

Federalism: Fiscal Issues

Galing Pook Fair 2016: Adapt and Innovate
11 November 2016

Rosario G. Manasan
Senior Research Fellow



Philippine Institute for Development Studies
Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

Overview of presentation

- ❑ Why adopt federal form of government? Benefits from federal form of government

- ❑ Decision points in designing fiscal aspect of federal form of govt
 - Scope of functions assigned to each level of govt
 - Variation in how powers/ functions/ competencies are distributed
 - Allocation of taxing powers and financial resources
 - Natural resource ownership and management
 - Intergovernmental transfers, equalization
 - Symmetry/ asymmetry in allocation of powers
 - Place of LGUs
 - Delineation of territorial boundaries
 - Role/ character of second chambers
 - Parliamentary vs presidential form of govt

- ❑ Conclusion

Benefits of shift to federal form of govt

- ❑ Increased efficiency → increased welfare
 - resulting from congruence of the geographic area where benefits of public service are confined and the geographical boundaries of level of govt operating and financing public service (i.e, fiscal equivalence)
 - federal form brings govt closer to the people, thereby allowing lower level govts to respond to the different needs and preferences of their local constituencies

- ❑ Increased efficiency – resulting from interjurisdictional competition (premised on population having the ability to “vote with their feet”)

- ❑ Increased citizen participation in local governance → greater accountability

- ❑ Federal form accommodates regional diversity

Benefits of shift to federal form of govt

- ❑ First 3 of these potential gains - largely a function of degree of decentralization

- ❑ → said gains may be secured with greater decentralization/ devolution with or without shift to the federal form of govt

- ❑ Note that countries with federal form of govt are not necessarily more decentralized than those with unitary form of govt
 - Germany more centralized than Canada
 - Malaysia (federal) more centralized than Philippines (unitary)

Distinction between unitary & federal form of government

- ❑ Multi-tiered unitary form of government – central government (CG) is ultimately supreme and subnational or local government units exercise only the powers that the CG chooses to delegate to them
 - CG can **unilaterally withdraw powers** delegated to subnational units
- ❑ Federal form of government – sovereignty is shared and powers are divided between two levels of government (i.e., constituent units and federal government) each of which deal directly with the citizenry in the exercise of those power
 - **Division of power** between federal government (FG) and constituent units (state/regional govt) is **written/ guaranteed in constitution**
 - FG has authority to decide on action for at least one function covering whole territory entirely on its own while constituent units have authority to decide on action for at least one function relating to their own territory independently of the center and each other
 - Neither level of government can **unilaterally** alter the powers of the other

Distinction between unitary & federal form of government

- ❑ Precisely because division of powers between FG and state governments are written in constitution , design of federal form of government should be subject of careful study
 - Otherwise, bad design gets enshrined in constitution, making it difficult to correct

Character of specific federal form of government determined by:

1. Scope of functions assigned to each level of govt
2. Variations in how powers/ functions/ competencies are distributed
3. Allocation of taxing powers and financial resources
4. Natural resource ownership and management
5. Intergovernmental transfers, equalization
6. Symmetry/ asymmetry in allocation of powers
7. Place of LGUs
8. Delineation of territorial boundary of states
9. Role/ character of second chambers
10. Parliamentary vs presidential form of govt

Scope of functions/ competencies assigned to each level of govt

- Guiding principles in assigning functions/ competencies
 - Responsibility for the provision of any given public service should be assigned to the level of government that has jurisdiction over the geographic area that fully captures the benefit from said public service (i.e., benefit area)
 - Efficiency in the provision of public services is also enhanced if the consumption benefits are linked to costs of provision via fees, service charges, or local taxes

- Federal government - assigned functions/ competencies whose benefits are national in scope
 - State governments - assigned functions whose benefits are of a more local nature

Scope of functions/ competencies assigned to each level of govt

- ❑ In most federations, foreign affairs, national defense, macroeconomic/ monetary policy, and inter-regional transportation are assigned to the federal govt
- ❑ Social services (including education, health services), local infrastructure, and maintenance of peace and order are assigned to state govts
- ❑ Agriculture, environment and natural resources and some areas of social services are shared

Variations in the distribution of functions/competencies

- ✓ Federal constitutions specify
 - list of **exclusive powers**, and **concurrent/ shared powers**
 - Which level of govt is assigned **residual powers**

- Length of list of exclusive powers of federal govt, exclusive powers of state govts, and concurrent powers of federal and state govts
 - Limited list of exclusive federal powers, with most federal powers being identified as shared or concurrent powers (e.g., USA, Australia)
 - Extensive list of both exclusive and shared powers specified (e.g., Austria, Germany, Malaysia, India)

Variations in the distribution of powers/ functions/ competencies

- ❑ Length of list of concurrent powers
 - Extensive areas of concurrent powers (e.g., US, Australia, Germany, India and Malaysia)
- ✓ Assignment of residual powers (i.e., powers not explicitly assigned in constitution to federal or state govt)
 - Influenced by the way in which federation is formed
 - When federation is formed by aggregation of previously separate units (e.g., US, Switzerland, Australia, Austria, Germany, Malaya before it became Malaysia), residual powers typically assigned to the constituent units
 - when federation is formed by devolution from a more centralized unitary state, residual powers typically assigned to federal government (e.g., Canada, India, Belgium)

Variations in the distribution of powers/ functions/ competencies

- Advantages of assigning powers exclusively to one level of govt
 - reinforces the autonomy of that government
 - makes it clear which level of government is accountable for policy in the area

Variations in the distribution of powers/ functions/ competencies

□ Advantages of concurrency

- provides an element of flexibility in the distribution of powers, enabling the federal government to complement state govt provision of services when needed
- federal governments may use concurrent jurisdiction to legislate federation-wide standards while giving constituent units room to legislate the details and to deliver the services in a manner that is sensitive to local circumstances

Variations in the distribution of powers/ functions/ competencies

- ✓ Significance of residual powers relates to the number and comprehensiveness of enumerated list of legislative powers.
 - assignment of significant residual power to the states intended to underline their autonomy and the limited nature of powers assigned to the federal government

Allocation of taxing powers

- ❑ Allocation of financial resources to each level of govt important for two reasons:
 - these resources enable or constrain governments in the exercise of their constitutionally assigned legislative and executive responsibilities
 - taxing powers and expenditure are themselves important instruments for affecting and regulating the economy

Allocation of taxing powers

- ❑ Guiding principles in assignment of taxing powers
 - Each level of government must have enough "own" revenues (whose level they control by setting tax rates, by defining tax base or by collecting/ enforcing) to finance the services they provide
 - Taxes ideally assigned to federal governments
 - taxes that can be exported to residents of other jurisdictions or which interfere with the interjurisdictional trade
 - taxes on mobile factors of production
 - Progressive or redistributive taxes like personal income tax
 - Taxes whose base are highly concentrated because of horizontal inequalities
 - Taxes ideally assigned to lower level governments
 - Taxes on immobile factors
 - User charges

Allocation of taxing powers

- ❑ Most federations specify in their constitutions the revenue raising powers of the 2 levels of govt
 - Customs and excise taxes are almost always assigned to federal govt in the interests of ensuring an effective internal custom and economic union
 - Corporate income taxes are most often assigned to federal govt because corporations in earning their income tend to cross state boundaries and location of their headquarters does not necessarily reflect the geographical sources of their income
 - ✓ In some federations, this tax may be under concurrent jurisdiction of federal govt and state govts
 - Personal income taxes may be more directly attributed to the location of residence and is often an area that is shared by both federal and regional governments but in some areas it has been exclusively federal (e.g., Austria, India).
 - Sales/ consumption taxes are areas which in most federations both federal and state govts share.

Allocation of taxing powers

- ❑ In nearly all federations, majority of major revenue sources have been assigned to the federal govt
 - Concentration of resources in the federal government is deemed necessary if it is to perform the redistributive role usually expected of it
 - This is deemed necessary from perspective of maintaining economic stability and development

Natural resource ownership and management

- Natural resources typically distributed unevenly across the country
 - Who owns the natural resource? FG or SG
 - Who controls the natural resource? FG or SG
 - ownership/ control of NR determines who gets revenue from NR exploitation → affects size of risks of uneven economic development which strains stability of federation
 - Ownership and control also affects rate of exploration/ extraction → environmental sustainability

Intergovernmental transfers and equalization

- ❑ Vertical and horizontal imbalances prevalent in most federations
 - ✓ Vertical fiscal gap – due to concentration of financial resources in federal govt and concentration of expensive expenditure responsibilities to state govts
 - ✓ Horizontal fiscal gap – due to varying fiscal capacity of state govts as a result of variation in level of economic development, degree of urbanization, natural resource endowment, etc. and variation in expenditure needs as due to socio-demographic characteristics of their populations, population dispersion, economies of scale in the provision of certain services, and physical environment

Intergovernmental transfers and equalization

- Role of intergovernmental transfers
 - to correct vertical imbalances by transfers in the form of tax-shares, unconditional block grants or specific purpose conditional grants (which tend to reduce autonomy of states)
 - to remove horizontal imbalances to assist poorer units

- Design of good intergovernmental transfers – key to addressing risks of greater disparities under more decentralized form of government

Intergovernmental transfers and equalization

□ Alternative equalization arrangements

- Non equalization scheme (e.g., USA)
- Federal transfers
 - ✓ Formula-based based on some measure of fiscal capacity (e.g., Switzerland, Canada, Belgium), expenditure need (e.g., Australia administered by Commonwealth Grants Commission), or combination of indicators of revenue capacity and expenditure need (e.g., Spain)
 - ✓ Based on recommendations of independent Finance Commission (India), National Finance Council (Malaysia)
- Combination of inter-state transfers and federal transfers (e.g., Germany) – formula-based distribution

Intergovernmental transfers and equalization

- ❑ Only some federations such as Germany, Canada, and Switzerland have written an obligation to fiscal equalization in their constitutions
 - Constitutional obligation not an automatic indication of the degree to which equalization is actually practiced
 - ✓ Australia has one of the most comprehensive systems of equalization, despite absence of constitutional obligation there

Place of LGUs

- Is state government simply an additional layer of govt – (i.e., maintain same 4 levels of LGUs that currently exist)?
- Which level of govt has the power to assign functions and taxing powers of LGUs?

Delineation of territorial boundary of states

- How many states? – 4, 10, 18, 25, 81
- How do you slice up the Philippines?

Character of specific federal form of government determined by:

1. Scope of functions assigned to each level of govt
 2. Variations in how powers/ functions/ competencies are distributed
 3. Allocation of financial resources
 4. Natural resource ownership and management
 5. Intergovernmental transfers, equalization
 6. Symmetry/ asymmetry in allocation of powers
 7. Place of LGUs
 8. Delineation of territorial boundary of states
 9. Role/ character of second chambers
 10. Parliamentary vs presidential form of govt
- ➔ An almost indeterminate number of options in design of federal form of government
- ➔ admittedly some of these options are not as interesting/ relevant as others

To sum up: design of fiscal arrangements of federation is complex ...

- ❑ Design of fiscal arrangement is a complex exercise requiring serious study
 - Need empirical data that will allow on to simulate likely implications of alternative models of federal form of government relative to the internal consistency of the fiscal aspects of design
 - Ongoing research at the Philippine Institute of Development Studies (PIDS)

To sum up: design of fiscal arrangements of federation is complex ...

- ❑ Political structures as well as electoral systems affect functioning of alternative fiscal design options – need for multi-disciplinary approach



Philippine Institute for
Development Studies

*Surian sa mga Pag-aaral Pangkaunlaran
ng Pilipinas*

Service
through
policy
research

Thank you

WEBSITE: www.pids.gov.ph

FACEBOOK: facebook.com/PIDS.PH

TWITTER: [twitter.com/PIDS PH](https://twitter.com/PIDS_PH)

EMAIL: youreemail@mail.pids.gov.ph

Thank You!
