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19 December 1988

The Distribution of Economic Policy Powers in the Public Finances of Federal Economic and Monetary Unions

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1. Introduction

While the EC's objectives with respect to its market and monetary organisation are clear and radical, this is far from the case regarding public finance. The present paper is, therefore, addressed to the question whether the public finance systems of federations offers us any guidance.

The subject matter is presented under three headings:

- public expenditure
- taxation
- deficits and debt.

public finance responsibilities and powers

In each case the purpose is to identify patterns in the distribution of ~~economic policy~~ powers by level of government, and techniques for the sharing of powers where these might be of possible relevance to the EC.

Information by country, for the United States, Canada, Australia, Germany and Switzerland is given in Annexes.

(public finance aspects of)

The present paper is largely confined to the allocation and stabilization functions of public policy, since the distribution function was treated in an earlier paper in the context of inter-regional transfers ("Regional Balancing Mechanisms in Economic and Monetary Unions", 1 November 1988).

2. Public Expenditure

The general principles regarding the distribution of competences between central and state authorities are normally laid down in the federal constitution. Typically the federal powers are enumerated exhaustively, the residual competences being conferred upon the states. Canada forms an exception to this rule, since there the federation retains residual competences. Presumably the EC will continue to follow the former model.

Very often the distribution of specific competences is not an exclusive matter. Policy competences can be shared in one of two ways: either the policy initiative and general design is a matter for the federation, with execution and control delegated to the states, or the financing of the expenditures associated with the exercise of policy competences is mixed, for instance through specific federal grants. It follows that the level of a government's influence on policies and the relative magnitude of its expenditures do not always match. In addition, of course, regulatory competences do not show up in expenditure (as is well exemplified by the completion of the internal market which does not expand per se the Community budget).

The distribution of competences has in all federations evolved over time, as a result of consitutional reforms, supreme court interpretations of contentious constitutional provisions and changes of emphasis in views on the best vertical assignment of powers. There is no standard federal model. If the total of federal public expenditure is taken as an indicator, Switzerland may be regarded as having the lightest federal structure and Australia the heaviest. The range here is from 1 to 3: 7.7% of GDP accounted for by the direct expenditures of the Swiss federal budget, as against 21% for Australia. In the Swiss case federal public expenditure is also only about one-third of the total for all levels of government.

The width of this range of experiences is already confirmation of an important point when reflecting upon the future EC system: while there are not so many real options or graduations in the design of internal markets or monetary unions, there is a seemingly continuous spectrum of possibilities for public finance.

The summary data in Table 1 uses the terms "gross" and "net" expenditure by level of government. The difference concerns transfers between levels of government, gross expenditure including transfers

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paid to lower levels, net expenditure including only direct payments from public to private sector. The data reveals that federal governments are making transfers of between 3% of GDP (in Switzerland) to 10% of GDP (in Australia) to state and local governments. These transfers consist of either general purpose grants (such as equalisation systems) or specific purpose grants which imply the shared financing of certain public expenditure functions such as education or transport infrastructure. These grant mechanisms are important also as regional balancing mechanisms (as analysed in the earlier paper referred to above).

Many of the core functions of federal governments are indicated in the sectoral breakdown of direct (net) public expenditures in Table 2. These are now briefly reviewed assuming a preference for a highly decentralised system.

policy competences and finance

There are some simple, powerful principles that dictate in theory at what level of government public expenditures should best be located. These are the natural geographic fall-out of the benefits from the public goods in question (thus defense may provide an indivisable public good for several states with respect to a common enemy), the importance of cross-frontier leakages of costs and benefits (thus a highly mobile population will see costly migratory movements where social security or education systems are insufficiently unified), and economies of scale in the production of certain public services (again defense, and some types of research).

In practice, defense and social security are the dominant features of most federal budgets, jointly accounting usually for about half or all federal expenditure.

As regards defense, it may be discussed how far alliance systems can be substitutes for common armies but this interesting topic can hardly be pursued in the present paper.

As regards social security systems, it is to be noted that Switzerland manages with a much smaller federal contribution (1.7% of GDP) than in

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this is not a valid point; one can conceive of social security systems

more solidarity should start with the family

Europe still needs to mount a few spurts on the federal level before it would be wise to shift from interregional solidarity to interpersonal solidarity within the spirit of the Community.

the other cases. For the EC, with full legal freedom of personal mobility but still major cultural and linguistic frontiers, the threat of large migratory movements induced by differences in social security benefits still seems relatively remote for the present 12 Member States (with Turkey the situation could be different). Adequate regional policies and possibly a minimal budget equalisation mechanism (as discussed in the earlier paper) would seem to be more plausible alternative to EC intervention in social security mechanisms for the foreseeable future.

Among the general functions of government, there are federations which decentralise the police and the implementation of justice virtually completely. The cost of federal general services (institutions, bureaucracy) varies widely, with Switzerland managing with 0.3% of GDP as against several times as much in other federations.

Foreign affairs shows a more similar experience as between the federations and generally costs about 0.5% of GDP (this includes development assistance). The EC is evolving in its external representation and development assistance, and could progress further.

Among the economic services of government, it may be noted that several federations (Canada, Switzerland) spend about as much on agriculture as the EC.

Transport, communications, natural resources, energy and education always see substantial federal expenditures, generally totalling 2-3% of GDP of direct expenditures, in addition to financial transfers to lower levels of government. But sub-federal expenditures are much larger.

Federal public expenditures may be significant on housing, culture and the environment. On the other hand some federations find it possible to decentralize these expenditures wholly or very largely, and the EC could presumably follow this model.

Service of the federal public debt costs 2-3% of GDP in the countries studied, which is irrelevant to the EC for the foreseeable future.

Let us summarise the overall inference - i.e. the extent of public expenditure functions in federal budgets that one might expect to see migrate upwards into the EC budget for reasons of efficiency of the allocation function of public finance. If one leaves defense out of the argument, and if a minimum centralisation of public expenditure functions for allocative policies is desired (note, this excludes the redistribution issue discussed in the earlier paper), then the conclusion seems to be that the size of the EC budget could well remain quite small, perhaps approaching 2% of GDP. We return, however, to the stabilization and distribution functions at the end of the paper.

3. Taxation

The distribution of fiscal powers in federal systems may be analysed in terms of the following four categories, presented in descending order of autonomy for the levels of government concerned (corresponding data are given in Table 2):

- Exclusive taxes: The federal state level of government enjoys full fiscal autonomy, as well as being the only government allowed to tax certain transactions or sources of income. A prominent example is the American general sales tax, yielding about 30% of states' total fiscal revenues. For the EC, customs duties are an example.

- Competing taxes: Two different layers of government levy each in a autonomous way a tax on the same transaction or source of income. There is thus an uncoordinated overlap of fiscal competences. The federation and individual states determine their own definition of the taxable base and their own rates. While giving room for political independence, competing tax systems may give rise to undesirable regional differences in fiscal pressure, and are complex and costly to implement for government, firms and individuals. Revenues from competing taxes are very important in Switzerland where they constitute more than 70% of cantonal fiscal income. The EC has no such examples.

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- Sub-federal surcharges: Under this regime, the states can introduce a supplementary levy on the tax imposed by the federation. In contrast to the competing taxes, the system of surcharges ensures the uniformity of tax legislation across the federation. The sub-federal competence is confined to fixing its surcharge. Aside from the transparency associated with the legal uniformity, the system of surcharges posseses the advantage of cheap collection as the federal authorities can also act as the agent for the states. A notable example is the Canadian personal income tax, with provincial surcharges payable on the federal tax. The EC, again, has no such examples at present.

- Shared taxes: According to this system, the proceeds of taxes levied and collected by the federation are shared with the states according to distribution keys. The tax base and rates are identical in the entire federation. The inter-state distribution key may reflect exclusively the territoriality principle but it may also serve as an instrument of interstate redistribution of public finance. The German Länder's fiscal revenue is composed of shared taxes. Hence, their fiscal autonomy is essentially non-existent. For the EC, the VAT system is an example of shared taxes.

Table 3 provides a picture of the relative share of different levels of government in total tax revenues. The federal share is clearly much larger than for expenditures. Whereas in terms of expenditures, the federal, state and local governments often possess roughly equal shares, the federations receive as a general rule more than half of fiscal proceeds, with the exception of Switzerland where the shares are nearly equal. This discrepancy is balanced by federal grants to lower levels of government. Besides considerations of interregional fiscal equity, such federal grants are justified by efficiency arguments (notably lower costs of tax collection and the need to compensate for the cross-frontier leakage of the benefits of some kinds of public expenditure).

The main efficiency reason for transferring fiscal competences to a higher level of government arises when the incidence of the tax becomes very widely diffused across frontiers, and difficult to identify in terms of residence in geographically smaller

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jurisdictions. This kind of effect is most likely to emerge in the EC in the case of the corporate income tax, as corporate structures become more integrated across national frontiers.

Federal taxes, notably income taxes and social security financing, typically fulfill important inter-regional redistribution and macro-economic stabilisation functions. If the EC budget and own tax resources remain small, it will still be necessary to provide for these policy functions in some adequate way, and this issue is returned to in the concluding section.

4. Deficits and debt

The distribution of powers with respect to borrowing and debt is crucial to both the economics and politics of all federations, and notably to the properties of the macroeconomic stabilisation function.

In North America federal budgets exhibit larger amounts and fluctuations in their borrowing and debt than lower levels of government. This is clearly so in the United States where the federal deficit has ranged between 2 and 5% of GDP in the present decade, whereas the lower levels of government have experienced surpluses ranging between 1 and 1.7% of GDP. In Canada the federal deficit has ranged between 4 and 6.8% of GDP, whereas the lower levels of government had deficits varying between 0.5 and 1.5% of GDP.

In European federations this picture is much less pronounced. In Germany the debt of the Bund is about the same as that of the Länder and local authorities together, and their fluctuations are not so different. Also in Switzerland the federal borrowing and debt does not dominate that of the Cantons and Communes.

The difference between these two groups of countries seems, however, to relate more to matters of economic philosophy than constitutional provisions.

As regards the federal level of government, the general pattern is one of little or no constitutional restriction on borrowing or debt. In the United States the legislated debt ceilings are revised so regularly as to be of weak effect. In Germany the rule that restricts borrowing to the financing of investment expenditures has not in practice been binding (?). Elsewhere, in Canada, Switzerland and Australia, there are no legal constraints.

As regards state governments, with the exception of Australia, there are no examples of federally imposed restrictions on state borrowing or debt. In the United States, however, state constitutions impose their own constraints, usually in the form of balanced budget values. However the states are free to revise these rules if they wish. The Canadian provinces and Swiss cantons are unrestrained by rules. The German Länder have in several cases adopted rules similar to that outlined above for the federal budget.

The predominant pattern, therefore, is one of constitutional freedom at federal and state level to borrow, constrained mainly by the combination of political preferences and the disciplinary effect of financial markets. Moreover, federal governments are in three cases (United States, Germany, Switzerland) hardly more capable of determining financial market conditions than state governments, given the independence of their central banks.

Nonetheless, uncoordinated competition of different levels of government in their borrowing activities can cause problems, and it is worth noting how far the federations have felt able or inclined to go in the direction of mutual coordination or constraints.

Four models may be identified:

(i) Freedom for all. This is the Canadian and Swiss model, with no or little coordination either between levels of government or between states. The Canadian case has, however, seen problems, with the provinces borrowing heavily abroad, and subjected to financial risks as the central bank changes exchange rate policy. This has led the

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provinces to argue that the federation should borrow externally, leaving them larger access to the domestic market, but no such rules have materialised.

(ii) Asymetrical constitutional constraints. This is the US model, where the states have by custom bound themselves by rules of budget balance, while the federation is free. But there is no coordination between federation and states, or between states.

(iii) Weak federal powers, coordination and concertation. This is seen in some degree in Germany and also the new quasi-federal regime in Belgium (effective 1.1.1989).

The German federal constitution allows the federal government, with majority support of the state representatives in the Bundesrat, to dampen borrowing by the Länder by a limited margin for conjunct~~io~~urnal policy purposes. However, the power has only been used once, in 1973. Concertation takes place between Bund and Länder with respect to timing of bond isues in the Konjunkturrat, and with respect to the medium-term programming of public finance aggregates in the Finanzplanungsrat (produces non-binding opinions). The resulting federal constraints on Länder policies are only mild in effect.

The new Belgian system has interesting features. The sub-national public authorities will basically be free to borrow. However a Council comprising 12 members, half from the regional governments, a quarter from the national government and a quarter from the central bank, will give opinions on desirable borrowing levels of all public authorities. The national government will also be empowered to impose limits on the borrowing of a sub-national public authority for a maximum period of two years. The timing of domestic bond issues is to be controlled by the national government, and external borrowing has to be approved by the national government.

(iv) Strong federal powers. The Australian Loan Council also has interesting features. Its powers were born of an episode in the

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1920's in which serious financial problems arose through competition between federal and state borrowing in domestic and external capital markets. The Loan Council is composed of the six states and federal government which has three votes (and therefore obtains a majority with the support of only two states). The Council determines, by majority, the total of all state borrowing each year, and then distributes it between states by unanimity (failing which, the previous five years' distribution key is used). This, however, has led to problems of excessive rigidity in the evolution of borrowing levels of different states.

Overall, the federations offer examples of several techniques for limiting competition between the borrowing of different public authorities: constitutional rules or limitations, power-sharing, and concertation procedures. No single model is dominant, except that in four out of five cases the independent powers of federation and state remain the main point. Coordination does not score strongly: certainly not for macroeconomic policy purposes, although it is more in evidence for the more technical purpose of scheduling bond issues. In some cases coordination is non-existent, in others it would be better just called national consultation.

5. Some implications for the evolution of the EC system

It may be convenient to expoit again the distinction between the three functions of public policy: allocative efficiency, distributional equity, and macroeconomic stability.

(i) As regards allocation functions, there are well established patterns in the federations whereby certain categories of public expenditure and certain taxes tend to gravitate towards the highest level of government.

Disregarding the special case of defense, criteria of allocation efficiency do not seem to point towards a compelling need for a very large expansion of the EC budget, either on the expenditure or the tax side.

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It is possible to graduate quite finely the degree of centralisation or decentralisation of many types of expenditures or taxes in accordance with efficiency criteria, compromises being possible with the aid of intra-governmental grant mechanisms and techniques for sharing taxes;

The choices can often be made on the level of individual expenditure functions or taxes bases, and is therefore not a dramatic issue for the system as a whole.

(ii) As regards the distribution function, there are some important needs, examined in an earlier paper, which may be combined with allocation functions, such as in the case of expenditure on economic infrastructures and manpower trainings, as already seen in the structural funds of the EC. With monetary union it is to be expected, in particular that the mechanisms of the inter-regional distribution function become more powerful, more automatic and more quickly responsible to the changing economic fortunes of regions, which will add further to the total size of the EC budget.

(iii) As regards the macroeconomic stabilization function, there are three concerns to be met:

- To avoid excessive borrowing and indebtedness of individual states, such as might drive up interest rates in the EC as a whole or threaten financial instability in the countries concerned; this could call for the adoption by Member States of some constitutional limitations on borrowing and/or debt.

- To assure sufficiently powerful automatic contra-cyclical mechanisms in the public finances of the EC economy as a whole; this would have to remain largely the role (~~automatic or discretionary~~) of national budgets, supported however by inter-regional redistribution mechanisms of the EC budget, which to some extent should acquire an automatic property.

Here is a big problem.

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- To avoid contractionary bias in a system dominated by national budgets; it is, of course, a controversial matter for economists and politicians how far this risk is a real one. There are only two solutions: either coordination becomes more effective than so far revealed by any existing federal or international system, or the redistributive mechanisms of the EC budget in effect substitute in some degree for the cross-country effects of more expansionary policies in external constraints.

Annex A

Distribution of competences for public expenditure between federal and lower levels of government in the United States, Canada, Australia, Germany and Switzerland

1. United States

The exclusive federal powers are mentioned in Art. 1(8) of the Constitution including, among others, defence, currency, foreign affairs and trade, as well as the regulation of interstate trade (the Commerce clause). The constitution also stipulates that Congress is entitled to adopt any laws it deems necessary for the proper execution of its competences. The latter provision formed the foundation of the development, soon after the country's creation, of the "implied powers" doctrine which led to very broad functional interpretation of federal competences. For instance, the Commerce clause was taken to mean a strict limitation of States' policy room for manoeuvre in order to preserve the unity of the domestic market and set the stage for the federal regulation of all economic and social policy aspects of interstate relations. As a result of the Welfare clause, also contained in the Constitution, and which provides that Congress possesses a general competence on matters affecting the country's prosperity, the federal competences for social security questions and welfare were greatly enhanced and Congress was given the general responsibility for macroeconomic policy. Recognition of federal competences relative to interpersonal solidarity and economic stabilisation has occurred primarily since the Great Depression of the 1930s. Between 1930 and 1980, the United States became an example of "cooperative" (or shared competence) federalism in that very many collaborative programmes were set up between the federation and the states, preponderantly in social policy domains. With the advent of the Reagan administration and its advocacy of the "new federalism" concept, the policy responsibility as well as spending autonomy of the states has been strengthened again, with a greater separation regarding both policy conception and implementation between the different layers of government.

At the beginning of the eighties, the federal government spent half of its funds in two areas : social security and defence. Energy and natural resources came as a remote third. State outlays went first of all to education and research (35%), and then to welfare programmes, transport infrastructure and social security; in these domains as well as on health, state spending exceeded federal expenditure. However, for each of the categories where state spending was predominant, indirect federal funding by way of specific grants played an important role: state budgets on welfare, transport infrastructure, education and public health were based on federal subsidies for respectively 56, 36, 15 and 13 per cent. It follows that the federal influence on social security and welfare policies is overwhelming whereas the states' dominance in the research and education area is equally clear-cut.

2. Canada

In Canada residual powers belong to the federation. Another distinctive feature of the Canadian federal system is that in contrast to the US, Germany, and Switzerland there is no direct provincial representation in federal decision-making, the Canadian Senate being of little importance and composed of federal appointees. Specific regional concerns are therefore seldom or not echoed in federal policies, which is also the reason why provincial competences are jealously guarded.

Exclusive provincial legislative competences are listed in Art. 92 of the Constitution. They include public order and justice, education, public health and welfare, the licensing of trade and industry, forestry, electric energy. A few policy domains, such as agriculture and pensions, are subject to competing legislative powers whereby both provinces and Ottawa can pass laws, one of them taking precedence in case of conflict.

Also noteworthy is that Art. 92(1) of the Constitution confers on the federation the competence to regulate interprovincial trade. Prima facie, this could be considered the equivalent to the US Commerce clause, which has proved to be a key instrument to keep the American internal market unfragmented. Unlike its American counterpart, however, Canada's Supreme Court has given a narrow interpretation to the federal powers on interprovincial trade with a view to preserving the autonomy of the provinces, principally because of the exclusive powers granted to the provinces by the Constitution. As a result, provincial regulatory and budgetary decisions erecting non-tariff barriers inside the Canadian internal market have often been validated by the judiciary.

The most important federal budget posts are social security, defence and oil and gas exploitation. Transport and communications are a federal matter, except for roads which are paid for by the provinces. The latter's expenditure primarily concern public health, education and research and welfare. For those three categories, along with justice, provincial spending outweighs that of the federation. However, as in the case of the US, the federal government exerts influence by way of specific grants. Provincial outlays on public health are financed for 25% by federal money, on post-secondary education for 30%, on welfare for nearly 40%. Federal control through grants is even more pronounced with regard to provincial spending on trade and industry, where almost three quarters of the resources originate from Ottawa.

3. Australia

Residual powers being allotted to the states, Australia's Commonwealth possesses an extensive number of exclusive competences. The chief ones relate to defence, foreign affairs, international and interstate trade, monetary matters, mail and telecommunications, social security and welfare. State competences concern mainly education, police, housing and public health. A specific attribute of the Australian division of powers is that, in clear contrast to the federal structure of Germany and Switzerland, the States' legislative competences are identical to their executive ones: they administer only the laws they have passed themselves.

Federal spending goes for more than one third to social security and welfare. Defense is the second most important recipient of federal funds.

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The States spend one third of their resources on education, about 20% on public health and some 12% on transport infrastructure. Federal grants are a significant part of state revenue for expenditures on housing (36%), education (33%) and transport (27%).

4. Germany

In the case of German federation it is particularly important to distinguish between legislative and executive competences.

Legislative competences. Here a further distinction needs to be made between exclusive and competing powers. Art. 73 of the Constitution identifies the exclusive competences of the Bund as including foreign affairs and trade, defense, monetary matters, the maintenance of the German internal market, rail and air transport, post and telecommunications.
In Art. 74 the policy domains falling under the competing legislative regime are listed. Belonging to this category are, among others, economic and labour law, social security and welfare, atomic energy, research, competition policy, road transport, the environment. In these domains the Länder dispose of legislative competence as long as the Bund has not made use of its powers. The federal right to pass laws in these areas is, however, conditional. Much in line with the well-known subsidiarity principle, the Bund can only act if the need to do so has been established. This is the case when policy responsibility cannot be assumed efficiently at the level of the Länder or when policy externalities exist that threaten to undermine the proper functioning of the economic union or to cause a divergence of "living conditions" across the country. As this conditionality proved to be interpreted in a broad sense, the federal government has made extensive use of its competences, thereby pre-empting legislative initiatives on the part of the Länder. In practice therefore the Länder's legislative autonomy has turned out to be highly circumscribed.

This rather strict division of powers between Bund and Länder was broken following the constitutional revision of 1969 which introduced the notion of so called "joint tasks", joint in the sense of involving federal financing but provincial execution of essentially provincial tasks, all subject to agreement by both parties. Such joint tasks, forming classic examples of the cooperative federalism model, concern project expenditures on infrastructure for tertiary education, regional economic development, agriculture and fishing.

Executive competences: The Länder have much broader executive competences than on the legislative plane. In practice they possess all competences, except for those matters whose execution has been explicitly assigned to the Bund. Because the overlap between legislative and executive powers is so limited, the Länder often act as the executive agent of the Bund. In those circumstances the Bund pays for the Länder's expenses.

Bonn's most important budgetary posts concern the federal contribution to the social security system and the funding of welfare programmes, defense, transport and communications and subsidies to trade and industry. On the side of the Länder, education absorbs 30% of expenditure, law and order claims 10%, regional transport infrastructure and the promotion of regional trade and industry each about 7%. Given the great variety of financial settlements between Bund and Länder, in particular relative to the coverage of Länder's outlays associated with its executive tasks, it is not feasible

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to indicate what categories of state spending depend to a considerable extent on federal grants. In any case, the working of the German federal system can also be broadly understood without this information, as policy design and formulation takes place to a very strong degree at the federal level. Using net payments figures, state funds are much more important than federal finance in the case of education, public health and law and order.

5. Switzerland

Switzerland is the country in our sample where the model of intrastate federalism has been carried farthest. Not only does the Swiss confederation have a "regional" chamber (Ständerat), where all cantons are represented equally, there is also the "popular initiative" procedure by means of which 100 000 voters or more can set in motion a process to modify federal legislation, even the constitution.

Federal exclusive powers are spread over several articles in the constitution and pertain to foreign affairs and trade, rail and air transport, post and telecommunications, polytechnics and universities, domestic trade and industrial policy, macroeconomic and labour policy and social security legislation in general. In practice, several of these areas, such as vocational training and universities, have been delegated to a large extent to the cantons. Cantonal powers centre mainly on primary and secondary education, environment, public health and welfare. As in the case of Germany, the cantons act as the executive agent of the federation in a number of policy fields such as roads of national importance where the cantons carry out Bund programmes on a shared cost basis. Virtually half of federal spending is destined for defense purposes and social security funds. Cantonal resources flow primarily to education and research, public health and transport. Given the frequent delegation of executive tasks to the Cantons, federal co-financing plays an important role in a large number of policy domains: cantonal spending on roads is covered for more than half by federal money, on the environment for about a third, on universities and vocational training for about a fifth. Cantonal expenditures prevail over federal outlays on education, welfare (no federal involvement), public health and transport. Switzerland is the only country in our sample where the subfederal level plays a non-negligible role (30%) in the public financing of the social security system.

Annex B

The structure of tax revenue as between federal and lower levels of government in the United States, Australia, Germany and Switzerland

1. United States

As can be seen from Table 5, there exist in the U.S. only exclusive and competing taxes. Except for customs duties, the US Constitution does not provide for an exclusive assignment of tax powers between the federation and the states. Thus, any tax could be of a competing kind. The current fiscal structure is therefore the result of an historic evolution. Up to the second world war, the states obtained their fiscal revenue virtually exclusively from indirect taxes, leaving direct taxation to Washington. However, as the proceeds from the sales tax did not grow in line with financing needs, the states saw themselves obliged to turn toward direct taxation as well. In the early eighties, the latter accounted for about 40% of states' tax income. To avoid the efficiency losses associated with competing taxes, the federal government has endeavoured (1972 State Local Fiscal Assistance Act) to switch with regard to personal income taxes to a system of state surcharges. However, these efforts have borne little fruit, with only a few states adopting the surcharge technique. At present personal income and corporate taxes account for nearly 90% of federal fiscal revenue.

2. Canada

In Canada exclusive taxes are reserved to the federation but do not represent very much in the latter's total fiscal revenue. Sales taxes are of a competing nature in that Ottawa acts at wholesale level, whilst provincial imposition occurs at the retail stage. Both Ottawa and the provinces have the constitutional power to tax personal and corporate income. Initially, there existed no coordination agreements between the two lovels of government to this effect. However, after the second World War the federation was able to convince most provinces through tax collection agreements to opt for a provincial surcharge regime. As regards corporate taxation, the seven smallest provinces follow this regime, but Ontario, Quebec and Alberta opted out from fear that it would limit excessively their fiscal room for manoeuvre. Personal income taxation forms an analogous case. Here Quebec still defines its own base.

3. Australia

Table 7 containing data of the early eighties, shows that practically all taxes in Australia are exclusive. Until 1986, the important exception was personal income taxes, which was a shared revenue. Since then, the share of this tax attributed to the states has been replaced by general purpose grants. This recent event marks a further step toward the concentration at federal level of public finance power in Australia, a tendency whose first signs can be traced back to the beginning of the century. More so than in the case of Canada, the second World War resulted in an erosion of the fiscal autonomy of the states. The exceptional arrangements to finance the war effort - a federal competence - were largely perpetuated afterwards. A deviation

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from this historical process of centralisation was seen in the 1971 transfer from Commonwealth to States of the wage tax, which is paid by employers. Heritage and donation duties used to be a much more important source of state revenue but have been diminished as a result of the process of interstate fiscal competition.

4. Germany

The precepts on financial relations between Bund and Länder are dealt with in arts. 105-115 of the Federal Constitution. The Bund enjoys a number of exclusive tax competences, generating about a quarter of federal fiscal income (see Table 8). The Länder can only tax certain transactions or sources of income if the Bund has not done so before. As Bonn was quick to extend the base of its taxation, competing taxes have always been virtually nonexistent.

Shared taxes constitute the essential source of fiscal revenue of the German Länder. Since the constitutional reform of 1969, personal income taxes are shared between Bund, Länder and municipalities. The latter receive 15% of the personal income tax, whereas Bund and Länder obtain 42.5% each. In exchange, the municipalities hand over 40% of the local enterprise tax (Gewerbesteuer), in two equal halves to the Bund and Länder. The corporate income tax proceeds are also split on a fifty-fifty basis between Bund and Länder.

Before 1969 sales tax income went exclusively to the Bund. Since then, the Länder obtain part of the VAT proceeds with a view to making Länder fiscal income less sensitive to business cycle fluctuations. Three quarters of the VAT destined for the Länder is distributed over the various regions in function of the number of inhabitants. Each Land's share in the remaining quarter is determined following solidarity criterions similar to those employed in the framework of the horizontal Finanzausgleich.

The Länder receive all the proceeds (collected by the Bund) from the wealth, car registration and bus taxes, but the legislation relative to these taxes is uniform across the country. All aspects of the imposition are regulated at the federal level, but the latter has no part in the revenue.

5. Switzerland

The Swiss Federal Constitution enumerates, in articles 41-42, federal tax competences, the most prominent being general and specific consumption taxes, personal and capital income as well as corporate taxes. By means of

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a federal law, Cantonal exchequers can be given the permission to operate also in these fiscal areas, which sets the stage for competing taxes. The Cantons possess residual tax power, explaining the existence on the part of the Cantons of exclusive taxes on vehicle registration, wealth, inheritances and real estate transactions. As can be read from Table 9, the confederation relies primarily on exclusive indirect taxes for its fiscal revenues. Evidence of the high degree of Cantonal fiscal autonomy is provided by the fact that about 90% of Cantonal tax income arises from exclusive and competing taxes.

As a corollary, however, a tax "jungle" has emerged, characterised by an extraordinary complexity in legislation and significant Cantonal differences in the definition of the base and in the rates, and therefore in fiscal pressure. A good case in point is the taxation of personal income and corporate profits, occurring at federal, cantonal and municipal level, each time following different rules. The federal part, for instance, takes the form of a "super" tax on high earnings only.

Several tax revenues accruing to the federation, notably the federal direct tax and stamp duties, as well as some non-fiscal sources of federal income such as the profits of the central bank, are shared with the cantons. The distribution among the 22 Cantons of this share takes place for about 60% following the territoriality principle, and for about 25% in function of the size of the population. Only 15% is governed by income redistribution considerations. Together with the absence of an explicit horizontal equalisation mechanisms, the paucity of federal grants, and the non-negligible role of the Cantons in the public financing of the social security scheme, it may be concluded that, of the five federal countries studied, the Swiss Confederation displays the lowest degree of interregional solidarity.

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Annex C

Rules governing the borrowing or indebtedness of sub-federal governments in the United States, Canada, Australia, Germany, Switzerland and Belgium.

1. United States

The federal constitution does not contain any presciptions regarding states' public finance imbalances, so no binding limits can be imposed from above. The federal government can, since 1968, exert a weak, indirect effect on states' behaviour on deficit financing in that the federal government is entitled to tax interest revenues from state bonds. When levied, such a tax is at least partly passed on to the borrower, thus making deficit-financing more costly.

Except for Connecticut, every American state has a constitution that lays down rules governing public finance imbalances. This has not always been the case, as is exemplified by the fact that several states, like Maryland, Pennsylvania or Mississipi defaulted on their external debt in the second half of the last century. The latter state never even resumed its repayments at a later stage and in 1875 passed a constitutional amendment disclaiming its debt obligations.

In general, the budget must be in equilibrium, barring explicitly mentioned exceptions. In some states, deficits are permitted only if a specific law to this end is passed. In others, deficits may be incurred only upon the approval of the electorate by means of a referendum. The maximum amount that can be borrowed is fixed in numerous constitutions. In a few states, budget deficits are admissible for the financing of investment programs. These rules concern long term loans alone. Short term borrowing to tide over purely temporary liquidity problems are not subjected to the same strict regulations. In none of the states do different rules apply to internal versus external borrowing.

The American states possess no systematic direct nor indirect possibility of financing their deficits through the Federal Reserve. Nor does the federal government have direct access to central bank credits.

2. Canada

The Canadian provinces are not constrained in any way by federal provisions to incur debt, within Canada as well as abroad. There is even no obligation to coordinate the dates and terms of the debt placement between the provinces, and between them and Ottawa. Nor have the Canadian provinces imposed any rules on themselves that would limit their public deficits. They, as well as the large public enterprises (the so-called crown corporations), frequently tap the domestic and international bond market. This absence of legal constraints on provincial deficit financing has not led to debt accumulation becoming unsustainable. It is generally considered that as they do not have access to central bank financing, the provinces' concern about their credit-worthiness constitutes an effective financial discipline.

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Since the second World War, but increasingly so in the recent past, the modes of provincial deficit finance have been called into question, primarily by the provinces themselves who resent their being subject to market constraints and to much greater uncertainities than the federal government.

This has sometimes given rise to calls to make financing from the Bank of Canada available to the provincial governments. Typically, interest rates on provincial bonds vary considerably from province to province, and all of them exceed those on federal bonds. As the provinces wished to limit the spread between the interest rate on their bonds and those of the federation the idea was launched of using the Bank of Canada as the fiscal agent for the provincial governments. The ensuing public debate quickly revealed, however, that if the central bank was compelled to secure a constant relationship between yields on provincial and federal bonds, each province could, in effect, engage in open market operations. As a corollary, the Bank of Canada would lose its control over the money supply.

The Western provinces in particular argued for a regional credit allocation regime, implying that lending in a given region bear some proportion to local deposits. These proposals were also given short shrift in that regional credit allocation is incompatible with the notion of an internal capital market and futile in practice due to the high fungibility of money and credit.

More justified is the complaint that, as provinces are forced to place a substantial part of their debt in foreign currency because the federal government has saturated the domestic market with its own paper, the actual weight of their debt service burden is in part dependent on the exchange rate policy of the Bank of Canada, which operates under the influence of the federal authorities. For a more appropriate matching of risk and responsibility, it has been recommended to tilt federal borrowing more towards foreign sources and to allow more room in the domestic capital market for the provinces. This could only come about through a systematic coordination between the federation and the provinces on debt issues, which has not so far occurred.

3. Australia

Unlike the states in the four other federal countries studied, the autonomy of Australian states as regards debt financing is highly circumscribed. This is the consequence of art. 105 A(1) of the Australian Constitution adopted in 1901 and the working of the Loan Council, set up in 1927. The Constitution provides that the Commonwealth (i.e. the federation) may make agreements with the states with respect to the latter's public debts leading to the taking over or management (consolidation, renewal, conversion or redemption) of such debts by the Commonwealth. Such agreements may also concern the coordination between states and federation regarding the placement of new debts or to the conditions under which the Commonwealth borrows on capital markets on behalf of the states.

Initially the provisions of the Constitution remained a dead letter because the Commonwealth was unwilling to assume responsibility for state debts until some means of influencing state borrowing had been put in place. In the 1920s both the federation and the states met with serious problems regarding the burden of their debts. These problems were aggravated by inter-governmental competition on capital markets at home and abroad, where governments made no attempt to coordinate their new issues and frequently outbid each other. In order to overcome these problems, a financial agreement was concluded in 1927 comprising the establishment on a durable basis of a Loan Council. Under the accord, the Commonwealth took over all existing state debts. In addition, all future borrowing, whether on behalf of the Commonwealth or States, was to be arranged by the Commonwealth subject to the approval of the Loan Council.

The modus operandi of the Council is as follows. Every year each of the six states and the Commonwealth submit to the Council the amounts they wish to borrow, be it for current or capital account purposes. The Council determines, by means of a majority vote, the total amount which may be borrowed by the federal and state government together, along with the financial conditions attached to its placement. Since the Commonwealth has two votes and a casting one, it requires the support of only two of the six States, which it has always managed to muster until now. The allocation among the seven governments of the loan proceeds, however, as well as the approval for a State to borrow abroad on its own initiative, is made on the basis of unanimity. If no unanimous view can be reached, the allocation is a function of net loan expenditures during the previous five years. As a result of the consensus requirement, the borrowed funds are scarcely allocated on economic analysis grounds but reflect overwhelmingly past deficit spending behaviour.

The Loan Council has no control over the uses to which loans are put. The amounts the Commonwealth passes on take the form of interest bearing general purpose grants which may be spent freely pursuant to each State's preferences.

The Loan Council has turned out to be a very powerful instrument for the Commonwealth to exert effective control over deficit spending by the States. Given voting rules, the federation has as yet always been capable of pushing through its own views. This predominance has been the object of repeated criticisms by subcentral governments and academics alike, on the grounds that it has led to unduly restrictive limits on State government borrowing, distorting the allocation of resources within the public sector, in particular as regards public investment.

The Australian States are not in a position to finance themselves at the central bank.

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4. Federal Republic of Germany

The general rule on state borrowing in Germany is that the Länder have full autonomy. Borrowing by Bund and Länder is regulated separately by their respective legislatures. The Länder to not need the consent of the Federal Minister of Finance to borrow externally either.

However, the Länder have tended to enact their own constitutional provisions limiting the maximum level of annual borrowing to the amount of public investment in the corresponding budget year (this is analogous to Art. 115 of the federal constitution regarding federal borrowing). A variant to this precept applies in Bremen and Bavaria where state loans must be tied to "well-specified expenditure categories".

In exceptional circumstances the federal government can intervene temporarily in state deficit financing for reasons of anti-cyclical fiscal policy. By virtue of Art. 109, par. 2 of the federal consitution and art. 19-25 of the 1967 Stabilitätsgesetz, the federal government can, with the approval of the Länder-controlled Bundesrat, limit the states' recourse to loans. This credit ceiling expires after at most one year and must not be lower than 80% of the annual average of loans that the states have contracted over the previous five years. The federal authorities have used this possibility only once, in 1973, when the German economy threatened to overheat.

The Stabilitätsgesetz also provided for the creation of a Business Cycle Council (Konjunkturrat) in which the federation, states and municipalities are represented. This council fixes a three month calendar for public bond issues in function of capital market conditions. At unexpected changes in the capital market, the federal economics Minister can, in concertation with the Bundesbank, suspend the execution of the calendar.

The Länder possess a direct credit line with the Bundesbank. The use of this line, whose ceiling per state is contingent on the number of inhabitants, is, however, subject to strong constraints and is designed to bridge short term cash shortfalls only. The Länder have in the past frequently argued that the existing ceilings are too low, a view that was opposed by the federal government.

5. Switzerland

The Swiss federal constitution does not contain any prescriptions regarding the borrowing of the Cantons. While thus enjoying full autonomy, the Cantons tend to cover only a small part of their outlays through borrowing. In 1982 their collective deficit stood at 1.5 % of their expenditure. All loans were placed on the domestic capital market.

Ties between the Cantons and the Banque Nationale Suisse are much closer than those existing between the subfederal governments and the central bank in any of the four other federations studied. The Cantons have an indirect financing mechanism, in that short term Canton paper bought by commercial banks can be rediscounted at the central bank. Furthermore, part of the central bank's profits are transferred to the Cantons.

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6. Belgium after the constitutional reform of 1988.

From 1989 the Belgian Communities and Regions will be able to issue bonds in Belgian Francs on the Belgian capital market in the framework of a programme established by the national government in collaboration with the regional counterparts. The conditions and timing of each public issue have to be approved by the national finance minister. The sub-national authorities only have to notify their borrowing from banks. External borrowing or loans in foreign currency can only take place with the approval of the national finance minister.

The new law on the transfer of financial resources will not provide for any specific limitations on the deficits or debt of the Belgian Communities and Regions. However, a special sub-group of the "Conseil supérieur des Finances" will be established to evaluate the financial needs of the national and sub-national authorities. This group will consist of 12 members, six of each language group and composed for one half of representatives of the national governments. Half of the national members will be from the central bank. The council will express annually its opinion on public deficit financing. It can on its own initiative or upon the request of the national minister of finance give its opinion on the desirability of limiting the borrowing of any of the major national and sub-national public authorities. The national government will have the power to limit during a maximum period of two years the borrowing of a sub-national public authority. In that case, the government in question will need the national finance minister's approval for private loans also.

The servicing of the existing national debt (now standing at over 120% of GDP) will remain essentially a task of the national government.

Table 1: public expenditure by level of government

	Federal[a]		State		Local	Net gov spending total	General govt.[b]
	(1) Gross	(2) Net	(3) Gross	(4) Net	(5)	(2+4+5)	
US	25.1[c]	21.5	9.9	N.A	N.A	N.A	35.5
Canada	23.3	19	21.5	15.2	9.3	43.5	N.A[d]
Australia	31.2	21.1	17.2	N.A	N.A	N.A	38.3
Germany	19.0	14.0	12.4	10.5	7.9	32.4	48.9
Switzerland	10.9	7.7	12.8	10.9	6.4[e]	25.0	28.9[e]

a Gross spending is defined as net spending + grants to subfederal or substate public entities.

b General government expenditure is defined as the sum of federal, state and local authorities' spending plus disbursements by social security institutions. Data source: OECD.

c Total federal US grants amounted to 3.6% of GDP, 2.3% or about two thirds went to state governments. For Canada these figures equalled respectively 4.3% and 4.2%, for Australia 10.1% and 8.1% and for Switzerland 3.2% and 1.9%.

d General government figures on Canada as existing statistical material on social security spending relates to the Canada Pension Plan and the Quebec Pension Plan.

e Current spending alone.

Table 2: Expenditure by level/function % GDP

	FEDERAL					SUB-FEDERAL				
	US	CAN	AUS	D	CH	US	CAN	AUS	D	CH
General services	N.A	1.2	1.6	0.6	0.3	N.A	1.3	0.9	0.8	0.6
Defence	5.2	2.0	2.8	2.8	1.9	0.0	0.0	0.0	0.0	0.2
Police	N.A	0.3	0.0	0.1	0.0	N.A	0.1	1.0	0.7	0.5
Justice	N.A	0.2	N.A	0.0	0.3	N.A	0.3	N.A	0.5	0.5
Foreign Affairs	0.5	0.5	*	0.5	0.4	0.0	0.0	0.0	0.0	0.0
Transport & Comm.	0.4[a]	1.3	0.5	1.9	0.7	1.0	1.6	1.7	0.9	1.5
Health	0.5	0.2	2.0	0.0	0.0	0.7	5.3	3.1	0.5	2.3
Social Security	5.5	6.7	8.0	2.4	1.7	0.9	1.0	0.2	0.0	0.8
Welfare	0.9	0.4		0.6	0.0	1.7	2.1		0.5	0.5
Education & Research	0.6	0.3	0.5	0.6	0.5	3.4	4.6	5.5	3.6	3.5
Agriculture	N.A	0.6	0.4	0.2	0.6	N.A	0.5	0.6	0.3	0.5
Trade and Industry	N.A	0.3	N.A	1.3	0.0	N.A	0.2	N.A	0.7	0.1
Environment	N.A	0.1	N.A	N.A	0.0	N.A	0.3	N.A	N.A	0.4
Culture	N.A	0.2	0.0	0.0	0.0	N.A	0.3	0.4	0.2	0.2
Housing & Zoning	0.5	N.A	0.1	0.1	N.A	0.0	N.A	0.5	0.6	N.A
Natural Resour.,energy	1.2	1.3	0.5	**	N.A	0.2	0.2	0.2	**	N.A
Debt servicing	2.4	3.2	2.0	2.4	N.A	0.3	1.8	***	2.2	N.A
Total[b]	21.4	19.0	21.1	14.0	7.7	9.9	21.5	17.2	12.4	12.8

* in general services
** incorporated in Trade and Industry
*** Loan Council

a) roads only
b) The various categories of functional spending do not add up to total outlays because for some categories data are not available and some types of spending are hard to subsume under specific functional headings.

Table 3: Aggregate tax revenue by level of government

	US	Canada	Australia	Germany	Switzerland
1. Percentage share in total tax revenue					
federal	61.0	61.8*	63.0	49.7	38.2
subfederal	23.9	38.2*	33.2	35.8	37.2
local	15.1	NA	3.8	14.5	24.6
total	100	100	100	100	100
2. Total tax revenue (general govt. receipts)[1] as a % of GDP	23.2 (32.1)	30.1 (39.7)	32.7 (35.1)	26.3 (44.8)	21.3 (32.9)

(1) including social security

Table 4: Income structure of sub-central governments in federal countries

	Switzerland	U.S.A.	Australia	Canada	Germany
1. Exclusive taxes	10.0	18.6	-	-	-
2. Competing taxes	43.5	30.9	31.8	29.2	-
3. Subfederal surcharges	-	-	-	24.0	-
4. Shared taxes	5.8	-	33.9	-	70.3
Total taxes	59.3	49.5	65.7	53.2	70.3
5. Federal grants	14.8	22.3	30.4	20.4	13.5
6. Non-fiscal income	25.8	28.2	3.9	26.4	16.2
Total	100	100	100	100	100

Source:

Table 5

U.S.A.

Federal and State tax income in the U.S.A.

	Federation		States		
	A.	B.	A.	B.	B.
Exclusive taxes	2.1	12.6	37.4	87.4	100
Customs duties	2.1	100	-	0	100
General sales tax	-	-	31.5	100	100
Property tax	-	-	2.1	100	100
Vehicle registration tax	-	-	3.8	100	100
Competing taxes	97.9	80.0	62.6	20.0	100
Personal income taxes	69.6	86.8	27.1	13.2	100
Corporate taxes	18.4	80.7	9.7	19.3	100
Selective sales tax (oil, tobacco, alcohol, etc.)	7.0	50.0	18.0	50.0	100
Heritages and donations tax	1.8	76.2	1.4	23.8	100
Other	1.0	30.1	6.3	69.9	100
Total	100		100		

A. percentage in total tax income of the Federation or of the States.
B. percentage share of Federation or States in proceeds of specific tax category.

Table 6

CANADA

Tax Income of Federation and Provinces in Canada

	Federation		Provinces		
	A.	B.	A.	B.	B.
Exclusive taxes	17.0	100	-	0	100
Customs duties	5.4	100	-	0	100
Air transport tax	0.3	100	-	0	100
Oil export taxes	1.5	100	-	0	100
Oil and gas taxes	9.7	100	-	0	100
Competing taxes	38.9	54.5	54.9	45.5	100
General sales tax	9.9	46.8	19.0	53.2	100
Petrol tax	0.7	14.5	7.0	85.5	100
Liquor tax	1.2	99.0	0.0	1.0	100
Tobacco tax	1.4	47.4	2.6	52.6	100
Social security tax	12.7	57.4	16.01	42.6	100
Corporate tax[1]	12.9	68.8	9.9	31.2	100
Federal tax with provincial Surcharges	42.9	61.4	44.1	38.6	100
Personal income tax[2]	42.9	61.4	44.1	38.6	100
Total	100		100		

A. percentage in total base income of the Federation or of the Provinces.
B. percentage share of Federation or Provinces in proceeds of specific tax category.

1 For the seven smallest provinces corporate tax is federal with provincial surcharges.
2 Personal income taxes are of a competing kind in Quebec.

Table 7

AUSTRALIA

Tax Revenue of Commonwealth and States in Australia

	Commonwealth		States		
	A.	B.	A.	B.	B.
Exclusive taxes	35.7	60.1	39.6	39.9	100
Customs duties	7.3	100	–	0	100
Sales tax	9.7	100	–	0	100
Primary production tax	0.8	100	–	0	100
Corporate tax	17.8	100	–	0	100
Wage tax*	0.01	0	15.9	100	100
Vehicle registration tax*	0.01	0	6.6	100	100
Other* (liquor and gambling taxes, stamp duties)	0.01	0	16.6	100	100
Competing taxes	0.01	0	3.3	100	100
Heritage and donation duties*	0.00	0	0.9	100	100
Property taxes*	0.01	0	2.4	100	100
Shared taxes	72.4	60.2	56.4	39.8	100
Personal income tax**	72.4	60.2	56.4	39.8	100
Total	100		100		

A. percentage in total tax income of the Commonwealth or of the States.
B. percentage share of Commonwealth or States in proceeds of specific tax category.

* Levied in Canberra by Commonwealth authorities.

** Since 1986 this has become an exclusively Commonwealth tax.

Table 8

GERMANY

Tax Income of Bund and Länder (in percentages)

	Bund		Länder		
	A.	B.	A.	B.	B.
Exclusive taxes	24.8	100	-	0	100
Taxes on minerals	12.0	100	-	0	100
Taxes on tobacco	7.1	100	-	0	100
Other	5.7	100	-	0	100
Shared taxes	75.2	50.5	100	49.5	100
Personal income taxes	35.1	50	47.5	50	100
Corporate taxes	8.1	50	11.0	50	100
VAT	31.0	60.6	27.3	39.4	100
Local enterprise tax	1.0	50	1.4	50	100
Wealth taxes	-	0	3.1	100	100
Car registration tax	-	0	5.0	100	100
Beer tax	-	0	0.8	100	100
Other	-	0	3.7	100	100
Total	100		100		

A. percentage in total tax income of the Länder or of the Bund.
B. percentage share of Bund or Länder in proceeds of specific tax category.

Table 9

SWITZERLAND

Tax Revenues of the Confederation and the Cantons in Switzerland

	Confederation		Cantons		
	A.	B.	A.	B.	B.
Exclusive taxes	62.5	80.5	16.9	19.5	100
Consumption taxes	41.1	100	–	0	100
Customs duties	21.4	100	–	0	100
Vehicle registration tax	–	0	5.7	100	100
Individual Wealth taxes	–	0	5.6	100	100
Heritages and Donation tax	–	0	2.7	100	100
Real-estate transaction tax	–	0	2.4	100	100
Competing taxes	0	0	72.7	100	100
Personal income taxes	–	0	57.6	100	100
Corporate taxes	–	0	9.4	100	100
Capital income taxes	–	0	5.7	100	100
Shared taxes	37.5	77.3	9.7	22.7	100
"Direct" tax on high earnings	31.9	77.4	7.6	22.6	100
Stamp duties	4.9	86.0	0.9	14.0	100
Military exemption tax	0.7	44.0	1.0	56.0	100
Total	100		100		

A. percentage in total tax income of the Confederation or of the Cantons.
B. percentage share of Confederation or Cantons in proceeds of specific tax category.