assigned Budget</b>	<b>Non-assigned Budget</b>	
<b>Departmental Expenditure Limit (DEL):</b>		<b>Annually Managed Expenditure (AME):</b>
<b>Barnett Formula determined</b>	<b>Non-Barnett determined</b>	<b>Main programme spending:</b>
Secretary of State's/Advocate General's office		
Education and arts, Health and social work Industry, enterprise and training, Transport and roads, Housing, Scottish Homes external finance, Law and order, Crown Office Domestic agriculture Environmental services, Forestry CalMac and HIAL's External Finance Requirements Student Loans: implied subsidies and provision for bad debts Capital Receipts Initiative Trust Debt Remuneration Scottish Renewables Obligation Bus Fuel Duty Rebates	HLCAs	CAP
	Welfare to Work	Housing support grant
		NHS and teachers' pensions
		<b>Other AME:</b> Certain accrual items such as capital charges and depreciation charges
		Local Authority Self Financed Expenditure (LASFE)
		Scottish Non-Domestic Rates
		Scottish Variable Rate of Income Tax
Other expenditure outside DEL: Police Loans charges		

Source: Treasury (2000), p. 27.

Other abbreviations: CAP = Common Agricultural Policy; HIAL = Highlands & Islands Airports Limited, a public corporation which runs certain small airports; and HLCAs = Hill Livestock Compensation Allowances.

FIGURE 5

## THE CASE OF THE NATIONAL ASSEMBLY FOR WALES

Public Expenditure Regime		
1999-2000 onwards		
Assigned Budget	Non-assigned Budget	
Departmental Expenditure Limit (DEL):		Annually Managed Expenditure (AME):
Barnett Formula determined	Non-Barnett determined	Main programme spending:
Secretary of State's office		
Economic development, industry and training, education and arts, transport, planning and environment, local government, housing and social services and health Domestic agriculture Forestry (from 1 April 2000) Capital Receipts Initiative Trust Debt Remuneration Bus Fuel Duty Rebate	HLCAs	CAP
	Welfare to Work	Housing Revenue Account Subsidy
		<b>Other AME:</b> Certain accrual items such as capital charges and depreciation charges
		Local Authority Self Financed Expenditure (LASFE)

Source: Treasury (2000), p. 29.

Other abbreviations: CAP = Common Agricultural Policy; and HLCAs = Hill Livestock Compensation Allowances.



FIGURE 6

## THE CASE OF THE NORTHERN IRELAND ASSEMBLY

Public Expenditure Regime		
1999-2000 onwards		
Assigned Budget	Non-assigned Budget	
Departmental Expenditure Limit (DEL):		Annually Managed Expenditure (AME):
Barnett Formula determined	Non-Barnett determined	Main programme spending:
Agriculture, trade and industry, employment, energy, roads and transport, housing, environment and water, fire, education, health, social security administration, public corporations and other public services, Student Loans: implied subsidies and provision for bad debts Capital Receipts Initiative Trust Debt Remuneration Fossil Fuel Obligation Bus Fuel Duty Rebate	Housing Loan Charges	CAP
	EU Peace and Reconciliation Programme	Social security benefits
	ERDF gas link and electricity interconnector	NHS and teachers' pensions
	HLCAs	<b>Other AME:</b> Certain accrual items such as capital charges and depreciation charges
	Welfare to Work	District Councils' self-financed expenditure
		Regional Rates

Source: Treasury (2000), p. 31.

**Other abbreviations:** CAP = Common Agricultural Policy; ERDF = European Regional Development Fund; and HLCAs = Hill Livestock Compensation Allowances.

**Note:** Under direct rule, the Northern Ireland Office and the Northern Ireland Departments were effectively managed together, in the name of the Secretary of State for Northern Ireland, a member of the UK Cabinet. Since devolution which was restored on 2 December 1999, there is a complete separation between the Northern Ireland Assembly (to which the above scheme applies) and the Northern Ireland Office, still headed by the Secretary of State for Northern Ireland, though now treated as a Whitehall department which negotiates bilaterally with the Treasury. In consequence, the Social security programme is devolved (as it has been since 1921) but the Law, order and protective services programme is not (though this could be done if the security situation was fully normalised).

FIGURE 7

Figure 7: Modified Comparisons of Identifiable GGE Relatives (England=100)

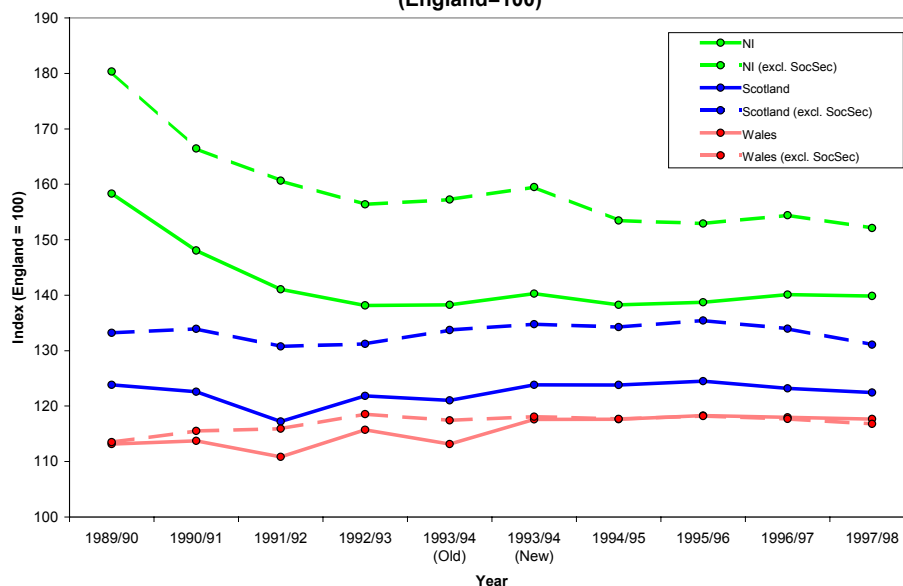


FIGURE 8

Figure 8: Identifiable General Government Expenditure Per Head, By Territory, Region and Function

1999-2000 data, expressed as £ per capita, relative to UK = 100

	UK weight	Scotland	Wales	Northern Ireland	England
Education	15.4%	126	100	136	96
Health and personal social services	24.1%	119	110	111	97
Roads and transport	3.1%	130	112	89	96
Housing	1.1%	176	145	325	82
Other environmental services	3.2%	131	168	106	93
Law, order and protective services	7.1%	96	96	236	97
Trade, industry, energy and employment	2.6%	149	113	255	90
Agriculture, fisheries, food and forestry	1.7%	267	155	283	73
Culture, media and sport	2.0%	99	157	60	99
Social security	38.7%	108	115	120	98
Miscellaneous expenditure	1.0%				
<b>Total</b>	<b>100.0%</b>	<b>118</b>	<b>113</b>	<b>133</b>	<b>96</b>
<b>Total excluding Social Security</b>		<b>125</b>	<b>112</b>	<b>142</b>	<b>95</b>

	North East	North West	Yorkshire & Humberside	East Midlands	West Midlands	South West	Eastern	London	South East
Education	100	101	96	93	101	92	96	108	82
Health and personal social services	102	100	98	88	92	91	92	121	85
Roads and transport	96	97	74	85	89	86	95	122	105
Housing	57	90	71	35	37	35	4	304	25
Other environmental services	117	106	45	90	92	79	76	126	94
Law, order and protective services	104	101	93	90	88	85	75	144	83
Trade, industry, energy and employment	103	94	91	96	90	87	86	94	76
Agriculture, fisheries, food and forestry	75	73	75	73	69	75	73	72	73
Culture, media and sport	143	88	87	81	82	83	75	176	76
Social security	119	112	101	94	99	97	89	97	84
Miscellaneous expenditure									
<b>Total</b>	<b>109</b>	<b>104</b>	<b>95</b>	<b>90</b>	<b>94</b>	<b>92</b>	<b>88</b>	<b>113</b>	<b>84</b>
<b>Total excluding Social Security</b>	<b>102</b>	<b>99</b>	<b>91</b>	<b>88</b>	<b>92</b>	<b>88</b>	<b>87</b>	<b>123</b>	<b>84</b>

Source: Treasury (2001a), Tables 8.6B and 8.12.

Note: An index of miscellaneous expenditure is not calculated since the administration costs of departments other than in the territories are not separated from functional expenditure. Such an index would be misleading.

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