PART ONE

DESIGNING FISCAL CONSTITUTIONS

Part I is concerned with division of fiscal powers in federal systems. Seven chapters are devoted to various aspects of assignment of spending, taxing, and regulatory powers among various orders of government.

Chapter 1 introduces basic concepts of federalism. It distinguishes between unitary and federal forms of constitutions and presents a stylized view of alternate models of federalism in theory and practice. It identifies the sources of inefficiency and inequity in a market economy and outlines the rational for public intervention. It argues that ultimately the assignment of powers in a federation and the optimal policies undertaken by each level of government depend on the same efficiency and equity considerations that determine the rationale for government intervention in the first place. Because federal economies consist of various autonomous jurisdictions, however, there are additional efficiency and equity considerations, some of which arise because decentralization has different effects on the fiscal capacities of different subnational jurisdictions, giving rise to fiscal inefficiencies and fiscal inequities. Others arise because of horizontal fiscal externalities, as the independent policies of governments at a given level have effects on residents or governments of neighboring jurisdictions. Still others arise when policies undertaken at a given level of government affect governments at another level, creating what are known as vertical fiscal externalities. The existence of these various effects will influence the case for decentralization, as they represent costs of decentralization that must be set against the many benefits. They will also determine the structure of fiscal arrangements that should exist between the various levels of government.

Chapter 2 is concerned with an examination of costs and benefits of decentralized governance. It evaluates the pros and cons of decentralization of spending, taxing, and regulatory responsibilities and highlights the theoretical and practical considerations and trade-offs policy makers must confront in making appropriate choices in centralization or decentralization of various service delivery responsibilities. An annex to this chapter provides a synthesis of empirical evidence on the impact of decentralization on service delivery performance and economic growth.

Chapter 3 highlights the assignment principles to guide the division of spending powers for specific services among various orders of government. It further reflects on additional problems that arise in coordinating decentralized provision of expenditure programs with national objectives. The chapter concludes by stressing that assignment of a service to a specific order of government does not necessarily imply public provision as the government could purchase such services from beyond government providers.

A common dictum to strengthen accountable, decentralized governance is to ensure that finance follows function. Chapter 4 highlights not only the principles and practices in assigning taxing powers to various jurisdictions but also the conceptual and practical difficulties in decentralizing taxing powers, especially those relating to mobile bases. It emphasizes the importance of a coordinated and harmonized tax system to ensure an internal common market and secure an economic union. It further provides guidance in achieving a harmonized tax system under decentralized governance.

Chapter 5 deals with the special issues that arise when natural resource endowments are allocated unevenly across a federation, which can cause both inefficiencies and inequities. In some federations, the problem is particularly pronounced because resource ownership resides with the subnational government. This decentralized ownership implies that resource revenues accrue directly to the subnational government, leading to potentially large net fiscal benefit differences across jurisdictions. In other countries where the federal government collects the revenues, resource-rich jurisdictions may feel that they are not getting their fair share of benefits. Of course, these tensions will be exacerbated if the federal government is perceived as using the resources unwisely or engaging in corruption. This chapter discusses public policy responses to mitigate these concerns in both unitary and federal nations, paying special attention to vertical and horizontal fiscal gaps in federal nations.

Chapter 6 is concerned with the role of local government in local governance. *Local government* refers to specific institutions or entities created to deliver a range of specified services to a relatively small geographically delineated area. *Local governance* is a broader concept and is defined as the formulation and execution of collective action at the local level. Local governance includes the diverse objectives of vibrant, living, working, and environmentally preserved self-governing communities. Good local governance is not just about providing a range of local services but also about preserving the life and liberty of residents, creating space for democratic participation and civic dialogue, supporting market-led and environmentally sustainable local development, and facilitating outcomes that enrich the quality of life of residents. The chapter is concerned with the conceptual underpinnings of the catalyst role in local governance that a local government could potentially play. It traces the evolution and analytical underpinnings of local governance as background to a better understanding of the comparative practices discussed in Chapter 7 and develops a model of local governance that integrates various strands of this literature.

Chapter 7 presents stylized models and institutions of local governance as practiced in different parts of the world during past centuries. It compares and contrasts the ancient Indian and Chinese systems of local governance with Nordic, Southern European, North American, and Australian models. The concluding section of this chapter provides a comparative overview of local government organization and finance in selected industrial and developing countries with a view to drawing lessons for future reform in developing countries.

ONE

Introduction to Federalism and the Role of Governments in Federal Economies

This monograph is a study of economic decision making by governments in a federation. A federation is simply a multilevel system of government in which different levels of government exist, each of which has some independent authority to make economic decisions within its jurisdiction. By economic decisions, we include a variety of things. Governments can acquire resources to provide public goods and services. Expenditures for these purposes can be of a current nature (e.g., hiring employees, purchasing materials) and a capital nature (e.g., buildings, infrastructure). Governments can raise revenues in order to finance services provided by the private or nonprofit sectors, such as hospitals, universities, or insurance. They can arrange to have resources redistributed among households in the economy. They can introduce regulations in the markets of the private sector so as to influence resource allocation there; or they can interfere with the pricing mechanism as an alternative way of achieving resource allocation or redistributive effects, such as through subsidizing or taxing certain activities. They can also attempt to influence the aggregate amount of activity that occurs in the economy both through budgetary actions and through changes in the amount of money and credit circulating in the economy.

BASIC CONCEPTS OF FEDERALISM

Constitutional divisions of powers among various orders of government fall into three categories: unitary, federal, and confederal.

Unitary Government

A unitary country has a single or multitiered government in which effective control of all government functions rests with the central government.

A unitary form of government facilitates centralized decision making to further national unity. It places a greater premium on uniformity and equal access to public services than it does on diversity. An overwhelming majority of countries have a unitary form of government. The city-states of Singapore and Monaco are single-tiered unitary governments. China, Egypt, France, Indonesia, Italy, Japan, Korea, New Zealand, Norway, the Philippines, Portugal, Sweden, Turkey, and the United Kingdom have multitiered governments based on unitary constitutions. Some unitary countries have decentralized responsibilities to lower orders of government (recent examples include Bolivia, Colombia, Indonesia, Italy, Korea, Japan, Peru, United Kingdom), and as a result some unitary countries (e.g., China, Denmark, Poland, Norway, and Sweden) are more fiscally decentralized than are some federal countries, such as Australia, India, and Malaysia.

Federal Government

A federal form of government has a multiorder structure, with all orders of government having some independent as well as shared decision-making responsibilities.[1] Federalism represents either a "coming together" or a "holding together" of constituent geographic units to take advantage of the greatness and smallness of nations. In a flat (globalized) world, it is increasingly apparent that "nation states are too small to tackle large things in life and too large to address small things" (Bell, 1987: 13–14). Subscribing to the "coming together" view of federalism, Daniel J. Elazar (1980) pointed out and elaborated that the word "federalism" has its roots in the Latin *foedus*, meaning "league," "treaty," or "compact." More recently, Robert Inman (2007: 530) noted that "the word 'federal' has come to represent any form of government that brings together, in an alliance, constituent governments each of which recognizes the legitimacy of an overarching central government to make decisions on some matters once exclusively the responsibility of individual member states." "Coming together" has been the guiding framework for mature federations such as the United States, Canada, and, more recently, the European Union.

[1] Federal countries (twenty-three in 2008) include Argentina, Australia, Austria, Belgium, Bosnia-Herzegovina, Brazil, Canada, Comoros, Ethiopia, Germany, India, Malaysia, Mexico, Micronesia, Nepal, Nigeria, Pakistan, Russia, St. Kitts and Nevis, Switzerland, United Arab Emirates, United States of America, and Venezuela. Nepal became a federal republic on May 29, 2008. In addition five more countries – Democratic Republic of Congo, Iraq, South Africa, Spain, and Sudan – have recently adopted constitutional provisions with federal features.

The alternative "holding together" view of federalism, also called "new federalism," represents an attempt to decentralize responsibilities to state-local orders of government with a view to overcoming regional and local discontent with central policies. This view is the driving force behind the current interest in principles of federalism in unitary countries and in relatively newer federations such as Brazil and India and emerging federations such as Iraq, Spain, and South Africa.

A federal form of government promotes decentralized decision making and, therefore, is conducive to greater freedom of choice, diversity of preferences in public services, political participation, innovation, and accountability.[2] It is also better adapted to handle regional conflicts. Such a system, however, is open to a great deal of duplication and confusion in areas of shared rule and requires special institutional arrangements to secure national unity, ensure regional equity, and preserve an internal common market.

Federal countries broadly conform to one of two models: *dual federalism* or *cooperative federalism*. Under dual federalism, the responsibilities of the federal and state governments are separate and distinct. According to William H. Riker (1964: 11), under such a system, (1) "two levels of government rule the same land and the people, (2) each level has at least one area of action in which it is autonomous, and (3) there is some guarantee . . . of the autonomy of each government in its own sphere." Under cooperative federalism, the responsibilities of various orders are mostly interlinked. Under both models, fiscal tiers are organized so that the national and state governments have independent authority in their areas of responsibility and act as equal partners. National and state governments often assume competitive, noncooperative roles under such an arrangement. Dual federalism takes either the *layer cake* or *coordinate-authority* approach. Under the layer cake model practiced in Mexico, Malaysia, and Russia, there is a hierarchical (unitary) type of relationship among the various orders of government. The national government is at the apex, and it has the option to deal with local governments either through state governments or more directly. Local governments do not have any constitutional status: they are simply extensions of state governments and derive their authority from state governments. In the

2 Not all federal countries are decentralized and not all unitary countries are centralized. For example, Canada is highly decentralized, but Australia and Germany are centralized federations, as is indicated by the share of subnational expenditures in consolidated public expenditures. Nordic unitary countries are more decentralized than are Australia and Germany.

coordinate-authority model of dual federalism, states enjoy significant autonomy from the federal government, and local governments are simply handmaidens of the states and have little or no direct relationship with the federal government. The working of the federations of Australia, Canada, India, Pakistan, and the United States resembles the coordinate-authority model of dual federalism.

The *cooperative federalism* model has, in practice, taken three forms: interdependent spheres, marble cake, and independent spheres. In the interdependent spheres variety as practiced in Germany and South Africa (a unitary country with federal features), the federal government determines policy, and the state and local governments act as implementation agents for federally determined policies. In view of federal domination of policy making, state or provincial governments in this model have a voice in federal policy making through a second chamber (the upper house of the parliament). In Germany and South Africa, the second-order (state) governments are represented in the upper house of the national parliament (the Bundesrat and the Council of the Provinces, respectively). In the marble cake model of cooperative federalism, various orders of government have overlapping and shared responsibilities, and all constituent governments are treated as equal partners in the federation. Belgium, with its three territorial and four linguistic jurisdictions, has a strong affinity with this approach. Finally, in a model of cooperative federalism with independent spheres of government, all orders of government enjoy autonomous and equal status and coordinate their policies horizontally and vertically. Brazil is the only federation practicing this form of federalism.

The *competitive federalism* model is a theoretical construct advanced by the fiscal federalism literature (Salmon, 2006; Breton, 2006; Kenyon and Kincaid, 1991) and not yet practiced anywhere in its pure form. According to this construct, all orders of government should have overlapping responsibilities, and they should compete both vertically and horizontally to establish their clientele of services. Some analysts argue that such a competitive framework would create leaner and more efficient governments that would be more responsive and accountable to people.

Countries with a federal form of government vary considerably in terms of federal influence on subnational governments. Such influence is very strong in Australia, Germany, India, Malaysia, Mexico, and Pakistan; moderately strong in Nigeria and the United States; and weak in Brazil, Canada, and Switzerland. In the last group of countries, national control over subnational expenditures is quite limited, and subnational governments have considerable authority to determine their own tax bases and tax rates.

In centralized federations, conditional grants by the federal government play a large role in influencing the priorities of the state and local governments. In Australia, a centralized federation, the federal government is constitutionally required to follow regionally differentiated policies.

Federal countries also vary according to subnational influence on national policies. In some countries, there is a clear separation of national and subnational institutions ("executive" or "interstate" federalism), and the two orders interact through meetings of officials and ministers, as in Australia and Canada. In Germany and South Africa, state or provincial governments have a direct voice in national institutions ("intrastate" federalism). In the United States, regional and local coalitions play an important role in the Congress. In some federal countries, constitutional provisions require all legislation to recognize that ultimate power rests with the people. For example, all legislation in Canada must conform to the Canadian Charter of Rights and Freedoms. In Switzerland, a confederation by law but a federal country in practice, major legislative changes require approval by referendum. Such direct-democracy provisions indirectly reinforce the decentralized provisions of public services. In all federal countries, local government influences on the federal and state governments remain uninstitutionalized and weak.

Asymmetric Federalism

Countries with a federal form of governance do not necessarily treat second orders of government in a uniform manner. They often offer flexibility in accommodating the special needs or demands of constituent units or impose a federal will in certain jurisdictions. This adaptability may take the form of treating some members as less equal than others. For example, Chechnya in Russia and Kashmir in India enjoy lesser autonomy than do other *oblasts* and states; or the federation may treat some members as more equal than others by giving them wider powers, as is the case with Sabah and Sarawak in Malaysia and Quebec in Canada. Some federations offer constituent units freedom of choice to be unequal or more equal than others through opting in or out of federal arrangements. Such options are part of the arrangements offered by Canada, Spanish agreements, and the European Union's treaty exceptions for the United Kingdom and Denmark (see Watts, 1999).

Market Preserving Federalism

Barry Weingast (2006) has advanced a theoretical concept for comparative analyses of federal systems. Market-preserving federalism is put forth as an ideal form of federal system in which (1) multiple governments have clearly delineated responsibilities; (2) subnational governments have primary authority over public goods and services for local autonomy; (3) the federal government preserves the internal common market; (4) all governments face the financial consequences of their decisions (hard budget constraints); and (5) political authority is institutionalized.

Confederal Government

In a confederal system, the general government serves as the agent of the member units, usually without independent taxing and spending powers. The United States had a confederal system from 1781 to 1787. The United Nations, the European Union, and the Commonwealth of Independent States (CIS), which now consists of eleven of the former republics of the Union of Soviet Socialist Republics (USSR), approximate the confederal form of government. A confederal system suits communities that are internally homogeneous but, as a group, completely heterogeneous. The European Union, however, over time has consistently moved to assume a federal role.

Role of Government in Federal Economies

The instruments that governments use to undertake their economic activities include, broadly speaking, the following:

- *Expenditures on goods and services.* Governments may purchase labor, capital, goods, and services from the private sector in order to provide goods and services to their constituents. Such major expenditure categories as defense spending, transportation, schools, and hospitals are included in their menu of goods and services expenditures. In some cases, the public sector actually produces the goods or services. In others, it merely finances their provision by private producers or the nonprofit sector.
- *Transfers to individuals or households.* Government spending also includes transfer payments. These can be provided to households in the economy, for example, in the form of welfare payments, payments for disability, and payments to the elderly. These transfers might be administered through the tax system or through an agency responsible for delivering them to their intended recipients.
- *Subsidies to firms.* A particular form of transfer is a subsidy to firms in the private sector, whose purpose is typically to assist the firm's participation in the private sector in ways that facilitate government objectives.

- *Transfers to other levels of government.* In a federation, transfers can also be from one level of government to another. Most commonly, intergovernmental transfers go from higher-level to lower-level governments, but in some cases they go the other way.
- *Taxation.* Governments can, and do, use a wide assortment of taxes to raise revenues, such as individual and corporate income taxes, general sales taxes, payroll taxes, excise taxes, import and export duties, and property and wealth taxes, to name the main ones. Different levels of government may have access to different taxes and may share some tax bases.
- *User fees.* Revenues may be raised from charges that are related to services provided. Examples include water, garbage, and sewage charges; road tolls; licenses of various sorts imposed on individuals and businesses; user fees for parks and recreational facilities; fines; and charges for health and education services.
- *Borrowing.* In addition to raising revenues from taxation and charges, governments typically borrow money, especially but not exclusively for capital projects. Because the borrowed funds must be paid back in the future, they can also be viewed as postponed taxes. Lower levels of government may be restricted in what they are able to borrow.
- *Money creation.* Governments, through their central banks, may also be able to obtain some revenues through the creation of money. To the extent that the creation of money induces inflation (i.e., the money supply grows more rapidly than that needed to meet the growth in the volume of transactions in the economy), it is viewed by economists as being analogous to a tax, in this case a tax on holding money. Control of the money supply, however, is typically not seen primarily as a source of revenues but as a means of controlling the movement of aggregate economic activity by affecting interest and exchange rates.
- *Regulation.* Regulation is a nonbudgetary way of influencing the allocation of resources. It can take many different forms, including labor market regulation (hours of work, union formation, discrimination laws, occupational licensing, rules for layoffs, worker safety, etc.), capital market regulation (asset or liability rules for institutions, bankruptcy laws, insider trading rules, accounting requirements, etc.), and the regulation of goods and services markets (product liability, advertising rules, price and profit regulation for large firms, competition laws, communications regulations, environmental laws, regulation of natural resources such as fishing and forestry, etc.). In a federation, one level of government may have some regulatory control over another. An upper-level government may be able to override or disallow the