FISCAL FEDERALISM IN CANADA, THE USA, AND GERMANY[1]

allocation of revenue resources for each order of government; provision for the designated representation of distinct regional units within the federal policy–making institutions, including a federal second legislative chamber designed specifically for this purpose; a supreme written constitution not unilaterally amendable by either order of government but requiring the consent of the federal legislature and of a significant proportion of the constituent units through their legislatures or representatives of their governments; an umpire in the ultimate form of a Supreme Court or a Constitutional Court to rule on constitutional disputes between governments; and processes and institutions to facilitate intergovernmental collaboration for those areas

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extensive non – discretionary unconditional transfers to the Länder. In addition, there are substantial intergovernmental transfers both from the federal government to the Länder, and among the Länder. These transfers fall into two broad categories. First, there are the specific grants, largely conditional, to the Länder for projects in the ‘joint tasks category’, for reimbursement of federally mandated expenditures, and for specific projects related to the creation of uniformity of living conditions. The second are the unconditional equalization transfers consisting of two elements: one, an interstate revenue pool into which rich Länder pay and from which poorer Länder draw according to specified criteria and a formula, and second federal supplementary payments based on a fixed percentage of the VAT.

(4) Differences in political dynamics. The three federations are also marked by significantly different federal institutions affecting policy – making at the federal level. The U.S. Presidential – Congressional institutions with the separation of federal executive and legislative powers and the checks and balances between them, contrast sharply with the Canadian fusion of executive and legislative powers in the parliamentary institutions, and these differences have produced contrasting processes for federal decision – making, consensus generation within the federation and intergovernmental relations. While Germany also has parliamentary institutions, the unique institution of the Bundesrat has provided the Länder a major voice the (overnm)8(e)1relatioecting policyTJT0.0475 TD0.0002 Tc0.001 Tw[ernmenc)-7ac3.dera8(oduc1]TJ0l decisifTjdera8(is

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implicitly equalize differences in state fiscal capacities.

The Canadian case differs from both the US and German cases. In Canada, transfers fall somewhere between the US and Germany in terms of their size. Though the Canadian fiscal system is decentralized, the provinces still rely on the federal government for a significant proportion of their expenditure financing, though less than in the US. And like Germany, there is a substantial program of fiscal equalization in place, which is perhaps the most important feature of the Canadian system.

Transfers to Correct Vertical Fiscal Imbalances

It is somewhat artificial to distinguish those transfers that correct vertical fiscal imbalances and those that correct horizontal ones: almost all transfers do both to some degree. Nonetheless, most transfers are predominantly for one purpose rather than the other. In the German system, this is not really an issue since vertical balance is virtually achieved by the revenue sharing system. Indeed, some would regard revenue sharing as a form of transfer from the federal government to the L@nder. Under that interpretation, which is certainly legitimate, revenue sharing would be the instrument for closing the vertical fiscal gap (although it also serves to address horizontal imbalance issues at the same time).

In the United States, as we have mentioned, the vertical fiscal gap is closed by a wide array of conditional transfers, both block and specific. This widespread use of conditional transfers is a relatively unique feature of the US federal system. It arises at least partly as a device to inducing accountability in state executive branches that, unlike in parliamentary systems, are not accountable to state legislatures. In federations where the division of powers is not is pronounced, the case for conditional transfers might not be as strong. Conditional transfers not only serve to facilitate accountability, they are also important instruments by which the federal government can encourage state governments to design their public service provision programs in such a way as to be compatible with national objectives. It is worth stressing that although such conditionality is a common feature of most federations, its role in the US is much more widespread than in most federations

As usual, the Canadian case differs from both of the other federations. The vertical fiscal imbalance is covered by the two major transfers systems that remain in existence, the block transfer used to support provincial social program expenditures (the Canadian Health and Social Transfer or CHST) and the equalization system. The latter is not primarily intended as an instrument for vertical imbalance, but because the system is a gross one (unlike the German self-financing net system), it does transfer funds from the federal government to the equalization receiving provinces. The CHST on the other hand serves largely to close the vertical fiscal gap. It is an equal per capita transfer to all provinces. It does have some conditions attached, but they are relatively general, unlike in the case of US conditional grants.

As mentioned, the effectiveness of transfers to correct for vertical fiscal imbalances is not in question. Vertical fiscal imbalances are simply defined as being the excess of provincial expenditure over own-source revenues. Perhaps more important is the extent to which these transfers serve subsidiary purposes. They can be partially equalizing, as is the case when they are allocated in equal per capita terms or on the basis of expenditure needs (the latter being common in may federations, such as Australia and South Africa). More importantly they can be the vehicles for exercising a federal influence on

Transfers to Correct Horizontal Fiscal Imbalances

Horizontal fiscal imbalances refer to differences in the capacity of state governments to provide ‘reasonably comparable levels of public services at reasonably comparable levels of taxation’, as the matter is put in Section 36(2) of the Canadian constitution. The source of such differences can be unequal tax capacities, or it can be differences in the need for spending on public services because of, say, different demographic make-ups across states. There is a consensus among economists that horizontal imbalances can result in both inefficiency and inequity in the federation. In virtually all federations, and more generally in countries with multiple levels of government, some explicit system of equalizing transfers exists whose purpose is to achieve some degree of horizontal balance. In many cases, the principle of equalization is ‘constitutionalized’, including in Canada and Germany.

A notable exception to this pattern is the United States, where no formal equalization system currently exists, and none is contemplated in the constitution. Nonetheless, the structure of conditional grants does incorporate a considerable implicit equalization component. The fact that some significant grants are matching, or are related to state expenditure needs, implies that the fiscal system is to some extent equalizing with respect to needs. On the other hand, states with greater revenue-raising potential are better able to take advantage of these grants. Moreover, some grants have elements of state per capita income in them or even equal per capita components that contribute to the equalization goal. However, unlike in most federations, the extent of equalization is not based on a formula that properly relates transfers to either revenue capacity or to expenditure need. Although data are not available for verifying the exact extent of horizontal imbalances after transfers are taken into account, it is unlikely that in the absence of a systematic attempt to address the issue, horizontal fiscal balance will be achieved.

Both Canada and Germany have highly developed equalization systems. In the case of Canada, the formal equalization system is designed to compensate provinces whose tax capacities are below some minimum national standard. The system is not perfect since, for example, it effectively excludes most of the unequally distributed oil and gas revenues and is a gross rather than a net scheme. Nonetheless, it is quite successful at ensuring that provinces have reasonably similar revenue-raising capacities. The system does not include a component reflecting the relative needs of different provinces. However, there is some implicit need-based equalization in the equal per capita CHST program, and there was even more so in the shared-cost programs that it replaced. As in the United States, various other components of federal spending (some would argue, too many) have equalizing features to them, such as the regionally differentiated unemployment insurance program, various regional development programs, and the relatively small conditional grants that remain.

Germany has an even more complete system of equalization. It is achieved by three main ways. First, three-quarters of the VAT share of the Länder are distributed on an equal per capita basis, which is an effective form of equalization on the basis of need (expenditure needs being highly influenced by the population being served). Second, there is an explicit equalization program applying to shared income and local taxation. Unlike in the Canadian case, the German equalization system operates on a net basis — payments to receiving Länder and financed by contributions from the better off Länder. The amount of equalization is based in the first instance of the revenue capacity of the Länder, but this is adjusted to take account of some elements of need. In particular population density is used as a scaling factor, with various density steps being involved. This is a relatively crude form of needs equalization, especially compared with explicit needs-based systems used in countries like Australia, South Africa, Japan, and the Scandinavian countries. These systems attempt to estimate the cost per demographic group of providing a standard level of important public services. The third component of German equalization is the so-called German Unity Fund, which is essentially a

reflected in the *Social Union Framework Agreement* of 1999, which while accepting the spending power as a proper policy instrument for achieving national objectives (at least by all provinces except Qu**J**bec), emphasizes that future spending power initiatives should be based more on consultation and less on unilateralism than in the past. It remains to be seen to what extent cooperative agreement can be made the basis of the use of the spending power. There has been relatively little success in the use of federal-provincial agreements in the past as vehicles for achieving equity and efficiency in the national economy. A major agreement on reducing internal barriers to trade (the *Agreement on Internal Trade*) has been criticized for being toothless. On the other hand, federal-provincial cooperation on a national child tax credit has been more promising.

Systems of Tax Harmonization and Collection

The extent of tax harmonization provides an interesting contrast among the three countries. All have very different forms and degrees of tax harmonization, and this is only partly related to the extent of decentralization or revenue-raising responsibilities.

The German case is the easiest to deal with. All major broad-based taxes comprising about three-quarters of tax revenues raised are fully harmonized and subject to a single federal tax law. The bases and rate structures of personal provincial VAT along side the federal one, and acts as tax collection agency for the latter. Five of the remaining provinces have separate single-stage retail sales tax systems with different rate structures and exemptions. One has no system at all. The result if a patchwork of sales taxes across the federation with the inefficiencies that entails. By the same token, provincial resource taxes, which are a major source of revenue for some, are completely unharmonized. Many provinces also have their own variants of a payroll tax, though in this case the scope for differentiation is relatively limited.

In the United States, there is no formal system of tax harmonization. The major taxes co-occupied by the federal and state governments are personal and corporate income taxes. In both cases, states have their own independent systems. Some states choose to piggyback on the federal system by basing state tax liabilities on the federal tax base, and sometimes also the federal rate structure. However, other states define their taxes independently. In the case of the corporate tax, there is the additional problem that different states apply different conventions for allocating to themselves taxable income earned by firms that operate in more than one state. This gives rise not only to inefficiencies but also to instances of double taxation or of non-taxation of some portion of incomes. Sales taxes are used only at the state level, and here too there is no harmonization. State sales taxes are single-staged retail taxes (for those that use this tax source), where bases and rate structures can vary considerably across states. This the tax system in the United States is highly differentiated across states, though the significance of this is somewhat diminished by the fact that states collect a relatively smaller proportion of total tax revenue than in Canada.

LESSONS LEARNED

Criteria to be taken into account

In assessing fiscal federalism in Canada, the United States and Germany and the lessons to be learned from their experience a number of criteria need to be taken into account: economic efficiency, equity, autonomy, transparency of decision-making, democratic accountability, and political stability. The emphasis upon each of these criteria and the balance struck among them has varied in the three federations.

Economic efficiency relates to the extent to which the specific decentralized fiscal arrangements in a federation contribute to the improvement of economic efficiency or compromise the efficiency of the federal economy as a whole.

relations are carried out with a minimum of conflict and have a stabilizing influence on the operation and development of the federation. A closely related consideration is the ability of the fiscal arrangements to assist the federation to adapt over time to changing circumstances without destabilizing the federation.

Lessons in relation to these criteria

In this section we examine the lessons to be learned from the effects and incentives of different arrangements in the three federations regarding (a) tax and expenditure assignment, harmonization and collection, and (b) the scope and form of transfers and different approaches to equalization in terms of the criteria listed above.

Economic Efficiency

Efficiency is a very broad concept with many dimensions. It encompasses efficiency in the allocation of resources in the private sector, which is inevitably affected by government policies, as well as efficiency in the provision of government services. Moreover, the multi-tiered nature of a government decision-making in a federation lends itself to conflicting effects on efficiency. On the one hand, the case for decentralization itself is largely based on efficiency arguments. Decentralization is said to contribute to the provision of the mix of public services best suited to the needs of state and local constituents and to induce cost-effective and innovative delivery. At the same time, the interdependence among state economies implies that policies in one jurisdiction will have spillover effects on other jurisdictions. And, perhaps most important, fiscal decentralization inevitably leads to differences in the fiscal capacity of the states, which provides an incentive for individuals and firms to locate inefficiently in fiscally advantaged states. These conflicting effects of decentralization on efficiency mean that the overall effect of a federation's fiscal arrangements is difficult to assess. The best we can do is to highlight the sorts of effects that various features of the federation have on efficiency, and where it might be possible to achieve efficiency improvements. Even that will not be conclusive because the sorts of measures that might improve efficiency might also exacerbate some of the other criteria discussed in this section. We proceed on a country-by-country consideration of efficiency.

The German case is an interesting one to start with because in it uniformity is the norm. The Länder are obliged to provide a common set of important public services as legislated by the federal government. As well, most of the financing of these public services comes from a common national tax system. And, the funding arrangements ensure that all Länder are able to provide comparable levels of public services at comparable tax rates to their citizens. Such a high degree of uniformity has two main efficiency advantages. First, efficiency in the internal common market is virtually guaranteed because economic activity faces common government policies no matter where they locate, and the possibility of individual Länder to use the fiscal system to attract businesses from their neighbours is minimal. Second, the high degree of equalization eliminates the possibility of fiscally induced migration since all Länder provide a uniform set of public services at basically the same tax rates (that is, so-called net fiscal benefits are largely eliminated).

While these are significant advantages of the fiscally centralized German system, they have disadvantages as well. Because the Länder act as administrators of major spending programs that are legislated federally, they have relatively little discretion to choose programs to suit their own needs. By the same token, given that they rely heavily on revenues raised nationally and distributed through revenue sharing, they do not have strong incentives for providing public services in the least cost way, for searching for better methods of delivery, or for enhancing the quality of services. Nor is inter- Länder competition available to provide a spur to efficiency In other words, many of the efficiency advantages of decentralization are forgone by the uniformity of fiscal policies across Länder.

The Canadian case achieves a number of the efficiency advantages of the German one while avoiding the major disadvantages, so receives relatively high marks on efficiency. The system of Equalization ensures that provinces have roughly comparable revenue-raising capacities.

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non-economic objectives such as non-discrimination and employment equity. Judging the contribution of government institutions and programs to equity is a difficult task. The extent to which equity should be pursued is a matter of value judgment on which reasonable persons can disagree. As well, the ability of governments to address equity issues is disputable, given the difficulty in knowing either the importance of the equity-efficiency trade-offs involved or the appropriate design of policy to meet given objectives.

In a federal setting, these problems are even more profound. As mentioned, important social programs that deliver equity are often decentralized to the state level of government. The extent to which (and the manner in which) the federal government ought to influence the states in the design of these programs is an issue. While decentralization is intended to improve the efficiency of program delivery, there is also the possibility that the existence of inter-state competition will diminish the redistributive content of social programs. There might also be serious disagreement about the role of national versus state-level equity objectives in guiding policy. To what extent should state-level preferences for redistribution influence policy rather than federal preferences, both expressed through political consensus? Thus, one must be cautious about drawing conclusions about the success or otherwise of achieving equity objectives in different federal systems.

One perspective that can be taken is to abstract from the major value judgment about the optimal degree of redistributive equity, and ask how well a given federal system is able to deliver whatever consensus level might be agreed on politically. In fact, this is the perspective taken in much of the fiscal federalism literature, and many of the normative judgments about the achievement of equity in a federal system are not dependent on the degree of redistribution. Instead, the emphasis is on horizontal equity issues, that is, the extent to which common levels of equity are achieved across the federation. Even this only partially resolves the problem, for it begs the question as to whether common levels of equity ought to be achieved across the nation. Should otherwise identical households residing in various states, provinces or Länder be treated comparably by the public sector? Should common levels of vertical equity, of equality of opportunity, of social insurance, prevail? These must remain open questions.

The social policies of the three federations achieve quite different degrees of redistributive equity. The progressivity of their tax-transfer systems differ; the extent of coverage under social insurance programs like unemployment insurance, health insurance and disability insurance differ; the extent of equality of opportunity achieved by their education systems differ. We can take these differences as given, yet ask to what extent the federal systems facilitate the achievement of the respective equity goals. Once again, the three federations differ considerably in their approach to equity.

In the case of Germany, common standards of equity apply across the federation. Social programs are highly uniform because of the fact that they are nationally legislated. Similarly, a common national system of income and sales taxation means that the extent of vertical redistribution is the same in all jurisdictions. Finally, the system of equalization roughly ensures that full horizontal equity applies nationwide. Indeed, it is a constitutional principle that that should be the case. On the other hand, this high degree of uniformity implies that there is little scope for individual Länder to affect their own equity objectives, should those differ from the national consensus. The most that they can do is to influence national

from shares of federal taxes, the size of which
they have some influence over through the

led to demands from Länder for a reform of the fiscal transfer system including the level of equalization payments and the manner in which joint tasks' are funded.

Despite these areas of contention, the fact remains that the Federal Republic of Germany has proven itself remarkably adaptable over its first fifty years. Adjustments in the federal fiscal balance have been accomplished by partial revisions to the constitution, by intergovernment negotiation and agreement, and by judicial review.

Some critics, such as Fritz Scharpf, have criticized the interlocked intergovernmental decision-making processes for being an impediment to adaptation.[3] In such an institutional culture which puts an emphasis upon consensus, the result may be indefinite postponement of difficult policy choices and hence a tendency to inertia in dealing with problems. While there is some evidence for this, overall the financial arrangements within the German federal system have, nevertheless, proved remarkably flexible to date. Nevertheless, enduring disparities in economic development of Länder since reunification and the consequent need for high levels of transfers are currently straining severely the inter-Länder solidarity on which the system depends.

Coordination and the degree of federal government influence upon state and local governments

It is clear from the review of these three federations that the financial arrangements in each involve a high degree of interdependence between the orders of government within them. This has arisen from two factors. One has been the inevitability within federations of overlaps and interdependence in the exercise by their executive branches relating especially to financial relations. These processes have come to be known by the label ‘executive federalism’. In Canada, unlike the United States, these direct intergovernmental relations have been confined to the federal and provincial governments, with all the financial transfers to local governments coming under the sole control of the provincial governments.

The main areas in which the involvement of combination of shared rule through a common government and of genuine self-rule of the constituent units, the overriding rule of constitutional law, respect and tolerance for territorial minorities, and the need for compromise to achieve democratic consensus – are common to the political cultures of all three federations, there are also significant differences in their political cultures and these have shaped