Published by the Forum of Federations · www.forumfed.org · Publié par le Forum des fédérations

International Conference on Federalism
Mont-Tremblant, October 1999

BACKGROUND PAPER

BURDEN SHARING OR DIVIDING THE SPOILS?

Robin Boadway
Department of Economics
Queen's University

INTRODUCTION

All societies share their wealth among their citizens to a greater or lesser extent. Not surprisingly, this is done largely by interpersonal redistribution policies?those that redistribute directly among individuals?such as the progressive tax-transfer system, social insurance programs, and the provision of major public services, like education, health care and social services. There is little evidence that the desire to support the less fortunate in society has waned, though the challenges to economize on public spending combined with advancements in our understanding of economic policy has had an impact on policy design. The cost-effectiveness of redistribution policies have been enhanced by moving from highly universal programs to more selective or targeted ones, and by incorporating design features such as user fees or work requirements intended to ensure that wasteful usage of social programs is reduced. In many federations, some of the most important redistribution programs are those implemented by lower-level jurisdictions, or what we shall call regional governments, either independently or jointly with those of the central government. Examples include transfers to the poor delivered through welfare programs, education, and health care.

Despite this vast network of social programs delivered by governments at all levels, central governments in federations also engage in significant amounts of redistribution among regional jurisdictions. This paper addresses the question of why that should be the case. Even if we take for granted an ongoing desire to redistribute among individuals in society, why can we not rely on interpersonal redistribution mechanisms, appropriately divided between levels of government, to achieve society's sharing objective? Why is it necessary to superimpose interregional redistribution on top of that? The literature on fiscal federalism has been preoccupied with that issue for a long time. Put simply, redistributive transfers from the central government to the regions are an indispensable complement to the decentralization of fiscal responsibilities. The more decentralized a federation is, the more important the role of central-regional transfers in achieving any given degree of redistribution.

At the same time, the public support for redistribution may itself be affected by the degree of decentralization. Decentralization may create an increased sense of identity with one's locality, which enhances the desire to share with those in that community at the expense of those in other regions of the country. Moreover, decentralization may itself make the perceived costs of redistribution higher as interjurisdictional competition leads to a 'race to the bottom.' This adverse effect on the ability and the desire to share the nation's wealth among persons of different regions can be viewed as being a potential cost to decentralization to be set against the many benefits.
To put the issues into some context, it is useful to begin with a brief summary of the various forms that sharing among regions can take in a federal system.

FEATURES OF FISCAL SHARING REGIMES

Sharing among regions is not unique to federations. In unitary states, it occurs virtually automatically and with little fanfare. Unitary state governments typically design tax systems on a nation-wide basis such that persons in like circumstance are treated comparably regardless of where they reside. And, public services are usually provided at uniform levels to individuals everywhere in the nation. The consequence is that there is considerable implicit redistribution from high-income to low-income regions. By the same token, within regions, persons in different localities are treated comparably, implying possibly significant implicit intra-regional redistribution. What makes a federation different is not the fact of interregional redistribution per se, but the fact that it is explicit. Indeed, the analog between interregional sharing within a federation and that within a unitary state in part accounts for the use of the financial arrangements of the unitary state as a benchmark for judging interregional sharing in a federation.

Interregional fiscal sharing schemes take different forms in different federations, depending especially on the nature and extent of the fiscal responsibilities assumed by the regions. In some federations, regions have significant expenditure responsibilities, but rely on the central government for their finances. Financing can be formula-based or it can have significant discretionary elements in it. Formula-based funding can include revenue-sharing arrangements, whereby the total finances available to the regions are some share of revenues from given tax bases. Alternatively, the size of regional grants may be determined separately from central revenues, according to either annual central government appropriations or an escalator related to some aggregate measure such as GNP, population or aggregate regional expenditures. The allocation of the total share among regions can reflect varying degrees of expenditure need, depending on the exact types of spending responsibilities devolved to the regions. The measure of need can be as simple as population, or it can incorporate rather more detailed factors such as the age structure of the population, geographic features of the region, health status, unemployment, and so on.

On the other hand, grants to the regions may be more discretionary, being determined on a year by year basis by central government administrators who exercise judgment as to the size of the grant and perhaps the use to which they are put. Both formula-driven grants and discretionary ones can incorporate interregional sharing elements, and the extent of interregional sharing typically depends upon the nature of the expenditure responsibilities devolved. The more important are regional responsibilities for redistribution, the more likely it is that elements of regional need are incorporated into the grant system.

When significant revenue-raising responsibilities are decentralized to the regions, an additional dimension of sharing becomes relevant. Different regions will typically have different capacities to raise revenues, and those capacities are often used as an element in determining the allocation of grants among regions. Relatively sophisticated indicators of regional tax bases or more approximate macro indicators such as gross regional output may measure tax capacity. The arguments for using tax capacity and need as determinants of regional grants are discussed below. In either case, the central government must be aware of the incentives that might be introduced for the regions to alter their behavior in order to take advantage of the transfer formula.

Transfers to the regions may also vary according to the discretion left to the regions in the use of the funds. If there is a perceived national interest in the level or design of particular types of regional expenditures (e.g., on education, health or social welfare), the central government may impose varying degrees of requirements on the regions using either the carrot or the stick approach. Mandating regional provision of certain types of expenditures may be used. Alternatively, conditions may be imposed on the use of funds by the regions, with full receipt of the funds contingent on the conditions being met. Matching formulas may also be used to induce the regions to spend sufficient amounts on programs that are deemed to be of value outside the region.

THE ECONOMIC RATIONALE FOR INTERGOVERNMENTAL FISCAL SHARING

To an economist, economic policy goals boil down to two objectives?efficiency and equity, appropriately tempered by feasibility and political acceptance. According to the former, policies should ensure that resources are allocated in such a way that there are no feasible policy changes that could make all persons better off; that is, all gains from production and exchange are exploited. Equity considerations suggest that among those efficient allocations, those that are the fairest should be chosen. Both efficiency and equity objectives require value judgments. In the case of efficiency, economists typically accept the twin principles of welfarism and individualism. These say first that policies should be judged according to how well-off they make individuals in the economy, and second that individuals are the best judges of their own well-being. There are obviously realms of public policy where these principles will not suffice, and recourse must be made to more general objectives, such as freedom, justice, non-discrimination, and so on. But for the purposes of our discussion, we follow the economics literature and adopt the welfaristic perspective.

Equity is more problematic since it requires judgments as to what is fair. It is conventional to disaggregate equity into two components?horizontal equity and vertical equity. The first says simply that 'equals should be treated equally'. It is very much at the heart of the rationale for fiscal sharing schemes. It rests on the notion that all citizens in the jurisdiction under consideration should have equal 'weight'. As such, it might be viewed as an economic statement of the implications of citizenship. Implementing the principle of horizontal equity implies not only accepting the principle, but also being able to judge when two persons are equally well-off, which is not a trivial matter in situations in which persons have different opportunities, different tastes and different needs. Vertical equity deals with the appropriate way to treat persons of different levels of well-being: how much of society's scarce resources should be taken from the better-off and transferred to the less well-off? This obviously involves a basic value judgement about the extent to which society ought in principle to engage in redistribution, as well as an economic judgment about the costs associated with the process of redistribution.

How a society collectively makes these judgments is an open question, but it is not one that is unique to fiscal federalism. Intergovernmental fiscal sharing schemes essentially complement policies implemented by the various levels of government and apply intact regardless of the extent of vertical redistribution pursued by governments. They can be looked at as policies that facilitate the decentralization of fiscal responsibilities, ensuring that the benefits of decentralization are achieved without compromising national objectives of efficiency and equity.

The Benefits of Decentralization

There are a number of reasons why economists are predisposed to decentralizing fiscal decision-making. Regional governments are likely to be better informed about the preferences and needs of local communities, and can tailor the mix of public goods, public services, transfers and taxes to suit their constituents. Decentralized decision-making can economize on costs of bureaucracy. Fewer layers of bureaucracy reduce the costs of administration and control (so-called agency costs), and reduce the possibility of pure waste. This is particularly important in the case of public services delivered to individuals and firms: their delivery must be decentralized to public agencies, so control might as well be. Decentralization can give rise to opportunities for innovation by the various regional governments, innovation that can then be copied by other jurisdictions. Local governments may also be subject to the discipline of political competition, which may induce more efficient local behavior. Related to that, opportunities for rent-seeking and outright corruption may be dissipated by decentralizing responsibilities to smaller jurisdictions. Some argue that accountability is enhanced by decisions being taken closer to the people. Regional politicians might be more closely connected to individual decisions and held accountable to them, and local media may be more vigilant in monitoring local decisions.

Taken together these arguments make a strong case on efficiency grounds for decentralizing fiscal decisions to lower levels of government. But the arguments apply with much different force to different types of decisions. They are most forceful when it comes to the provision of public services, to public goods of a local nature, and to expenditure items which are targeted according to criteria which are location-specific. They are less forceful when it comes to national public goods, or to large transfer programs. Most important, the case for decentralizing expenditures on goods and services is generally much stronger than for decentralizing transfers and the collection of taxes. Thus, efficient decentralization would likely result in a vertical fiscal gap, with more expenditure responsibilities being decentralized than revenue-raising responsibilities. Indeed, given that decentralization itself generates an argument for central-regional transfers, as discussed below, the existence of a vertical fiscal gap is desirable. The exact size of the gap is a matter of judgment, though, given that fiscal and accountability principles might suggest that the political responsibility for expenditures be accompanied by responsibility for financing a good part of them.

The Costs of Decentralization and the Need for Fiscal Transfers

Along with enhanced efficiency and innovation in the delivery of public services, decentralization brings with it some potential efficiency and equity costs, which are closely related.

Efficiency Costs

There are three main sorts of efficiency costs. The first is that programs enacted in one region may provide spillover benefits or costs to another. Persons educated or trained in one region may move to another to use their skills; highways built by one jurisdiction are used by residents of another; and so on.

The second efficiency cost is that regional policies may interfere with the efficient allocation of resources in the internal economic union (common market). That is, the national markets for labor, capital, goods and services may be distorted at regional borders. This may be because different regions impose different taxes or transfers on transactions in their jurisdictions. They may actively engage in 'beggar-thy-neighbor' policies that are designed to attract factors or businesses from other jurisdictions. Or, they may design their expenditure programs in such a way as to inhibit the free movement of persons or firms from one jurisdiction to another, for example, because of residency requirements, preferential hiring or procurement policies, or local product or factor regulations. Some of these policies may be enacted to achieve some legitimate regional objective, such as the protection of language or culture or the regulation of health and safety. But others may simply distort the free flow of goods, services and factors across regional borders.

The third efficiency cost, and the one most closely related to the case for fiscal-sharing transfers, arises because the process of fiscal decentralization itself leaves some regions with greater fiscal capacities to provide public services and transfers than others. They may have larger revenue-raising capabilities (e.g., larger natural resource or industrial bases) or they may have lower expenditures needs (e.g., fewer elderly citizens). The implication is that the net fiscal benefit (NFB) generated by one region for its residents?the difference between average levels of public services and average tax payments?will differ from that of another. This will provide a purely fiscal incentive for persons and firms to migrate to jurisdictions with the higher fiscal capacities, referred to as fiscally induced migration. This is purely a consequence of the decentralization of responsibilities. In a unitary state where taxes and expenditures are nationwide, no differential NFBs arise?a given national tax rate will finance similar levels of public services nationwide. This is one reason why the unitary nation benchmark serves as a useful standard of comparison.

Equity Costs

Decentralization can also compromise national equity objectives. Regional governments typically have policy instruments that are important components of redistribution policy, such as the provision of education, health and/or welfare services, elements of social insurance, and redistribution taxes. These may give rise to unacceptable differences in equity across regions. As well, the pursuit of redistributive goals might be compromised as regions compete with one another for higher skilled workers and firms, as well as for persons who place fewer demands on public services. Of course, in a federation, different preferences for redistributive equity may be viewed as legitimate and therefore tolerated. But, to the extent that inadequate or uneven levels of redistribution are simply a result of competitive constraints or uncoordinated decisions, national equity objectives will be compromised.

More important for fiscal sharing is the fact that horizontal equity will be violated by decentralization. The same differences in the capacities of regions to provide given levels of public services at given tax rates that is the source of fiscally induced migration also causes horizontal inequities in a decentralized federation. Differences in NFBs across regions, whether due to different revenue-raising capacities or different needs for public expenditures, imply that like persons residing in different regions of a federation will not be treated alike by the public sector: there will be fiscal inequity. This is the ultimate source of the equity argument for redistributive grants across regions. Grants that redistribute from regions of high fiscal capacity to those of low fiscal capacity will give different regions the potential to provide comparable public services at comparable tax rates. Again, comparison with the unitary state benchmark is instructive. In a unitary state, differences in regional fiscal capacities are effectively negated by the fact that the unitary state government levies comparable tax rates and provides common levels of public services over all regions

Some important caveats are in order concerning the role of fiscal sharing among regions to alleviate fiscal inequities. First, the object of such grants is not to redistribute among regions as an end in itself. It is ultimately to ensure that like individuals are treated alike across the federation. As such, in principle it would be possible to replicate interregional transfers by transfers to persons that are contingent on the region of residence. Interregional transfers are typically used because they are much simpler to administer, and because they accord with the desire to decentralize fiscal decision-making in the federation. Transfers to regions effectively allow the regions to use them as they see fit; they do not force conformity. That is, they provide the potential for different regions to provide comparable public services at comparable tax rates, but do not force them actually to do so. While this may compromise the objective of horizontal equity, it is consistent with the spirit of federalism.

It is also important to recognize that interregional equalizing transfers are intended to address horizontal equity concerns. They are not intended to be an instrument for vertical redistribution among high- and low-income groups. It would be very misleading to judge them on those grounds. As such, the case for them is not conditioned on any particular evaluation about how redistributive the fiscal system ought to be. That is really a matter for policy instruments that apply directly to individuals.

Perhaps the most important caveat concerning the argument for interregional equalization transfers is the value judgment underlying it. The equity case rests on the notion that like persons ought to be treated alike across the federation (or to put it in technical economics terms, all persons should enter equally into the nation's 'social welfare function'). This seems like a reasonable extension of the notion of citizenship: citizenship ought to confer notions of equal treatment to all citizens of like circumstances no matter where they reside. This judgment will not be accepted by all, especially in a very heterogeneous federation with high degrees of decentralization.

One of the interesting features of the equity case for interregional fiscal sharing is that, unlike most economic policies, it is not in conflict with efficiency: there is no efficiency-equity trade-off. On the contrary, fiscal equity and fiscal efficiency both call for the elimination of the NFBs that would otherwise accompany decentralization. And the more decentralization there is, the greater the need on efficiency and equity grounds for fiscal sharing. Of course, the public support in all regions for fiscal burden sharing may also be weaker the more decentralization there is.

Finally, before leaving the equity basis for fiscal sharing transfers, one other dimension should be mentioned. Some economists have argued that an essential argument for regions joining a federation is to share the idiosyncratic risks that each faces. According to this view, equalization is a form of social insurance: lucky regions effectively contribute part of their success to those suffering adverse shocks. There is no doubt some element of risk-sharing in equalization schemes. But it is unlikely to explain all interregional sharing. In many federations, some regions are chronically less well-off than others.

ISSUES IN THE DESIGN OF FISCAL SHARING REGIMES

The appropriate parameters for a fiscal sharing scheme depend on a number of factors, including the degree of fiscal decentralization in the federation, the instruments devolved to the regional level, and perhaps most important, the political commitment to fiscal equity. In outlining the implications of these factors for system design, it is useful to refer to the unitary state benchmark. In a unitary state, one government enacts all policies affecting the regions. Regional affiliation typically plays little role per se in determining the taxes paid or public services received?a single tax system applies and relatively uniform public services are available across the nation. There will, of course, be an issue as to how much sharing takes place among individuals, but persons of a given level of well-being will be treated on a par regardless of where they reside.

It is the decentralization of fiscal responsibilities to regional governments that brings with it the need for fiscal transfers. That need will be greater, the greater are the NFB differentials created by decentralization. If regions were to finance all their public services on the benefit principle?the taxes or user prices paid by each resident to their regional government just reflecting the benefit received?there would be no NFBs created by decentralization and no need for corrective grants. All redistribution could be carried out through the central system of interpersonal taxes and expenditures. But, regional governments do not operate on the benefit principle. Their public services, which tend to be enjoyed by all residents, are financed by tax payments that depend on income. Therefore, higher income regions will be able to provide a greater level of public services at given tax rates than lower income regions; hence the need for fiscal sharing. We conclude by drawing attention to a number of factors that affect the design of these systems.

Central-Regional versus Interregional Approaches

Since the purpose of fiscal sharing grants is to transfer among regions, a natural first question to ask is who should make the transfers. In principle, the form of these transfers could be determined by negotiation among the regional governments without the participation of the federal government. But, this is rarely used, and with good reason. Unless the sole motive for grants were efficiency (or pure risk-sharing), interregional bargaining is likely to come to naught since better-off regions are unlikely to condone a bargaining outcome which gives them negative transfers. Moreover, even if altruistic urges motivated the regions, bargaining would be difficult since it would require consensus, which is difficult whenever there are several parties involved. The central government has a natural advantage in implementing interregional transfers. Its constituency is the entire nation. Expenditures are likely to be more decentralized than taxes, resulting in a vertical fiscal imbalance that provides the federal government with the resources to achieve fiscal equity.

Political Constraints

The amount of fiscal sharing that a nation will tolerate will be resolved through the political process. It is a widely held view that more decentralization reduces the political support for fiscal sharing. Indeed, some advocates of decentralization have that outcome precisely in mind when proposing decentralization, taking the position that there is too much redistribution in the first place, and decentralization will rein in governments.

The Formula for Grants

Most economists advocate a formula-driven approach to fiscal sharing. The precise formula depends jointly on the types of responsibilities that are devolved to the regions, and the extent to which fiscal equity is to be incorporated into the system. If fiscal equity is an accepted principle?that is, if residents are to be treated equally by the fisc regardless of where they reside?the basic design of grants should in principle reflect different needs of the regions and different tax capacities.

If decentralization takes place mostly on the expenditure side, regions must rely heavily on grants from the center. Ideally, the grants would be sufficient to allow the regions to provide comparable levels of relevant public services, while at the same time affording them the opportunity to design their programs to suit their own needs. The formula used could reflect the amount of funding needed to supply a representative level of regional public services, that is the average level supplied in the regions collectively. In some countries, this might be informationally demanding, so simpler formulas might be used that incorporate basic indices of need (such as, especially, population).

To the extent that taxes are decentralized, sharing formulas would reflect the relative tax capacities of the regions to raise revenues. Where data are available, tax capacities could be measured by the ability of the region to raise revenues from representative tax bases at average tax rates across all regions. If this representative tax base approach were not feasible, some cruder indicators of fiscal capacity could be used. Since most major tax bases used at the regional level are closely related to income, regional income would be one possibility, perhaps corrected for differences in major sources of regional income, such as natural resources or international corporations.

Unconditional versus Conditional Grants

The essence of federalism is the existence of independent political decision-making at different levels of government. Thus, a prima facie case exists for using unconditional grants whenever possible. Nonetheless, there are good reasons for attaching some conditions to some grants; indeed, the use of such conditions often facilitates the decentralization of fiscal responsibility by enabling the benefits of decentralization to be achieved without incurring the costs. In fact, conditional grants can be a much less intrusive way for the central government to influence regional fiscal decisions that more direct means like the imposition of mandates, the overriding of regional legislation, disallowing regional laws, and so on.

The use of conditions might be warranted in two sorts of circumstances. The first is when the benefits (or costs) of one regions fiscal policies spill over to the residents of neighboring regions. A classic argument in fiscal federalism is that such spillovers should be corrected by matching conditional grants.

From the point of view of fiscal sharing, the second circumstance is more relevant. That is where the responsibilities of central and regional jurisdictions overlap. It is generally conceded that the central government has some responsibility for seeing that efficiency prevails in the internal economic union and that national standards of equity apply. Yet, many of the instruments devolved to the regions have a major impact on these objectives. For example, the case for decentralizing the provision of public services in the areas of health, education and welfare to the regions is strong. But, these major public programs are important instruments for achieving national equity goals, such as equality of opportunity, more equal distribution of economic well-being and economic security. Harmonized provision of these services can also ensure that free mobility in the federation is not compromised. A way to ensure that the decentralized provision of these important public services contributes to national efficiency and equity objectives in a way which does not compromise the advantages of decentralization is to attach general conditions to the full receipt of central grants to the regions.

Local Preferences for Redistribution

Finally, the issue arises as to which level of government should be responsible for redistribution. In one sense, this is a moot question. Policies enacted by regional governments will necessarily have redistributive effects, most of which cannot be undone by the central government. Nor is it obvious that the central government ought to undo them: the regions might have legitimately different views about the extent of sharing within their jurisdictions. Those need not conflict with the desire of the federal government to institute fiscal sharing among regions to pursue fiscal equity. The best that can be hoped for in a federation is that the different regions have the potential to provide reasonably comparable levels of public services at reasonably comparable tax rates. A system of equalizing transfers achieves this. Whether they choose to provide exactly the same services is up to them. In that sense the unitary state will not be exactly replicated in a decentralized federation. This form of compromise, which balances national equity and efficiency objectives with the ability of regions to accomplish their own individual objectives, is the essence of a federation. In the end, the amount and type of fiscal sharing is very much a matter of judgment and compromise.

Forum of Federations / Forum des fédérations
forum@forumfed.org