



## Fiscal Decentralization

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**T**he exploration of fiscal decentralization starts with three fundamental issues. First, it is assumed that subnational levels of government will be major providers of public services. Second, in an open, complexly interrelated and mobile society, there are important spillovers of costs and benefits from the fiscal operations of particular subcentral units.

Thus, a national interest in the performance of local public services requires a set of institutional checks and balances combining the “choice model” and the “agency model” in the action of decentralized units. Third, the distribution of revenue-raising capacities among states (regional) and local units is often uneven, which necessitates some kind of compensation between the levels of government (vertical) or among themselves (horizontal). Consequently, policy-oriented prescriptions must address four

issues: the distribution of competencies and revenues between governments, equalization and budget responsibility.



## **1 Public expenditures**

The “optimal” division of competencies between the three levels of government is of course never definitive and the question of which tasks should be assigned to which level of government has never been finally answered. It may be explained in terms of subsidiarity and centralization. Yet, decentralization of public expenditures does not imply decentralization of public competencies.

### **1.1. Subsidiarity**

The fundamental principle in the distribution of tasks between the various levels of government is subsidiarity. In fiscal federalism, this is a “bottom-up” policy: competencies are vested at the local level and can be transferred to the regional (State) level only insofar that the lower level is no longer in a position to provide a service “efficiently”. Usually, a transfer of competence from the sub-national units to the federal government should be passed by constitutional law.

Opinions diverge about which “efficiency” criteria are appropriate for the organization (and the reorganization) of functions within the three layers of government. Economies of scale, homogeneity of preferences, spillovers and congestion costs, are generally accepted as efficiency criteria. The criteria of financial capacity and budgetary resources are disputed by poorer governments which argue that they ought to receive more equalization payments. In Switzerland, for example, the resulting allocation of expenditure functions and of policy-making within the Communes, the Cantons and the Confederation does not obey

simple rules that ensure neatness, tidiness and smoothness. Instead, elaborate institutional procedures limit horizontal and vertical coercion, which has led to the budgets of the different levels of government becoming increasingly entangled.<sup>1</sup>

The question of subsidiarity does not arise in decentralization (as distinct from fiscal federalism). Although the criteria for (de)centralization are essentially the same in this case, the central government holds *sui generis* all competencies. Taking into account allocative efficiency and constitutional distributive equality, it has to decide (1) those tasks which should be devolved upon lower level units and (2) to which extent local performances should be standardized (the “agency model” versus the “choice model”).

## 1.2. Centralization

In fiscal federalism, centralization is seen basically as a negative policy measure in which a higher level of government takes over public local services. Sound arguments are needed, such as internalization of spillover or the necessity to level out unacceptable differences in the provision of certain public services (environment and health are good examples). The concept of centralization is difficult to measure: it is not simply the respective shares of public expenditures at the three levels, local, regional, central. Centralization also creeps in the ways in which subcentral governments perform, which can be described as “agency” (produce what you are told to produce) or “choice” models (offer what corresponds to your local preferences). A combination of both is probably closer to reality.

In Switzerland, there is continual dispute in the Cantons about the effective extent of autonomy in local public expenditures, first and foremost because no single measure of independence is appropriate so that the Cantons and the Communes have divergent

claims. A second difficulty in measuring a decentralization concept is that the fiscal-financial relations between local and cantonal governments vary from one Canton to another according to the 26 individual cantonal Constitutions. Yet, the general trend in all the Cantons has been that (1) under the constraint of a current balanced budget, the “choice” role of the Communes has made more and more way for the “agency” role and (2) the change in the relative weight of the two roles is inversely related to the population size of the Communes: larger municipalities have been better able to maintain a higher proportion of the “choice” role. At the federal-cantonal level, centralization has been forcing its way both in environmental, health and social policies.



## **2 Public revenues**

In decentralization, taxation is the most important single source of revenue: it determines the volume of proper financial resources which can be used by the member States and municipalities themselves away from financial transfers, thus the extent of their financial independence. Yet, the question of fiscal sovereignty rises at the same time those of tax coordination and harmonization.

### **2.1. Fiscal sovereignty**

The concept of fiscal sovereignty concerns both the ability of a government to decide which taxes it should raise, that is: the design of the tax and the direct access to fiscal sources. The extent of fiscal sovereignty can be measured in the following sequences of choice:

- a) taxes versus user charges;
- b) the object of taxation;
- c) the definition of the taxpaying unit and
- d) of the tax bases;

- e) the tax rate schedules including deductions and exemptions;
- f) the annual coefficient of taxation for purpose of balancing the budget;
- g) tax collection;
- h) the rules over tax dispute.

*Full fiscal sovereignty* comprises letters a) to h) in the list. *Partial fiscal sovereignty* exists where a government can decide a) and some but not all items listed between b) and e). *Tax flexibility* means that a government can at least decide on the coefficient of taxation (f) but has no access to defining the kind of taxes it can raise. *Compulsory taxation* qualifies taxation where a government has no choice over a) to f) and must raise taxes (or user-charges) according to the regulations set by a higher level of government.

*Tax sharing*, certainly one of the most complex issues in fiscal federalism and decentralization, offers two solutions. 1) The rules of taxation are exclusively set at the centre, and the governmental units share vertically and horizontally the proceeds of taxation. 2) Each government unit is free to tax the same base (for example, individual income, corporate profit), in which case the tax base is shared. The first solution solves the allocative problems of harmonization and tax competition; but leaves open the intricate questions of the apportionment of tax revenues and financial independence. The second solution favours independence, but leaves open the other questions.

In practice, some form of compromise is possible which partly limits the inconveniences of both solutions. In Switzerland, many Cantons regulate the financial room for manoeuvre of local governments by establishing budget principles, a uniform accounting model, taxation rules and debt limits. Local governments have a limited fiscal sovereignty in that they can choose between taxation and user-charges where appropriate. They are however tied to the tax system of their Canton. For many taxes, local governments

have only fiscal flexibility: they must apply cantonal laws and limit their decision to the annual coefficients of taxation in percentage of the Canton's taxes. If a Commune chooses to raise user-charges, it can also define the main components (items b) to f) above), however within the limits set by case law of the Federal Court of Justice.

Whichever its design, fiscal sovereignty should enable each level of government and each government within a level to finance its own budget independently and according to its own criteria. This includes the capacity of financing public services in response to the preferences of their own electorate (the "choice" model) as well as those expenses which correspond to minimum standard (merit) goods and services set by a higher level of government (the "agency" model), net of conditional grants. Financial dependence on grants-in-aid should be limited. General grants should be preferred to specific ones.

## **2.2. Direct access to many revenue sources**

When decentralized finance should not depend on transfer payments from higher levels of government, an important characteristic of fiscal sovereignty is direct access to many revenue sources. Direct access to a number of diversified fiscal or non-fiscal sources secures regular annual receipts compared with a situation where a government can rely on one tax only. It enables a better distribution of the fiscal burden and avoids exasperating particular categories of taxpayers in case of higher fiscal needs.

## **2.3. Tax coordination and harmonization**

An extensive freedom in shaping the tax system would enable each government level and each government unit within the same level to determine the tax price level for a specific bundle of pub-

lic goods and services within its own jurisdiction. In the theory of fiscal federalism, these government units may use their tax systems to compete for firms and individuals and attract them within their boundaries. Yet, fiscal sovereignty is not unlimited. Allocative inefficiencies would arise if decentralized jurisdictions were to adopt widely varying forms of taxation. Each individual and business firm would have an incentive to move in that jurisdiction whose particular tax system gives him the best tax break. Under a non-neutral tax system, the location of individuals and productive capital might be guided by particular pecuniary advantages afforded under varying kinds of taxes irrespective of public provision. But tax competition between jurisdictions has no efficiency properties comparable to market pure competition; it is rather in the nature of oligopoly.<sup>2</sup> Furthermore, it is not possible for subcentral jurisdictions to decide a sharp redistributive policy through taxation. Acceptance of this policy will not only vary on ethical grounds, but also depend on the mobility of individuals and business enterprises, that is: their capacity to avoid, through voting-with-their-feet, the incidence of high redistributive taxation. Minimizing these distortions calls for a substantial degree of coordination and tax harmonization, that is for a cooperative effort to secure a system of taxation that minimizes excess burden and yields a desirable pattern of incidence.<sup>3</sup>

### 2.3.1. Tax coordination

Tax coordination is designed to distribute taxation competencies among the governments. *Vertical coordination* concerns the assignment of tax authority to the various levels of government. It should be clear which jurisdiction is entitled to tax which items from which taxpayer. Attention must be given to the geographical distribution of tax yield. A good tax under subcentral authorities should have a tax base that is widely and evenly distributed throughout the country. *Horizontal coordination* serves to appor-

tion tax competencies and the tax yields among the jurisdictions at the same level where the tax base has its origin in several jurisdictions.<sup>4</sup>

### 2.3.2. Tax harmonization

Different jurisdictions at the same level of government will generally find it desirable to adopt at least roughly similar systems of taxation. There are three reasons; two of them pertain to the criteria of fiscal neutrality. First, where the interjurisdictional mobility of certain economic units is of a high degree, taxation of these units, if it is employed, should be of similar form across the jurisdictions. Second, the rates at which these units are taxed locally should not vary greatly among the jurisdictions except to the extent that differences in rates correspond to differences in benefits to these units from the services provided. In this way allocative distortions in both resource use and incidence resulting from the tax system itself can be kept to a minimum consistent with other fiscal objectives of the individual jurisdictions (Oates, 1972, p. 147). Note that when used in every jurisdiction for development policies, tax breaks do not really give a net advantage to one region over another, which results in a typical prisoner's dilemma situation. Third, harmonization simplifies the tax perceptibility and minimizes the administration and implementation costs.

*Formal tax harmonization* concerns any attempt to bring the various tax systems decided independently by each jurisdiction towards a uniform system and towards a unique definition of the tax bases (letters b) to d) in the sequence of choice in section 2.1. above). As a result, information and transaction costs are reduced for those who pay taxes in several jurisdictions; administrative and implementation costs are reduced for the tax departments, litigious cases decrease. *Real tax harmonization* is



obtained when fiscal allowances, the amounts of deductions and exemptions and the tax rate schedules are identical in all jurisdictions. Complete real harmonization, while it solves the question of allocative neutrality across jurisdictions and guarantees nation-wide equity for the taxpayers, would run against the ability of individual jurisdictions to adjust their own tax level for financing their budget according to local preferences. Thus a trade-off between allocative neutrality, equity, fiscal independence and own preferences for the provision of local public services, is unavoidable. There is no ready-made policy prescription for solving this problem.

### **2.3.3. Fiscal burden in the jurisdictions**

It should be clear, at this stage, that tax harmonization does not imply perfect uniformity in the rates and forms of taxation across the jurisdictions. The consequences of subcentral tax autonomy is that the tax burden can differ substantially from one jurisdiction to another according to their view about the tax system, the combination of taxation and user-charges, and the progressiveness of the rate schedules. Additional reasons are that individual governments may provide varying levels of consumption of public services and have significant differences in the unit cost of providing public services at comparable minimum standards. They can have also significant differences in the levels of income and wealth or the regional distribution of national income. It is in the nature of fiscal federalism that the use of nonbenefit taxation by decentralized levels of government, cost differences in public provision and wide variations in national income per capita introduce disparities in the tax liabilities and, with it, some inefficiencies and inequalities. This is to be expected and can be accepted as far as "efficiency" is not only "economic" but refers to the general capacity of federal institutions to strengthen the system of checks and balances (as, for example against autonomy;

Wiseman, 1990, p. 120) and as far as those disparities are not too blunt and remain within politically acceptable limits. But significantly higher tax rates (and maybe inferior public services) in some poorer jurisdictions may lead to the need for substantial equalization payments.



### 3 Fiscal equalization

Differences between the constituent members of a federation, in terms of size, geography, population and economic potential may be so great that, without equalization measures, fiscal federalism would perform under regional disparities which would be intolerable. Therefore, the federal government might have to intervene to correct the primary distribution of resources between the members. Three courses of policy measures are usually possible: fiscal equalization, agricultural aid policy (while rural areas are generally less developed than urban areas) and regional policy (for example, in Switzerland: assistance to mountain areas, with the purpose of strengthening structurally weak regions).

An equalization target must be first decided, which inevitably raises the difficult question of “who decides”. Three models are at hand.

- (1) Absolute equalization, with the objective that each taxpayer wherever he lives should benefit from the same services and pay identical taxes. It is not widely proposed because, besides an evidently high cost, this target also has negative allocation and demobilizing effects.
- (2) Relative and partial equalization, which sets out nationwide minimum standards for the provision of public services and a nationwide admissible fiscal burden (for example, – and + 10 percent). In this case, jurisdictions placed below the service standard and/or above admissible fiscal burden would benefit from equalizing transfers to fill (partly) the gap. Equalization

could be either vertical (paid from the centre to the benefit of the poorer members) or horizontal (richer members finance an equalizing fund to the benefit of poorer members).

- (3) Minimal equalization is practised in Switzerland. There are no constitutional provisions and no claims from the cantonal governments or the citizenry that equalization measures should compensate entirely for the differences between the Cantons in order to obtain identical economic or fiscal conditions. The pragmatic objective is to render regional disparities politically acceptable so that remaining differences do not endanger the cohesion of the Confederation.

Revenue equalization payments should take the form of general revenue-sharing or unspecified grants. Specific equalization grants should only serve when cost differences in the provision of decentralized public service are to be taken into consideration.



## 4 Budget responsibility and discipline

Budget responsibility and discipline is discussed here in the context of Switzerland. But for this purpose, Switzerland could serve as an observatory for other countries. The federal Constitution does not impose budget principles on the Cantons. There is no federal constraint on deficit financing, except that all tiers of government have no access to borrowing from the Central Bank. The main *external* limitation on budgetary sovereignty of the Cantons is intrinsically competition with other Cantons: If a Canton pursues an inefficient fiscal policy with a poor cost-benefit relationship, individuals and firms move to another Canton ("exit", in Hirschman's terminology); or voters use initiatives and referenda in order to obtain a modification of the "public goods / tax" mix in comparison to that of other Cantons ("voice"). Competition is even more important at the local level, particularly between Communes in the same urban agglomeration.

The fairly extensive autonomy of cantonal and local governments for their finance is not unlimited. There are also *internal* limitations in cantonal Constitutions or legislations. Two rules are generally respected, at the level of the Cantons in their own financial laws, and in the Communes under cantonal supervision.<sup>5</sup> The first rule is concerned with the requirement of a more or less balanced budget for providing goods and services. Due to financial regulation, for most local and cantonal governments it is quite difficult to run or to accumulate deficits in their (current) budgets. If a large budget deficit occurs, taxation would have to be increased. If a local authority would not follow this rule, the cantonal government might decide to raise the annual coefficient of taxation in place of the Commune. The second rule concerns borrowing and debt limitation. Public debt is allowed in many Cantons only for financing capital expenditures, and if the local and/or cantonal government has the financial capacity to pay the interest and amortization of the debt out of its current budget. The rates of amortization are fixed according to the kind of investment and its possible length of use (pay-as-you-use finance). This of course requires a distinction between the current budget, which must be balanced, and the capital budget, which can be financed by borrowing.

These two quite strict requirements express the principle of *accountability or budgetary responsibility*. They must be viewed in the perspective of financial autonomy and access to own revenue sources as described above. On the one hand, cantonal and local governments have a fairly large (though diminishing) amount of autonomy to decide and offer public services, and direct access to taxation. On the other hand, it is expected that these governments will act in a responsible way and will finance without excess borrowing what they are asked to produce, either by law ("agency") or in response to their electorate's own demands ("choice"). This is definitely a classical approach to fiscal federalism.<sup>6</sup> Budgetary *discipline* intervenes when such rules are imposed by a higher government level to subordinate jurisdictions.<sup>7</sup>

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- <sup>1</sup> Dafflon, The assignment of function to decentralised government: from theory to practice, in *Environment and Planning C: Government and Policy*, 1992, vol. 10, pp. 283-298, summarizes the normative arguments. Wiseman (*ibid.* 1987, pp. 383-410), *The Political Economy of Fiscal Federalism: a critical appraisal*, and *Principles of Political Economy: an Outline Proposal, Illustrated by Application to Fiscal Federalism, Constitutional Political Economy*, 1990, vol. 1/ 1, pp. 101-124, argues that efficiency criteria must be related to the capability of strengthening political checks and balances through appropriate procedures and not to the tax-and-expenditures outcomes as such.
- <sup>2</sup> Tulkens, *Analyse économique de la concurrence entre juridictions fiscalement souveraines*, in Université de Louvain, Center of Operation Research and Econometric, 1985, Reprint no 676.
- <sup>3</sup> Oates, *Fiscal federalism*, 1972, Harcourt Brace Jovanovich, New York (p. 145).
- <sup>4</sup> Normative issues are discussed in King, *Fiscal Tiers : the Economics of Multi-level Government*, 1984, Allen and Unwin, London, pp. 220 ss. Problems and application to Switzerland are presented in Dafflon, *Fédéralisme, coordination et harmonisation fiscales*, 1986, *Recherches Economiques de Louvain*, 52/1, pp. 3-43.
- <sup>5</sup> Dafflon, The requirement of a balanced local budget: theory and evidence from the Swiss experience, in Pola, France and Levaggi, *Developments in local Government Finance: Theory and Policy*, Edward Elgar, Cheltenham, 1996, pp. 228-250.
- <sup>6</sup> Tollison and Wagner, *Balanced Budgets and Beyond*, in Buchanan, Rowley and Tollison (eds): *Deficits*, 1986, Basil Blackwell, Oxford, pp. 374-390.
- <sup>7</sup> The attribution of the Maastricht convergence criteria about tolerable limits of [deficit < 3 percent GNP] and [debt < 60 percent GNP] will no doubt pertain to this latter.