Fiscal Federalism and Equitable Development

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Introduction

Governments are providers of public goods and services and engines for the promotion of economic growth. They are also primary instruments for the redistribution of resources. Inequality in the spatial allocation of basic public services and disparities in the endowment of infrastructure and in economic growth may spark conflicts in federations and other multi-tiered systems of government. This happens more so in developing countries, such as African ones, where excessive disparities can threaten national unity. In all federal and de-centralized systems the instruments for redistribution are shared between different levels of governments. This creates hard challenges for policy-makers: how to choose the appropriate criteria for orientating redistribution policies and how to select the proper instruments for their implementation.

Federations are characterized by extensive devolution of expenditure and revenue responsibilities. While devolution promotes efficiency and adaptation to local preferences, it can also endanger macroeconomic stability. Here, again, proper institutions have to be introduced to minimize risks. Managing equitable distribution and development is subject to additional challenges in countries with abundant natural resources, as rents from them are highly volatile and have, in most cases, a very unequal spatial distribution.

1. What factors can guide the assignment of responsibilities and revenue-raising powers towards promoting equitable development and reducing potential fiscal conflicts?

National governments are typically assigned monetary instruments for redistribution that are targeted directly to individuals, such as payments for pensions and social protection. This is particularly evident in the industrialized countries, where social protection outlays absorb a very large and growing share of public expenditures and effect a massive redistribution of income.

A pervasive feature of federations is the assignment to constituent units of policies that have a high potential for redistribution, such as health, education and welfare. Indeed, public intervention in these areas is strategic to poverty alleviation policies.

Financing these expenditures is a challenge. On the one hand, fiscal accountability requires the use of own revenue sources. On the other, if the financing were based entirely on own revenue, levels of local public service provision could be subject to considerable variations thorough the federation, in view of disparities in revenue raising capacity and needs. This is considered contrary to a crucial equity criterion that prevails in most societies, which says that residence should not impact negatively—exacerbating existing differences—on the distribution of income and well being.

To enable constituent units to provide comparable levels of public service, national governments allocate equalization and other kinds of transfers, which have reached considerable dimensions in most federations. The allocation of equalization transfers is made on the basis of formulas that include a large variety of criteria and mechanisms aimed at determining expenditure needs and fiscal capacity. Classical federations, such as Switzerland and Canada, have a long experience in the use of these transfers systems. There is also considerable experience in a number of African countries, such as Ethiopia. Promotion of local growth is also a main responsibility of all levels of government, particularly in developing countries. According to a recent stream of literature (Rodden, 2006), "federations are – if properly structured - growth inducing mechanisms, through the building of infrastructure and contribution to accumulation of human capital."

Again, federations and other multilayered systems of government need to find a balance between the implementation of national development priorities, on the one hand, and the preservation of their constituent units' autonomous decision-making power, on the other.

1.1. How much equalization to insert into the system

In general, persons, and thus countries, have different views about equity. The degree of decentralization, however, does not seem to influence these views. In fact, many federations – such as Australia – have introduced important systems of territorial equalization that allow each constituent unit to provide a level of service close to the national average, or, in some cases, close to that of the richest units. Disparity in unitary costs of productive factors may also impact local expenditure levels.

The principle of horizontal equity implies that national governments should compensate by transferring the higher costs of smaller or otherwise more expensive jurisdictions. In this case, the welfare maximization at national level may have to be sacrificed, because transfers would be paid not only to persons in greater need, but also to persons who might be less needy but happen to live in small and/or high cost localities.

1.2. How much weight has to be given to inter-individual equity versus inter-jurisdictional equity?

Federations could decide to intervene mainly at national level with transfers targeted to reduce disparities among individuals, instead of using intergovernmental transfers. This option will be resisted by the constituent units on the basis of their own preferences about redistribution and equity. Other arguments can be advanced in favor of transfers to constituent units and local governments. One of them, often put forward in literature, is that transfers can serve to absorb temporary and asymmetric shocks in sub-national governments' fiscal capacity, such as regional economic recessions, or natural disasters.

1.3. Reliance on local taxation

A basic tenet of the literature on fiscal federalism is that the promotion of efficiency and accountability requires local taxation; however, geographical disparities in the tax bases limit reliance on local taxes. This limit can be partly removed through the assignment to constituent units of tax bases that are less sensitive to disparities of economic conditions (for example, sales taxes versus income taxes), or by limiting the range within which local tax rates can be set. Other options can also be conceived.

1.4 How to cope with realization that constituent units may choose different expenditure and tax policies?

Choices among different policy priorities by distinct constituent units will result in equals being treated unequally. For example, poor, elderly persons are well taken care of in region A, but they are neglected in region B, where all effort is concentrated on assisting poor, young families. The national government can obviously correct these situations by allocating sector and conditional grants instead of general unconditional grants. It can also impose minimum standards for each sector of expenditure. These interventions would come at the expense of local autonomy, which is a cornerstone of decentralized government. Experience sharing on the appropriate balance of conditional and unconditional transfers, to ensure both autonomy and accountability, is desired. The experience of federations also shows that it is possible to develop allocation systems of equalization transfers that can cope with large disparities of cost and needs factors without negatively impacting the autonomous decision-making power of the constituent units.

1.5 Should transfers target levels of service provision disparities or target regional disparities in growth?

To some extent, this amounts to a choice between short-term and long-term objectives for inter-governmental transfers policies. The choice also implies the use of different transfer systems. Transfers for regional growth are targeted towards the elimination of impediments to growth and use for their allocation factors, such as differences in the stock of infrastructure and levels of gross national product that are quite different from those used for the allocation of pure equalization grants. Emphasis on transfers for only investment purposes can help fill cleavages in growth rates. European systems, such as Italy and Spain, provide interesting examples in this respect.

1.6 The trade-off between efficiency and equity in the context of poorer countries

The traditional fiscal federalism literature stresses the efficiency advantages of decentralization and assigns most redistribution tasks to the central level. In the developing world the balance between equity and efficiency is tilted towards the former goal. More equality, or enhanced poverty reduction thorough local action, may also generate more growth. It may improve political accountability as well, for poverty reduction should lead to increased literacy and thus greater likelihood of popular control (Bardhan and Mookherjee, 2005).

2. How can federations promote fiscal responsibility, accountability and transparency in the context of fiscal interdependence between government levels?

High reliance on transfers from the national government can imperil efficiency by reducing accountability. Furthermore, recent literature on fiscal federalism points out that federal and decentralized systems of government can exacerbate problems *vis à vis* macroeconomic policy, because without proper institutions regional politicians have little political responsibility for macroeconomic performance. Overspending and excessive reliance on borrowing can affect the national economy. This raises the question of how to engage constituent units in the preservation of the financial equilibrium of the whole public sector.

Federations may have a harder task than unitary governments, but they have developed various instruments, both informal and formal, to address these issues. These instruments can also be operated in combination.

2.1. Constraints on decision-making versus general rules promoting transparency and accountability

An example of traditional instruments for implementing national priorities and for promoting accountability are conditions imposed on transfers and/or shared taxes (as in the case of Latin American countries), such as, alternatively, ceilings and floors on spending for the various sectors. Minimum standards are designed to reach the same objectives. The main example of general rules is the extension to constituent units of a federation of the fiscal responsibility law. This is an instrument aimed at promoting fiscal discipline by establishing fiscal rules and by reforming overall budget planning and practice. It has been introduced in a number of federations (Argentina, Brazil, and India among others).

2.2. Crucial role of monitoring and reporting systems

Even advanced legal institutions, such as the fiscal responsibility law operating at national and at constituent unit levels, may not increase accountability if federations do not develop the ability to effectively monitor the budget process and its outcomes. In general, constraints on policy-making and policy-makers are not likely to be binding in the absence of relevant and timely information. This requires the introduction of proper institutions and mechanisms, such as government information systems. Here, too, there is a need to share good practices.

2.3. Market discipline versus national regulation for controlling borrowing

Constituent units of federations and local governments around the world are increasingly incurring debt, raising the risk of insolvency, particularly in developing countries. Hence, there is a need to appropriately design and regulate sub-national access to credit. Sole reliance on market discipline in governing local borrowing is not enough, as it requires a number of pre-conditions, which are seldom met in practice, and has to be supplemented with regulation.

2.4. Balance between ex ante and ex post mechanisms for controlling debt

Ex-ante sub-national borrowing regulations — such as balanced budget rules, limits on the ratio of debt to gross domestic product — need to be complemented by ex-post mechanisms. Experience and literature show that the effectiveness of ex-ante regulation is limited without an ex-post mechanism for sub-national insolvency to deter irresponsible borrowers and imprudent lenders. There are several arguments in favor of ex-post, sub-national insolvency mechanisms, such as:

a) Putting insolvent local governments back on a sustainable fiscal path to guarantee public service delivery;

b) Protecting creditor rights to nurture embryonic capital markets; and

c) Improving the creditworthiness of constituent entities by introducing clarity in default.

2.5. Command or cooperation?

Command systems for controlling local borrowing are rarely found in federations. Most federal constitutions recognize that constituent units are entitled to borrow. This applies particularly to borrowing for capital purposes. Mechanisms for intergovernmental cooperation could have higher chances of effectiveness, as shown by a number of EU member countries involved in the Stability Pact. Additional evidence is badly needed about this choice, particularly for potential federations.

3. How can federations or potential federations work to reconcile regional and national interests, both economic and environmental, in natural resources such as oil, gas, minerals, water and forests?

Natural resources are important in many established federations and in countries debating federal arrangements. Such resources are usually regionally concentrated. There are cases where per capita rents from natural resources reach astronomically high levels due to the very low population density of producing areas. Producing regions, local communities and pastoralists may make claims regarding the control and access to these resources, the protection of the local environment, and benefits from associated revenues. However, the national interest may include equitable development across the country and between generations, as well as sound fiscal management (including using stabilization funds). While not usually a major revenue source, water can be the object of conflicts between constituent units over its use, especially for agriculture in arid regions.

Geological or geographical differences should not determine the distribution of revenue from national resources, but the claims by constituent units of a federation or by local governments to have access to a "fair" share of these revenues cannot be easily dismissed. If the sharing of natural resource rents is not properly addressed, disparities in access to them will feed rivalries between the constituent units of the same nation and put a great strain on national unity.

3.1. Arguments for keeping revenues from natural resources with the national government

Attribution of volatile resource revenues to sub-national governments can complicate fiscal management and macroeconomic policy at central level. Fluctuations in international prices may place excessive strains on the basic spending of constituent units during price downturns, and may lead to waste and unsustainable spending during periods of rising prices.

Resource revenues bring with them little accountability; this problem exists at national level, but according to part of the literature, it is probably exacerbated in local government.

The size of resource revenues, relative to the size of the jurisdiction, may bring risks not only of absorptive capacity, but also of corruption.

The central government is often in a better position to smooth fluctuations in natural resource revenues, provided that these resources are transparently managed.

3.2. Arguments for sharing revenues with constituent units and local governments

Political economy and legal (when the issue is addressed in the constitution) considerations suggest some sharing of natural resource revenues. Reaching an agreement on the proper shares of the national government and the constituent units is very hard. There are, however, some considerations that can facilitate the agreement. To start with, exploitation of natural resources requires a large local investment in infrastructure, such as transport and communications, and the provision of public services to the new population attracted to the producing areas.

Secondly the exploitation of, natural resources, particularly oil and natural gas, may cause substantial environmental damage, particularly when the responsibility for environmental policy is not devolved to (or implemented by) the constituent units and local governments (as in the case of the Delta area in Nigeria). Sharing of the revenue can thus act as compensation for environmental damages.

As the literature shows, corruption and misspending are context-specific. In other words, no case can be made a priori on this basis for assigning resource rents to the national government.

Some of the problems derived from the assignment of natural resource rents to sub-national levels of governments, such as insufficient absorption capacity, can be alleviated by increasing the number of layers of government that benefit from the allocation — more specifically, by adding municipalities and districts to federated states and provinces. This is done in a number of countries for political economy reasons, but it has also an economic rationale.

3.3. Instruments for sharing of the rents

Governments have to devise proper instruments for the extraction and the sharing of the rent among different layers of government. These can be various taxes, as well as non-tax instruments, such as auctioning exploration and exploitation rights, production-sharing agreements, and the acquisition of equity in natural resource extracting enterprises. Issues of administration suggest that more complex instruments should be assigned to the national government. Furthermore, fluctuations in revenue could be avoided by assigning tax bases that might be invariant to prices (e.g., taxes related to the volume of production); this would also be more closely related to environmental damage.

Finally, horizontal imbalances engendered by the assignment of natural resources to sub-national jurisdictions could be addressed through equalization transfers to non-producing areas.

Essential references

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