Económica, La Plata, Vol. XLIV, N° 3, Año 1998

TOWARDS DECENTRALIZED FISCAL CONSTITUTIONS

PAUL BERND SPAHN*

1. Introduction

The theory of fiscal federalism makes a strong case for decentralizing government functions in order to enhance efficiency in allocating public goods where preferences differ among regions. Under political considerations, decentralized collective decision making fosters social and political cohesion at the level of the nation states by protecting minorities, by strengthening the accountability of politicians, and by mobilizing citizens through greater participation at the local level. Federalism respects different cultural and individual traditions among regions, and it emphasizes local diversity. Federalism thus reflects the regional dimension of democracy.

Many emerging countries have adapted federal constitutions (Argentina, Brazil, Mexico), some are on their way (Colombia, Venezuela), and even unitary states have typically devolved certain government function (education, health, local services) to regional bodies and municipalities (Chile). Recently, the option of engaging resources through the devolution of state powers and greater use of local tax potentials has found increasing attention. This is partly explained by successful development strategies based on regional rather than national initiatives (China). It is also nurtured by supranational institutions like the European Union and the forming of regional economic groupings (Mercosur, APEC) whereby the relationship between sovereign nation-states and supranational competencies can be expected to play a crucial role for political, economic and social developments.

While the benefits of decentralized government are usually unquestioned

* University of La Plata, Argentina.
University of Frankfurt am Main.
Fachbereich Wirtschaftswissenschaften.
E-mail: pspahn@wiwi.uni-frankfurt.de Web: http://www.wiwi.uni-frankfurt.de/professoren/spahn/
University of Frankfurt am Main.

objectives which are implemented through agents—local authorities. While the gains of lower tiers of government are immediate, the central government may reap informational advantages through its agents that are closer to local demands for public services and pending political problems. In this framework, local agents are accountable to the central government, *not* to their constituencies. While such models are useful to analyze intergovernmental relations—especially in the horizontal model of federalism—, there are clear limitations where national and local goals are in conflict *and* local authorities are accountable to their taxpayer-voters at the same time. In this case, coordination must respect the autonomy of lower tiers of government, and eventually be restricted to information exchange among governments where the aim is to reach consensus and compromise.

Where authorities freely establish coordination mechanisms the outcome of which they consider binding for their actions, we shall speak of cooperation. Cooperation is often found at the horizontal level among lower-level governments where there are regional spillover of policy actions. For instance, two or more municipalities may pool their resources in order to build local infrastructure that is jointly used. Cooperation is, however, also found among jurisdictions at different layers of government as long as participants feel the need to coordinate their actions for the sake of a longer-term maximization of welfare. Such cooperation—because more permanent—usually takes the form of joint-decision making and cost sharing within coordinating bodies or institutions. The German 'joint-tasks' (e.g. for the construction of universities) may serve as an example of such cooperation among states. Where institutional cooperation in decentralized government plays a prominent role (Switzerland, Germany), one also speaks of 'cooperative federalism'.

The term 'control' is rather ambiguous and may signify either formal surveillance of government agencies through a central authority or special institutions (like in the case of auditing budgets), or the rigorous pursuit of a principal's policy goals with the aid of fully accountable agents. The rigorous version applies, for instance, to macroeconomic control at the national level. Macroeconomic control is a prerequisite for stable and sustainable economic development throughout the nation, and this function is typically attributed to the central government. But this function may be undermined in decentralized government by the very fact that local accountability calls not only for self-rule; but also involves independent financial competencies of lower tiers of government—including the right to borrow. Uncontrolled access to capital markets and possible mismanagement of budgets by local government may thus jeopardize efforts to stabilize the economy at the national level. However, it is far from clear that a central government would control fiscal policy more effectively than lower-level authorities. Some authors have attributed macroeconomic policy failures to decentralization (Prud'homme 1995), especially in Latin America, while others have considered decentralization even as an device to reduce total government deficits (Fuhr/Campbell/Eid 1995, p. 2). Recent research indicates that the case for a centralization of the stabilization function has been overstated and that decentralization of public functions is not necessarily at variance with macroeconomic stability (Spahn 1997c).

Often, national control is also requested for the distribution function of government, because the decentralization of social policies would reinforce existing inequities among regions and cause policy-induced migration within a nation. This could be prevented by nationally uniform standards for social services. Furthermore, the implementation of such policies at lower levels of government would require strong regional or local administrations in order to enhance the effectiveness of providing social services—which may be costly in terms of coordination and cooperation. Central provision of social services would thus entail economies of scale in administering such policies. However, controling distribution policies at the central level runs counter the factual experience that there is sufficient scope for interpersonal redistribution at regional and municipal levels.

The allocation of public resources is typically attributed to the lower tiers of government, but even this requires vertical and horizontal balance between expenditure needs and fiscal capacity (including grants) in order to achieve some degree of economic and social cohesion within a nation. Again, this would call for intergovernmental cooperation and control whenever the national government wants to interfere in order to mitigate horizontal fiscal imbalances among regions or to realize national goals in a federal context. Uncontrolled decentralization of government is thus not without risk for the stability of the economy, for the effectiveness and fairness of social protection, and for the efficient allocation of public resources.

The example of more mature federations in the industrialized world demonstrates, however, that there is scope for decentralization without excessive risks for public decision making or the loss of macroeconomic control. There are various forms of informal, institutional and procedural coordination mechanisms designed to monitor and control public budgets, and there are implicit or explicit constraints to public borrowing and debt at subnational levels. Furthermore, there are attempts to cooperate among governments through framework legislation of the central government, through semi-autonomous institutions, and through economic incentives (for instance through the grants system).

2. Basic philosophies of coordination and cooperation in multilayer government

2.1 General remarks

It is important to understand that there are different philosophies that guide decentralized policy making and intergovernmental fiscal relations. The traditional theory of federalism seeks to minimize policy conflicts through constitutional arrangements which assign exclusive competencies to the various levels of governments (vertical division of functions or 'layer-cake' federalism). Where there is remaining need for vertical coordination and cooperation, this is preferably effected through economic incentives, for instance through the grants system. As to the horizontal coordination of public decisions among lower-level governments, the layer-cake model favors intergovernmental cooperation on a voluntary basis and in response to spillover effects that warrant collaboration on specific policy questions. General policy issues are typically dealt with according to the principle of reciprocity. Central government interference is seldom needed under this view. This model of 'vertical federalism' is typical for the Anglo-Saxon world.

Although inspired by the former model, the German approach to federalism interlaces government functions and emphasizes explicit cooperation among different layers of government (Spahn 1978, Spahn/Föttinger/Steinmetz 1996, Spahn 1997b). The guiding principles for harmonized—if not uniform—policies are defined at the national level and cast into 'framework legislation'. This secures social and political cohesion and the realization of the 'uniformity of living conditions' within the nation. However, specific legislation as well as the implementation and administration of programs are attributed to subnational governments which are closer to demands and needs, options and costs (horizontal division of functions). As in the case of vertical federalism, public budgets of all layers of government are independent and autonomous. However, tax rules are harmonized across the nation leaving little discretion for lower-level government on the revenue side. Self-rule finds its expression in the outlay functions of local budgets, and financing is secured mainly through tax sharing and the provision of unconditional grants. This interdependence of policy formulation, implementation and administration across levels of government renders more formal and institutionalized coordination and cooperation important, both at the vertical and the horizontal level and is typical for 'cooperative federalism'.

Many developing countries with a unitary form of government would consider decentralization of government more in terms of deconcentrating public functions rather than full independence for regional authorities. This is for political, economic and administrative reasons. Under the decentralization approach, regions are feared to become too powerful and even prone to secession, and strong regional economies may be apprehended a threat to central political leadership and a denial of social and economic cohesion among the various regions of a nation. Finally, not all local government may possess the administrative capacity to handle the competencies attributed to the lower tiers which stresses the need for central government surveillance and ongoing responsibility. This calls for a cautious deconcentration process whereby local potentials are exploited which mobilize public resources and reap efficiency gains through better use of resources—without loss of central government control. This renders the principal-agent model particularly relevant for this type of approach to decentralization. Government functions are then delegated for autonomous implementation within a given policy framework. This is closer to the German model of horizontal federalism although it may lack the robust administrative capacity of lower-level authorities.

Devolution of competencies to local authorities may be successful in nurturing administrative capacity if accompanied by conforming training and information policies. This often renders decentralization in developing countries a long-term process rather than a simple reform exercise. Local administrations have to 'learn' their new functions through training and practicing at a smaller scale before embarking on more ambitious projects. Any policy rush bears the risk of failures and would constitute a setback for effective decentralization.

2.2. Central versus decentralized government

Both models of federalism, vertical or horizontal, exhibit a number of variants. A fundamental question is whether the emphasis is placed on national standards, homogeneity and even uniformity; or whether the emphasis is on regional autonomy, diversity and variance. While the German constitution highlights the 'uniformity of living conditions' in the nation2, the European Union—which in many ways follows the German approach to federalism—underscores the 'subsidiarity principle' and hence the supremacy of regional over supranational policy objectives.

The traditional theory of 'vertical federalism' with its independent division of functions is rather centralist and often ignores problems of coordination and cooperation among governments. In fact coordination and cooperation are alien to a philosophy which purports to avoid policy conflicts by its constitution. Stabilization and distribution functions are exclusively in the hands of the central government, and only the allocation of resources is attributed to lower level authorities. This view has nursed centripetal trends as illustrated by the examples of the United States or Australia. In the latter case,

[2] The constitutional mandate to secure the uniformity of living conditions is very strong in Germany, and no other federation has gone so far in equalizing public resources across regions. The term 'cohesion' used in the European Union is much weaker indeed.

concentration of revenues in the hands of the Commonwealth has even created severe vertical fiscal imbalances and eroded state autonomy to a certain degree (Bird 1986 or Spahn/Shah 1995).

The centralist 'layer-cake' model is a convenient framework for a *top-down* approach to federalism. Starting from a homogeneous national policy framework, public functions can be devolved to regional and local governments in accordance with the 'decentralization theorem' (Oates 1972) which obeys to certain political and economic criteria. Judicious decentralization of functions, mainly in the area of allocation policy, may thus preserve many of the features of a national policy like the uniformity of tax laws, national standards for the provision of public services, and a common framework for administration. Fiscal decentralization follows the devolution of outlay functions either through the assignment of own revenue, or through grants3. At least initially, these grants can be conditioned in order to create incentives and/or to protect national policy objectives. The constitution may restrict lower-level government responsibilities or impose financial constraints, like a balanced-budget requirement. It is hard to see, however, how accountability and the efficient allocation of resources could be realized within such a system unless regional governments control own resources that are sufficiently large and allow some policy discretion (like in the United States), and are in a position to compete among themselves at more or less equal footing (Eichengreen/von Hagen 1995). Both requirements are typically neglected in developing countries where local tax bases are limited and taxable capacity exhibits large regional inequities.

Germany's approach can be characterized as a *bottom up* approach to federalism. The federation rests on the autonomy of lower tiers of government which limit its competencies and financial resources. And the central government can rely on the states' capabilities of implementing and administering their own and central policies. This renders the model attractive for the European Union, but it may have its limitations when applied to

[3] Some authors emphasize the need to maintain a proper sequence in the process of decentralization where revenue transfers should not outpace the transfer of outlay functions (Wiesner 1994, p. 192), and it is criticized that this sequencing has often been despised in Latin America (Fuhr/Campbell/Eid 1995, p. 2).

developing countries where administrative potentials at lower levels of government are typically weak. Where local administrative capacities exist, however,—albeit at a reduced scale—the horizontal approach to decentralization seems to exhibit advantages over the Anglo-Saxon paragon of vertically independent government functions.

However, German federalism has also tended toward centralization over the years. Although the constitution assigns full sovereignty to the states, current legislation has eroded such sovereignty to some degree. Moreover, the states have often been incapable of resolving pending conflicts without the help of the federal government. This has contributed to reducing their effective power. Nevertheless, the general approach of German federalism is an important reference point for European economists and politicians alike, because the European Union will have to be built upon the national sovereignty of its member states (CEPR 1993). In order to avoid the German fate of centralization, European national governments have protected, through the Maastricht Treaty, their sovereignty against usurpation by the Union through a 'subsidiarity clause' which establishes the primacy of national and regional policies over centralization. Diversity of national policies with all their facets is thus sheltered, but this calls for coordination, cooperation and harmonization of government policies in order to realize common policies and to achieve 'social and economic cohesion' within the Union. Moreover, the realization of a Monetary Union with a single currency in Europe has evoked the specter of potential 'budget bail-outs', by the European Central Bank, of capricious or profligate member governments, which would require budget coordination and control in order to preserve macroeconomic stability within the Union.

2.3 Competing governments

More recently, attempts have been made to counteract the centrist bias of the 'layer cake' model by marrying it with the 'subsidiarity principle', but without succor of explicit intergovernmental cooperation. Coordination of public decisions is essentially left to the market and to competition among governments. This market analogue to the coordination and cooperation of decentralized government may be labeled 'competitive federalism' (Israel 1992, Kasper 1995). A decentralized government system is seen to be "a surrogate for competition, bringing to the public sector some of the allocative benefits that a competitive market brings to the private sector" (Tanzi 1996, p. 299). This follows Tiebout (1956) who argued that, if public goods are financed by local taxes that reflect the costs of provision, mobility between localities will provide information and bring about an efficient outcome in the allocation of resources. The Tiebout model thus relies on mobility and competition to solve the preference revelation problem that both the central and local governments face in determining the local demand for public goods[4].

It is true that the layer-cake approach, which assigns independent revenue and outlay functions to the different tiers of government, in conjunction with the principle of subsidiarity would, by itself, serve as a coordination mechanism through horizontal competition among regional governments. Rivalry among public jurisdictions would—like market forces—constrain government and bring about effective policy coordination. Moreover, competition among governments would not only help to realize static efficiency gains; it could also foster dynamic welfare improvements through its effect on experimentation and innovation. However, the model tends to overrate voters' mobility and the capacity of the market to deal with non-rival and non-excludable public goods, externalities, and other market imperfections. However it may serve to constrain an oversized and expanding government sector which is continuously eroding the scope for private economic activities[5]. Switzerland comes closest to such precepts, but it has neither avoided the need for coordinating policies, nor the expansion of its public sector.

Competitive federalism may eventually be appropriate for highly industrialized economies with an oversized public sector, especially where horizontal regional inequities in fiscal capacity are small. In developing

---

[4] Ironically, the Tiebout argument has been used to make a case for centralizing the distribution function rather than to constrain public sector activities.

[5] Competition for fiscal resources could, however, become overly fierce and even ruinous which would limit the scope for financing lower government through own taxes. This can be avoided through intergovernmental coordination like agreements on minimum rates.

countries, however, such policy is likely to fail. Vertical competition among a central and lower-tier governments may flounder due to the latter's incapacity to implement and administer policies. At the horizontal level, it is likely to eternalize existing regional inequities and/or induce impoverishing regional migration. Horizontal tax competition among governments could eventually retrench the scope for public policy action well below efficient levels. And often, government involvement at lower levels is small and there is no need to constrain their action. On the contrary, it is presumable that efficiency and national welfare would increase through the strengthening of local governments, not by curtailing their functions through market competition.

2.4 Vertical federalism: assigning exclusive responsibilities

The vertical approach to federalism attempts to coordinate government actions implicitly through the constitution. According to this view, consumption of government services can be defined over—ideally distinct—geographical areas forming separable layers of constituencies for each public good. Larger constituencies supersede smaller regions forming higher layers of government responsibility whenever this is warranted by a larger geographical distribution of public goods. Efficiency considerations then require that regional governments decide on the supply of public services for their respective jurisdictions rather than to provide these services at uniform levels across all regions[6]. Public constituencies are thus ideally formed and delineated in accordance with the local distribution of 'internal' benefits derived from government activities. The efficient outcome would reflect both specific preferences as well as the ability to pay of taxpayers within each region. As a consequence there would be no conflict between governments at the vertical level—neither for the provision of public goods itself, nor for its financing (which would obey the principle of pure benefit taxation).7 The philosophy is to avoid conflicts *a*

[6] This is the essence of Oates' 'decentralization theorem' cited above.

[7] For a theoretical discussion of the division of functions among levels of government see, for instance, Oates (1972), Chapter 2, and on tax assignment within the 'layer-cake' approach Spahn (1988). See also Van Rompuy/Abraham/Heremans (1990).

priori, and hence the need to coordinate policies among public authorities.

However, national priorities may rival with preferences couched at lower levels of government; public functions may overlap at various layers of government; and they may collide with government decisions at the same level. In some instances (as in the United States or Switzerland), different levels of government compete for the same revenue source (tax overlapping), and conflicts have to be resolved by legal rules on reciprocity and mutual immunity. Moreover, local resources may prove to be insufficient in regard to local needs which occasions unavoidable vertical and horizontal fiscal imbalance among governments. Conflicts of this nature are inescapable in the layer cake model, which calls for a continuous redefinition of the constitution by the Courts, or for effective coordination and cooperation among authorities—despite the endeavor to impute government responsibilities exclusively.

Nonetheless, the concept of dividing government competencies and resources vertically *is* powerful in avoiding potential friction, overlap and waste within decentralized government. All federations, including Germany and the European Union, have adopted this approach to varying degrees. Furthermore, the theory of federalism establishes positive guidelines for distributing expenditure functions vertically among layers of governments.

Modern welfare economics has established a compelling case for the government to provide public goods, to compensate for externalities, to ensure an adequate production and consumption of merit goods, to provide insurance in the case of information asymmetries, and to regulate natural monopolies (partly through public ownership). In the case of public goods, externalities, and natural monopolies, the criteria for deciding between central and local provision are fairly clear-cut. Public goods with a national impact should be provided at a central level (e.g., national defense), while most others are better provided locally (e.g., policing). Similarly, the central government should deal with externalities that cut across localities (e.g., air and river pollution) while local governments can control activities that have a restricted impact (e.g., aircraft noise). And natural monopolies based on national networks (e.g., telecommunications) need to be regulated centrally, while the regulation of local monopolies (e.g., in-city transportation) can be decentralized[8].

In the case of merit goods like health, education, and other social programs, the issue is less clear. Just as the central government has an advantage in securing efficient income redistribution, the central government should—in support of wider social objectives—ensure access to a minimum level of health, education, etc. But this can be done without the central government being actively involved in the provision of these services. Economics provides little guidance as to whether social spending should be a central or local responsibility, although there is a presumption in favor of central coordination of local provision based on the argument of regional fairness and social cohesion.

One important argument in favor of centralized distribution policies is based on Tiebout (1956) who has stressed the importance of interjurisdictional migration as an effective constraint on regional taxation and hence on the scope for redistribution at lower levels of government. Comparably high local tax rates combined with generous social policies would ostracize the rich, as they would attract the poor. Centralization is then a device to secure the welfare state in the presence of competition among governments.

This centralist view is, however, questioned by other authors (e.g. Tresch 1981) who emphasize the need to respect different local preferences with regard to redistribution[9]. The real issue should be whether the required degree of coordination does or does not warrant central provision. Many federal states explicitly assign responsibilities for social welfare functions to subnational governments. And public health and education as well as land use or rent controls—also functions typically attributed to local jurisdictions—have profound distributional implications (Sewell 1996). As it turns out, there are wide differences across countries in which merit goods are provided centrally as opposed to locally (Hemming/Spahn 1996). Traditionally, local governments

[8] Regulating such monopolies does not imply government provision of such services, and technological developments may even allow to dismantle such monopolies altogether (e.g. in the telecommunication industry).

[9] For Tresch, respect of local preferences is the *only* original reason for decentralizing government, since all other aspects result from asymmetrical information.

have often assumed an important role in alleviating social hardship of their citizens, and more recently, there is a trend in the United States to hand over federal welfare programs to the states concomitant with some fiscal resources in the form of unconditional bloc grants[10]. In developing countries, decentralization may even be a precondition for the effective targeting of social spending to specific situations and locations (Gómez 1993).

The criteria for distributing tax revenue among governments are less salient and often contradictory (Spahn 1988, 1995). First, local taxes should enhance the accountability of politicians, they should thus be non-exportable, so that their burden falls on residents. Second, efficient local taxes should respect the benefit principle of taxation. Many local services fees and user charges fall in this category, but taxes—e.g. a tourist tax or a local business tax—can also be defended under the benefit-tax principle where they are understood to correspond to local services rendered. Third, local taxes should be non-distortive in that they do not affect allocation decisions in the private sector. At the regional level, this criterion is particularly important since it may lead to horizontal tax competition among governments. Taxpayers attempt to avoid local taxes by transferring the tax base into low-taxing jurisdictions. This imposes discipline on the level of tax rates and the freedom of local governments to vary rates. Furthermore, the tax base must be regionally immobile.

Also, regional taxation is often inequitable among jurisdictions (e.g. of natural resources) and it may be unreliable as a revenue source where tax bases vary with the business cycle (e.g. income taxes). While some federations have opted for centralizing such taxes in order to avoid these effects, others continue to operate such taxes—or surcharges thereon—at the regional level (e.g. Canada). Finally, local taxation is often restricted by the requirement of administrative simplicity which is difficult to accomplish for some typical local taxes (e.g., the property tax).

Since it is difficult to realize all criteria for local tax assignment at the

[10] This strategy, also adopted by the government of Argentina, for instance, is also used to constrain the public sector to the extent that the financial compensation through grants does not cover the full costs of the decentralized outlay responsibility.

same time, revenue of local governments from own sources tend to be insufficient to meet expenditure needs where government functions are commonly more decentralized. This requires tax sharing or supplementary funding by the central government. Such financing serves to correct vertical imbalances between fiscal capacity and needs, and to mitigate horizontal regional imbalances at the same time.

Tax sharing provides unconditional funds and thus respects the budget sovereignty of lower tiers of government. This is also true for unconditional general-revenue grants distributed by the central government, but often such funding is subject to certain conditions defined by the grantor, which renders the transfer system an effective instrument for coordination within the layer cake approach. Such form of coordination is, however, often criticized as allowing the central government to impose its preferences and to restrict the budget autonomy of lower-level governments.

2.5 Horizontal federalism: Procedural division of public functions

Although the German model of federalism equally attempts to separate government functions vertically (e.g. defense at the federal, education at the state, and communal services at the municipal level), it mainly follows a different philosophy as outlined above[11]. The emphasis is laid on legislative functions (in particular framework legislation) at the central level, and states and local governments (municipalities) are generally in charge of implementing and administering policies. Policies may thus be divided through stages of processing—from an initial policy concept which is typically uniform and defined by the center, through its realization and administration whereby supervision and management is thoroughly attributed to lower tiers of governments. For one thing, this distribution of responsibilities is to safeguard the independence of lower levels of government. For another, it is to realize the 'uniformity-of-living-conditions' within the nation, a principle based on

[11] For more details on the German model of federalism see Spahn (1978, 1997b), Spahn/Föttinger/Stein-metz (1996).

collective welfare arguments and equity. This approach emphasizes the administrative role of the states not only in areas of their own responsibilities, but also in areas of federal competencies: The states execute most of the federal laws *as matters of their own concern* (for instance social welfare and environment protection), and in some special cases they execute federal laws *as agents of the Federal government* or 'by order' (e.g. federal highways). In this case, the federal government can give directives, but it also assumes the costs. Similarly, local governments have safeguarded the right to regulate their own affairs within certain limits. Besides their own duty, they also accomplish tasks assigned to them by law (for example, registration offices). Municipalities are supervised by the states, and the same model of a horizontal division of functions also applies to the relationship between states and their communes.

In the horizontal model of federalism, central administration is less developed in general (except for specific functions like defense, foreign affairs etc.), and the states and municipalities bear the brunt of administrative responsibilities (including for tax administration). This requires high professional competencies of public servants at lower-level administrations. Moreover, municipalities have to spend a large share of capital expenditure in such fields as communal services (sewerage etc.), health, sports and recreation, schools, housing and road construction. They carry out, on their own or on behalf of higher tiers of government, a large share of public investment in Germany (about two thirds of the consolidated total).

The horizontal interrelationship between policies asks for effective and often institutionalized mechanisms for coordination and cooperation. This is why the formulation of national guidelines through federal legislation also requires participation of the lower tiers of government to the extent that it affects the costs of implementation. While the implementation of policies within such guidelines may vary among regions, it may—in some instances—become subject to formal responsibility sharing and cofinancing arrangements among levels of government. Also the harmonization of genuine state policies—where the central government has no right to interfere (e.g., in education)—requires more formalized cooperation mechanisms and intergovernmental institutions for coordination. Such characteristics of the horizontal approach to decentralization are often associated with 'cooperative federalism'.

However consensus-forming is not confined to the government sector alone; it often involves consultation and coordination processes among public and private sectors which may also be effected through institutions—albeit more loosely conceived. In this regard, the German approach exhibits similarities with the Swiss model of public decision making where the constitution preserves a continuous and more rigorous consultation process between the private and the public sector—even for ordinary legislation—through expert-based discussions and consulting procedures (*Vernehmlassungs-verfahren*) which requires government agencies of different levels, political parties, and economic and social groups to confederate in preparing laws[12].

2.6 The functional tradition: Earmarking and special funding

Systems of functional government tend to materialize in centralized states and they are typical for some more decentralized Latin American countries (e.g. Argentina, Colombia). Decisions concerning different sectors and policies are taken at the central level by the competent authorities—be they ministries or agencies. Then, these decisions are implemented in the various administrative subdivisions of the country by single-purpose agencies, structured along a rigid vertical hierarchy. For example, the Ministry of Health decides the quality and quantity of services to be delivered to the targeted population and the distribution of funds among various administrative subdivisions. Then, in the case of a two-tier hierarchy, the effective provision of these services is mandated to the regional branches of the ministry. In its pure form, a functional system does not need, or have, a general budget. Typically, distinct revenue sources are earmarked for certain purposes and attributed to the various ministries and central agencies, or to special agencies and funds.

In the functional model, the use of earmarking is often motivated by accountability problems or mistrust—the national government having doubts

[12] For a description of Swiss federalism see Dafflon (1977, 1986), Bieri (1979), Bird (1986), Spahn (1997a).

whether public moneys will be used for the 'appropriate' purpose. A vertical hierarchy—with a number of special funds and the earmarking of revenue—is expected to ensure that resources are being spent 'properly' and in accordance with centrally-made decisions. Occasionally, the establishment of specific-purpose agencies and funds may also have been motivated by the desire to produce 'turf'. However, the absence of proper information flows and budgetary procedures can severely hamper the task of monitoring the outcome of policies thus protected against scrutiny, and render the possibility of judging and reordering priorities over time inaccessible. Arbitrariness and corruption are possible under such auspices. Contrarily, accountability is secured in a decentralized system of government through the voters' possibility to scrutinize the use made by governments of their taxes and 'untied' transfers.

The vertical funding of public functions through earmarked taxes entails severe budgetary inflexibility, and it bears the risk of inefficiencies and waste. Resources attributed to the funded programs will escape public attention and democratic control, and they may diverge from local needs in the longer run. Also, it is politically difficult to abolish strings to the use of public resources once they are attached. Moreover, the earmarking of revenue allows specific interest groups to shelter a share of public resources—often for long periods. And finally, the vertical funding of public activities reduces the scope for autonomous public policy at the territorial level, and it often implies the supremacy of national goals. This runs counter the spirit and the objectives of decentralization.

In industrialized countries, special funds detached from general budgeting are severely restrained. Typically they are used to coordinate the funding of social security programs based on specific financial contributions of individual members—like public pension funds—with the aim of protecting entitlements acquired by the individual or a group of persons against the policy makers' greed. This logic is particularly stringent for fully-funded schemes where the contributions serves to nurture personalized capital accounts. It can also apply to pay-as-you-go funding or revolving funds where recurrent contributions are being used to honor legal entitlements based on personalized life-time contributions to the program. In practice, however, the latter schemes often serve to absorb—at the expense of the group of the 'insured'—general commitments of a merit-goods character (like bonuses for education, for motherhood, etc.) that should ideally be disbursed from tax revenue, not specific contributions. This practice blurs the boundary between ordinary budgeting and specific funding. Moreover, there is always the temptation to ease temporary budget constraints at the expense of specific funds and their contributors, which entails the risk that these funds become unsustainable in the longer term.

3. Toward a financial constitution

The "layer-cake" model stresses the vertical division of independent government functions. This leaves ample room for autonomous policies at each level of responsibility. It emphasizes cooperation among governments at the horizontal levels. The model has no need for equalization payments or intergovernmental grants -- except for those warranted by regional benefit spillovers horizontally. Moreover, all government services can be attributed to the various governments, and these are free to design their respective tax systems independently and in accordance with benefit-pricing rules.

3.1 Tax assignment

Within the framework of the model, the problem of tax assignment is solved by giving each layer of government its own revenue source (tax separation). Indeed, financial constitutions typically follow this formula, trying to establish firm rules on exclusive entitlements on certain tax bases and/or the sharing of the various sources in order to avoid conflicts. In some instances (as in the United States or Switzerland), different levels of government compete for the same revenue source (tax overlapping), and conflicts are resolved by legal rules on reciprocity and mutual immunity. But in other cases, tax rules are harmonized across the nation (as in Germany), or allow limited discretion through surcharges on formally harmonized taxes or tax bases.

The criteria applying to tax assignment are not treated in this essay[13]. However, intergovernmental financial relations will typically have to deal with two types of problems: (i) the vertical distribution of financial means in accordance with the assignment of functions at a *minimum* level (*revenue function*); and (ii) the adjustment -- among regional governments -- of the resulting primary distribution of resources in order to enable them to provide a *standard* level of services (*equalization function*). In practice, both functions are intertwined, yet it might be helpful to distinguish them when looking at a given system of intergovernmental grants, or when designing such a system for the first time.

Ideally, one would attempt to assign taxes vertically in such a way that the primary distribution of tax revenue allows each level of government to function at a minimum level of services. In this case, tax assignment matches the vertical distribution of government expenditures, and there is no need for intergovernmental transfers on grounds of insufficient resources. In practice, however, vertical fiscal imbalances (VFI) will arise since there is often a mismatch between outlays and own revenues at each level of government.[14]

3.2 Vertical fiscal balance

Intergovernmental transfers are needed to correct for VFI. Such transfers are "general revenue means", and they can be upward or downward oriented. Australia, for instance, collects all the main taxes at the central levels with downward oriented financial flows, while the European Union budget is financed mainly through upward oriented grants from its member governments. No conditions should be attached to general revenue transfers, and, ideally, the rules on such transfers should have the same rank as the rules for tax

[13] The "layer-cake" philosophy might disregard this question because it allows tax competition among different constituencies. In the United States and in Switzerland, there is in fact some competition for similar tax bases -- with complicated mutual immunity rules. Yet even in these countries, the Constitution makes an attempt to avoid conflicting tax assignments.

[14] Even though an original assignment of taxes may avoid VFI, such imbalance tends to appear over time as the buoyancy of taxes might not match outlay trends.

assignment -- since they are designed to guarantee the functioning of minimum government operations.

In practice, two ways to correct VFI have emerged: (i) vertical general revenue grants and (ii) tax sharing. While the economic function of both instruments is identical, tax sharing rules are politically stronger -- since no party can claim the exclusive right to exploit the tax base, and sharing rules are usually established at the constitutional level. We shall call "primary distribution" of resources the one which emerges after taking general revenue means into account. The primary distribution of revenue is thus consistent with the revenue function of intergovernmental finance, i.e., it allows governments to function at a minimum level.

3.3 Primary distribution of resources

The practical arrangements are usually tentative since no explicit level of minimum services is defined. In other words, all governments are expected to supply minimum services *at the given level of finance*. The level of finance of the poorest constituency thus defines minimum services implicitly.

If an *explicit* minimum level of minimum services is aimed at, the methodology for designing intergovernmental grants has to cope at least with four sets of questions:

Needs - It is argued that government services should reflect certain basic needs whatever these needs are. Regional governments should be given sufficient resources to satisfy such needs. But which services should be considered basic, and at which level should they be supplied? Is it appropriate to assume a standard basket of basic services, or wouldn't it be appropriate to work with different baskets for different regions (mountainous, seaside; urban, non-urban, etc.)? Should one take into account the different structure of the population (old, young, level of education)? And how could regional differences in demand patterns for public services be accounted for? Who should decide on the level of needs, and by which procedures? What -- in particular -- should be done if a constituency does not provide a service considered to be essential, despite sufficient financial means?

Costs - Government services are provided at different cost. While some of the cost differential tends to diminish under market conditions (for instance wage differentials), others will remain -- in particular those associated with regional transactions (transportation). Such cost differentials are technically easier to deal with in principle than regionally varying preferences. Costs are measurable and cost compensation schemes can be based on statistical information. However, basic normative judgments remain as to the definition of the service to be subsidized.

Tax potential - Regional governments can be left with an inequitable distribution of tax bases. If, for instance, taxes on natural resources are assigned to the regions, an uneven dispersion of resources is reflected in an uneven distribution of tax potentials. Such problems can be resolved through assigning those taxes to higher levels, or, eventually, by incorporating them into a vertical sharing arrangement whereby regions are left with a portion of these taxes for political reasons or regional fairness[15].

Unexploited potential - Despite having the exclusive right to impose regional tax bases, a particular government may chose not to exploit them in full. This is particularly annoying if the intergovernmental fiscal machinery would honor such behavior through compensating general revenue grants to be provided by other constituencies. This would give rise to "moral hazard" and, eventually, to mutually ruinous tax competition among governments.

It is our view that one should avoid normative questions relating to the definition of needs, costs, and unexploited tax potentials at the level of the primary distribution of public resources. Such problems should be resolved at the second stage within the equalization function of the grants system. The assignment of taxes, revenue sharing and general revenue grants committed on a firm basis should in fact allow each level of government to function at a minimum level, and it should be clear that any redistribution will be an expression of solidarity and be at the expense of other jurisdictions. This would then require a judicious financial constitution whereby taxes are assigned in a

[15] In this case, such special resources are considered as acquired by the region over and above normal tax revenue. It would thus be consistent to keep them outside any horizontal sharing or equalization arrangements.

way as to secure basic functions both in a static sense and in a dynamic perspective[16].

This implies that minimum needs must be defined implicitly without further consideration of specific criteria. The performance of the poorest region under the scheme sets the pace for minimum provisions of services.17 It also implies the neglect, at this stage, of existent cost differentials for the supply of services among regions. It may be argued that some higher costs (like for transportation) are offset through savings (for instance, lower wages in remote areas), and that -- on average -- adjustments for cost differentials are not necessary[18]. As to the avoidance of "moral hazard" and tax competition among regions, this could be achieved either through nationally uniform tax rules even for regional taxes (as in the case of Germany), or through base harmonization rules with minimum rates (as in the case of VAT and excises in the European Union).

If regional differentials are too serious and it is not possible to define a set of common rules for the primary distribution of resources among governments without inflicting hardship, a first set of corrective measures could be envisaged that mitigates some of the discrepancies. We would not call this intermediate phase "equalization", because it simply tries to correct imperfections of the first round. It also seems clear that the exercise should be mainly bilateral between the central government and those provinces that can claim compensation for deficiencies in the financial constitution. It is this spirit that has governed the earlier "special grants" of the Australian system whereby states could apply for compensation from the Commonwealth government for deficiencies of the constitutional arrangements, although reference to the two wealthier "standard states" (New South Wales and Victoria) -- necessary to calculate such grants -- have introduced elements of equalization, and led to

[16] For a discussion of the main criteria for tax assignment see Spahn (1993, 1995).

[17] However, some global criteria -- like the number of population -- have a strongly equalizing impact even within arrangements on the primary distribution of resources. If we speak of "specific" equalization criteria we mean those that go beyond more general rules.

[18] A further argument is that cost differentials would somehow be reflected in the tax base. A higher regional tax base -- and hence revenues -- is thus a compensation for possibly higher costs -- especially if the income tax is a regional tax.

compensations that went beyond healing the deficiencies of the primary distribution of resources[19].

3.4 Secondary distribution of resources: equalization

Equalization grants or corresponding formulae for tax sharing arrangements are targeted toward interregional equity. Thus, they involve political choice and value judgments. The questions raised above with regard to fiscal needs, costs of producing public services, and revenue potentials are typically posed at that level of intergovernmental financial relations.

Obviously, the philosophies regarding interregional equalization differ very much among federations, as there is a host of methods to achieve the objectives of redistribution. Germany, for instance, follows the uniformity-of-living-conditions principle for distributing resources among its regions, the *Länder*, whereby the standard provision is related to the average fiscal performance of all states. Tax competition and "moral hazard" is virtually excluded by uniform tax legislation -- even for state taxes -- with only limited discretion accorded to municipalities for their local taxes. Cost differentials are not accounted for at all. It would contradict the philosophy of uniformity of living conditions which aims at similar income levels in each state. In fact, one result of the arrangements on intergovernmental finance might have been a *de facto* balanced development of the various regions in the Western part of the federation.

Other federations have developed a lower degree of solidarity among regions, and standard provisions are defined only with regard to specific programs (like primary schooling or certain infrastructural investments), they are conditional (as regards the spending area),and they are often limited to cofinancing. Often, they tend to minimize resource flows deliberately. This

[19] The special grants operated from 1933 through 1980 and were accorded on the recommendation of the Grants Commission. The volume was relatively small because the financially weaker States were also the States with the smallest populations. The special grants were financed from the Commonwealth budget and did not affect the total amount of the financial assistance (general revenue) grants.

approach is applied, for instance, in the European Union, but also in the United States and in Brazil. The European Union applies the much looser concept of "cohesion" for its intergovernmental cooperation, and much of this cohesion is expected to be effected through the market. Grants within the Structural Funds are designed to support regions with structural problems in providing the necessary infrastructure, which aims at establishing a "level playing field" for market operations. Whether the market will indeed create cohesion remains to be seen. There are examples where this may have happened -- in the United States with regard to *regional* income differentials, for instance. In other cases, however, the redistribution of resources among regions was insufficient to bring about a more homogenous and regionally balanced development of incomes, for instance in Brazil.

Australia is an interesting hybrid which disburses general revenue grants on the basis of criteria derived from specific programming with a rather general and comprehensive character[20]. This may be related to the large vertical fiscal imbalance in the Australian federation. It is doubtful, however, whether one should be too specific at the level of distributing *primary* resources among government, and whether sophisticated equalization criteria should be used for disbursing general revenue grants.

Equally diverse as philosophies are the methods of interregional equalization. Grants schemes can be comprehensive, or selective and program specific. They may be closed-ended or open-ended[21]. Equalizing grants can be

[20] The distribution model used in Australia embraces all states and territories and determines the distribution of the total amount of Commonwealth general revenue grants. It involves the calculation of grant relativities by reference to the relative per capita revenue-raising capacities for all recurrent own-source revenues, the relative per capita expenditure needs (costs of providing standard services) for all recurrent expenditures where most specific purpose grants are deducted from standardized expenditures. In effect, each state's or territory's share of the total Commonwealth general revenue grants depends on its standardized deficit, which is the product of its population and its per capita grant relativity. The latter is assessed as its per capita standardized expenditure minus its per capita standardized own-source revenues, plus (or minus) its differential per capita specific purpose grants. Separate assessments are made for 19 revenue categories and 41 expenditure categories.

[21] In the first case, the amount of resources to be redistributed is determined in advance, while the level of redistribution is unconstrained and only determined by the applied criteria in the

totally unconditional, or conditional on being spent for specific programs[22]. They may require cofinancing, joint decision making within some intergovernmental body, and observance of implementation procedures and legal constraints. They may support and encourage local decision making, but may also go far in eroding any discretion or regional sovereignty by imposing a set of undesired conditions while using the grant as a bait. Often, regional governments act "on behalf" of the central government in which case grants may seen as restitution of costs[23]. Grants schemes may be organized totally at the horizontal level among states -- without central government interference --, or they may imply asymmetrical vertical flows in favor of poorer regions.

Any choice to be made on the grants system -- particularly the equalization part of it -- will hinge on political decisions and value judgments. The choice will, however, decide on the longer-term impact of government on the political and cultural stability of the nation and its economic development. The uniformity-of-living-conditions philosophy of Germany may have required readiness for sacrifice of some wealthier regions at the outset; yet it may have also generated comprehensive welfare among regions and thus fostered economic development in general -- with obvious benefits for those same, initially wealthier, regions. Also, the economic fate of regions may change over time[24]. It is thus decisive to establish a financial constitution that is flexible enough to cope with regional diversity and can adjust appropriately, in order to foster regional initiatives and economic growth while generating the conditions for comprehensive welfare improvements for the whole nation.

---

second case.

[22] There are doubts, however, whether such conditions make sense because they are often non-binding. Grants on specific programs -- for instance, schooling -- may free resources at the local level for other use whenever the government's intentions were to provide such services anyway.

[23] Of course, the lower-level governments may also ask the higher level to act on their behalf, as in looser Confederations and International Organizations.

[24] After World War II, the driving economic force was in the Northern regions of West Germany while the South was lesser developed. This situation has been reversed during the last decades whereby the South with its reliance on modern services has achieved higher per capita incomes than the North with its structural problems related to declining industries.

4. Conclusions

Recent political and economic developments have spurred the interest in decentralized forms of government. Given the need for greater economic and political cooperation in an increasingly integrating world, and the sensitivities of nation states and their regions, such forms of government are likely to become even more important in the future than in the past.

Federal institutions exhibit costs and benefits which cannot only be assessed in economic terms. Political and organizational costs of federal arrangements are extremely important and should not be discarded. Although an ideal fiscal federal machinery cannot be sketched at the drawing board, well-balanced federal systems may evolve over time in the process of free negotiations among equal partners, who recognize and exploit the benefits of interjurisdictional cooperation. Federalism will thus contribute to enhance economic welfare, to establish interregional equity and fairness, and to promote stability through greater economic and political integration.

REFERENCES

BIERI, S. (1979), Fiscal federalism in Switzerland, Research Monograph No. 26, Canberra (Australian National University, Centre for Research on Federal Financial Relations).

BIRD, Richard (1986), Federal finance in comparative perspective, Toronto (Canadian Tax Foundation).

CEPR (Centre for Economic and Policy Research) (1993), Making Sense of Subsidiarity: How Much Centralization for Europe? London: CEPR.

DAFFLON, Bernard (1977), Federal Finance in Theory and Practice—With Special Reference to Switzerland, Bern and Stuttgart.

DAFFLON, Bernard (1986), "Fédéralisme, coordination et harmonisation fiscales: étude du cas suisse", Recherches Economiques de Louvain, Vol. 52/1.

EICHENGREEN, Barry, and VON HAGEN, Jürgen (1995), Fiscal Policy and Monetary Union: Federalism, Fiscal Restrictions and the No-Bailout Rule, CEPR (Centre for Economic and Policy Research) Discussion Paper Series, No. 1247.

FUHR, Harald, CAMBELL, Tim and EID, Florence (1995), Descentralización en los países de América Latina y el Caribe—La mejor práctica y las experiencias de política, Memorandum, The World Bank, Washington D.C..

GOMEZ, H. J. (1993), "Algunas consideraciones sobre el proceso de privatización en Colombia", Estrategia, Vol. 33 (November).

HEMMING, Richard, and SPAHN, Paul Bernd (1996), "European Integration and the Theory of Fiscal Federations", in Mario I. Blejer and Teresa Ter-Minassian, Macroeconomic Dimensions of Public Finance, Essays in Honor of Vito Tanzi, International Monetary Fund, Washington D.C.

Inter-American Development Bank (1994), Economic and Social Progress in

Latin America, Washington D.C.

ISRAEL, Arturo (1992), Issues for Infrastructure Management in the 1990s, World Bank Discussion Paper 171, Washington D.C.

KASPER, Wolfgang (1995), Competitive Federalism. Promoting Freedom andProsperity, Institute of Public Affairs, The Federalism Project Issues Paper, No. 3, Perth.

MUELLER, Dennis (1989), Public Choice, Cambridge:Cambridge University Press.

PRUD'HOMME, Rémy (1995), 'The Dangers of Decentralization', The World Bank Research Observer, Vol. 10, No. 2, 201-26.

SEWELL, David O. (1996), "'The Dangers of Decentralization' According to Prud'homme: Some Further Aspects", The World Bank Observer, Vol. 11, No. 1, 143-50.

SPAHN, Paul Bernd (1978): The German model of horizontal federal decentralisation, in: Principles of federal policy co-ordination in the Federal Republic of Germany: basic issues and annotated legislation, edited by P. Bernd Spahn, Research Monograph, Centre for Research on Federal Financial Relations, The Australian National University, Canberra, 3-23.

SPAHN, Paul Bernd (1988), "On the Assignment of Taxes in Federal Polities", in Taxation and Federalism: Essays in Honour of Russell Mathews, edited by G. Brennan, B. Grewal, and P. Groenewegen, Canberra: Pergamon Press/ANU Press.

SPAHN, Paul Bernd (1993), The Community Budget for an Economic and Monetary Union, Houndsmill, Basingstoke, Hampshire: Macmillan.

SPAHN, Paul Bernd (1995), "Local Taxation: Principles and Scope", in Jayanta Roy (ed.), Macroeconomic Management and Fiscal Decentralization, EDI Seminar Series, The World Bank, Washington D.C. 221-232.

SPAHN, Paul Bernd (1997a), "Switzerland", in Teresa Ter-Minassian et alii (ed.), Fiscal Federalism, International Monetary Fund, Washington, D.C.

SPAHN, Paul Bernd (1997b), "Germany", in Teresa Ter-Minassian (ed.), Fiscal Federalism, International Monetary Fund, Washington, D.C.

SPAHN, Paul Bernd (1997c), Decentralized Government and Macroeconomic Control, paper presented at the University of La Plata, Argentina (to be published.

SPAHN, Paul Bernd, and Anwar Shah (1995), "Intergovernmental Fiscal Relations in Australia", in Jayanta Roy (ed.), Macroeconomic Management and Fiscal Decentralization, EDI Seminar Series, The World Bank, Washington D.C. 49-72.

SPAHN, Paul Bernd, Wolfgang Föttinger, and Imke Steinmetz (1996), "Tax Assignment and Tax Administration in the German Model of Co-operative Federalism", in Tax Administration in a Multi-level Public Sector, Hacienda Pública Española, Madrid (forthcoming; also in Spanish).

TANZI, Vito (1996), Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects, Annual Bank Conference on Development Economics 1995, The World Bank, Washington D.C., 295-316.

TIEBOUT, Charles (1956), "A Pure Theory of Local Expenditure," Journal of Political Economy, Vol. 64, 416-426.

TRESCH, Richard W. (1981), Public Finance: A Normative Theory, Plano-Georgetown, p. 565.

VAN ROMPUY, Paul, Filip Abraham, and Dirk Heremans (1990), "Economic federalism and the EMU", in European Economy, Special edition No. 1, 'The economics of EMU', Brussels—Luxembourg, 109-135.

WIESNER, E. (1994): See Interamerican Development Bank (EDB).