Federalism and Fiscal Transfers:

Essays on Australia, Germany, Switzerland, and the United States

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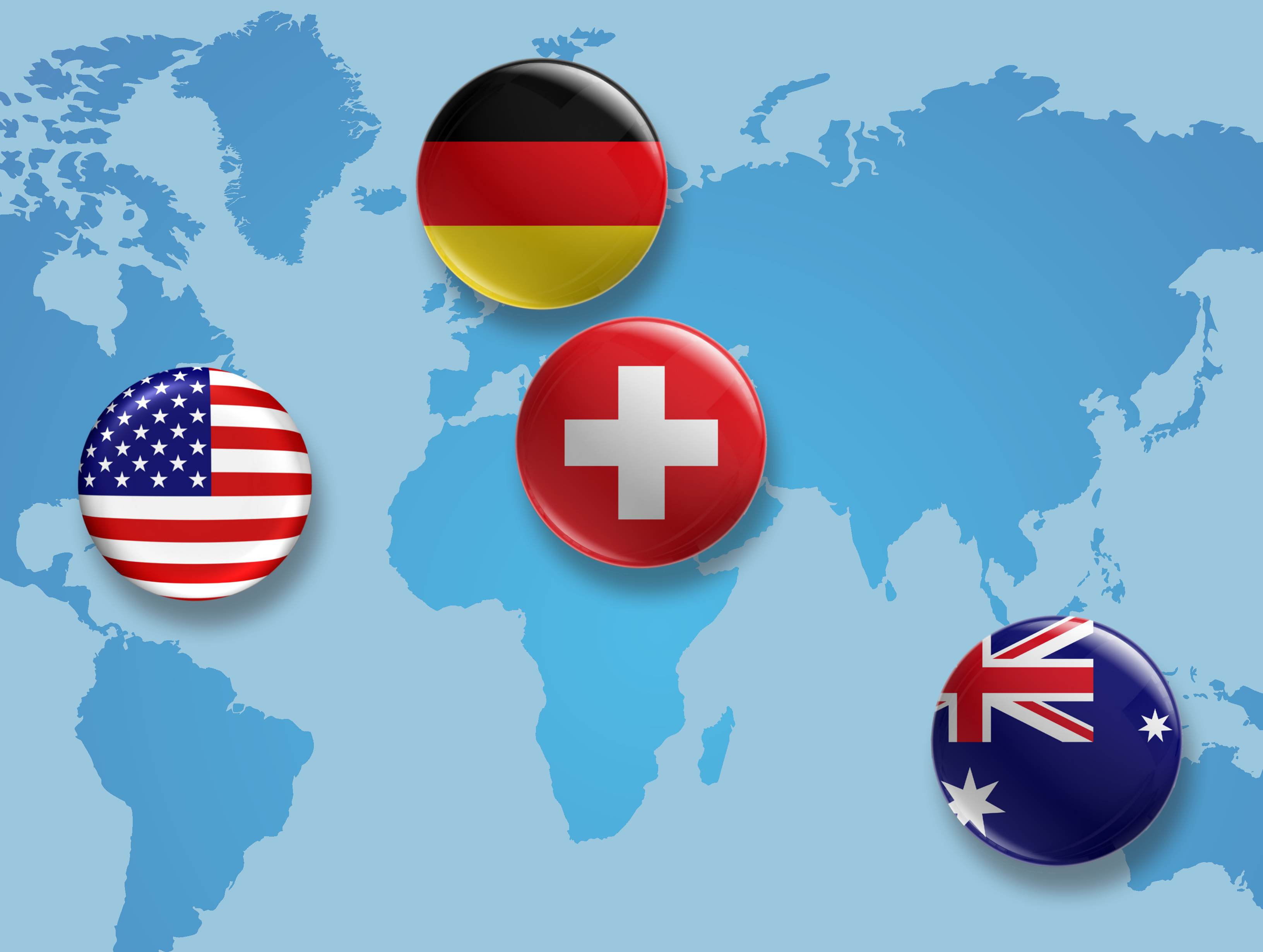
edited by Jason Clemens and Niels Veldhuis



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Executive Summary

Jason Clemens and Niels Veldhius

One of the constant pressures within countries organized along federalist grounds, like Canada, is the balance of power between the central and subnational levels of governments—provinces or states. Federalism is a political system whereby a group of jurisdictions has chosen to bind themselves together by covenant. In Canada's case, provinces voluntarily decided to join the Canadian confederation. Federalism is characterized by a constitution or other binding agreement regarding the rights and powers of each level of government. Disputes regarding tax powers, spending authority, legislated mandates, and regulatory encroachment are but a sample of the many struggles observed on an ongoing basis in federalist countries between the two levels of government.

Canada is not immune to these disputes. Surprisingly, however, very little attention has been given in Canada to the ways other federalist countries manage similar strains. This publication contains commissioned essays on the nature of transfers between the national and subnational levels of government in four developed federalist countries: Australia, the United States, Switzerland, and Germany. The aim of the essays is first to understand how other federalist countries transfer resources between the two levels of government as well as between jurisdictions at the subnational level. Second, we hoped for insights into possible improvements in Canada's arrangements and indications of areas for research in the future.

1. Overview of Federalism and Fiscal Transfers in Canada

Before delving into the specifics of how other federalist countries transfer resources between different levels of government, it is worthwhile to refresh our understanding of the Canadian system. There are several programs designed to transfer resources from the federal government to the provincial governments in Canada.[1]

1. The federal department of finance has a section on its website explaining federal transfers to the provinces and territories that provides interested readers with a reasonable overview. Please see <http://www.fin.gc.ca/access/fedprov-eng.asp>.

Canada Health Transfer (CHT)

The Canada Health Transfer (CHT) is the single largest transfer to the provinces (and territories) by the federal government. As the name suggests, it is meant solely to support provincial spending for health care. Beyond the specified use of the transfer for health care, the use of the transfer is largely regulated by the Canada Health Act.[2] In 2013-14, the CHT cash transfer will reach an estimated $30.3 billion, which represents almost half (49 percent) of the resources formally transferred from the federal government to the provinces (**ExSum figure 1**).[3]

Canada Social Transfer (CST)

A companion transfer to the CHT is the Canada Social Transfer (CST), which was previously combined with the CHT, a transfer referred to as the Canada Health and Social Transfer.[4] The CST is a federal block grant to the provinces to support post-secondary education, social assistance, early childhood development, early learning, and childcare. The fungible nature of the grant means that the provinces have a great deal of flexibility in using these funds for various social programs. The total cash transfer for the CST in 2013-14 is expected to reach $12.2 billion.

Equalization

By far the most controversial of the major transfer programs to the provinces is Equalization. It is intended to address fiscal disparities between the provinces and theoretically allows payments to be made to less prosperous provinces to ensure their public services are comparable with those in other more prosperous provinces at reasonably comparable levels of taxation. Equalization payments to the provinces are unconditional, meaning that the recipient provinces have full discretion over the use of the funds.

Equalization payments represent a little over one-quarter of the total transfers made to the provinces (figure 1), behind only the Canada Health Transfer (CHT). Unlike the CHT and CST, however, equalization is only distributed to provinces deemed to be "have-not", which refers to their ability to raise revenues compared to other provinces. In other words, not every province is eligible for equalization whereas all provinces receive CHT and CST payments. In addition, Equalization is also unique in that it is formally part of the Canadian Constitution (subsection 36 (2)).

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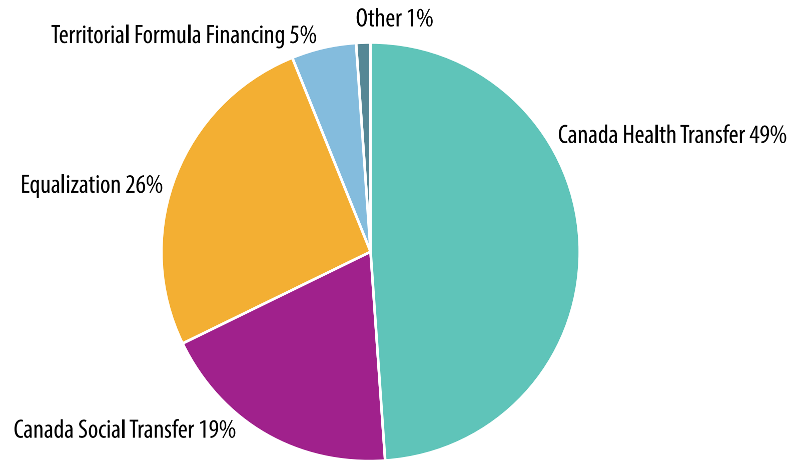
2. For an overview of both the CHT and the Canada Health Act, please see Jason Clemens and Nadeem Esmail (2012). *First, Do No Harm: How the Canada Health Act Obstructs Reform and Innovation*. Macdonald-Laurier Institute. <http://www.macdonaldlaurier.ca/files/pdf/How-the-Canada-Health-Act-Obstructs-Reform-and-Innovation-June-2012.pdf>. A succinct summary of the study is available at <http://www.macdonaldlaurier.ca/calgary-herald-let%E2%80%99s-remove-barriers-to-health-care-reform/>.

3. We purposefully use the term "formally" when describing these transfers because there are a number of informal mechanisms through which the federal government transfers resources to the provinces and regions. A forthcoming paper entitled *Unseen Equalization: An Overview of Provincial Subsidies in Federal Programs* by David Mackinnon with Jane Loyer, Frazier Fathers, and Milagros Palacios, to be published by the Fraser Institute, explores these informal but nonetheless important mechanisms for redistributing federal resources to the provinces.

4. For a brief history of the CHT and CST, please see <http://www.fin.gc.ca/fedprov/his-eng.asp>.

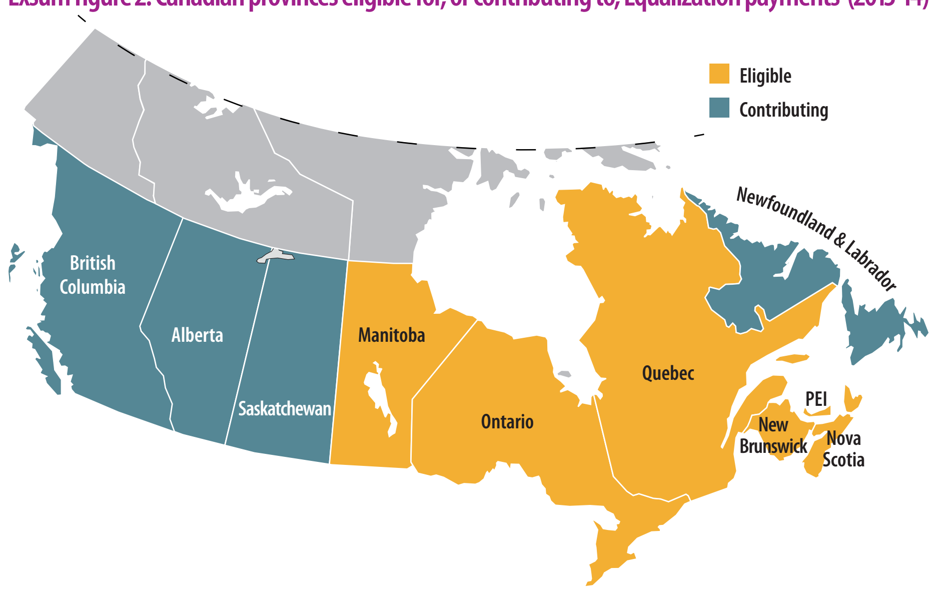
ExSum Figure 1: Federal Transfers to Canadian Provinces and Territories (2013-14)



Sources: Canada, Department of Finance (2012). *Federal Support to Provinces and Territories*. Department of Finance. <http://www.fin.gc.ca/fedprov/mtp-eng.asp>, as of April 16, 2013.

Equalization is an extraordinarily technical and complicated program, with an enormously elaborate calculation used to determine eligibility and payments.[5] In 2013-14, equalization payments were expected to reach $16.1 billion with six provinces eligible for equalization payments: Manitoba ($1.8 billion), Ontario ($3.2 billion), Quebec ($7.8 billion), New Brunswick ($1.5 billion), Nova Scotia ($1.5 billion), and Prince Edward Island (PEI) ($340 million). The remaining four provinces were contributors to equalization (**ExSum figure 2**).[6]

Exsum figure 2: Canadian provinces eligible for, or contributing to, Equalization payments (2013-14)



5. For information on the calculations used and the system of equalization, please see the Expert Panel on Equalization and Territorial Formula Financing at <http://www.eqtff-pfft.ca/english/index.asp>; in addition, for a broader overview of both equalization and transfers, see Jason Clemens and Niels Veldhuis (2007). *Beyond Equalization: Examining Fiscal Transfers in a Broader Context*. Fraser Institute.
6. See <http://www.fin.gc.ca/fedprov/eqp-eng.asp> for additional information on equalization in 2013-14.

2. Federalism and Fiscal Transfers in Australia

The chapter on Australia is perhaps the most pertinent to Canada because its economy is similarly structured and it too has a formalized fiscal transfer aimed at equalization. In the 2012-13 financial year, the federal government in Australia budgeted $90.4 billion in total payments to the states, equal to 24 percent of federal government spending or 5.8 percent of GDP. Roughly 80 percent of this funding is in the form of untied grants, which provide general discretionary funding to the Australian states. The remaining funding from the federal government are largely special purpose payments, which have specific purposes linked to the use of the funds.

Equalization Evolves in Australia

Unlike Canada, Australia does not have a formal constitutional requirement for equalization.[7] Section 96 of the Australian Constitution provided for the federal government to "grant financial assistance to any State on such terms and conditions as [federal] Parliament thinks fit". According to Stephen Kirchner, who was commissioned to write this essay, Section 96 of the Australian Constitution was intended as a safety net to assist states that encountered financial difficulty.

Beginning in mid-1970s, there was a move away from fiscal need towards a principle of equalization by the Australian federal government. In its 1993 report, the Commonwealth Grants Commission, which administers the system of equalization in Australia introduced the principle of "full" fiscal equalization. The Commission defined the principle of "full" fiscal equalization quite similarly to Canada: "The principle of fiscal equalisation is that each State should be given the capacity to provide the same standard of State-type public services as the other states, if it makes the same effort to raise revenues from its own sources and conducts its affairs with an average level of operational efficiency".[8]

Equalization in Australia

There is a key difference between the two equalization programs in addition to the existence, or not, of a constitutional mandate. Payments to the Australian states are based on assessed fiscal capacity on both the revenue and expenditure side of state budgets. In other words, both the spending and taxing of the Australian states are considered in determining equalization. Canada, on the other hand, only assesses the taxing or revenue capacity of the provinces in calculating equalization.

7. It is worth noting that some legal scholars in Canada have contested the strength of the constitutional requirement in Canada for equalization. See, for example, Burton H. Kellock, Q.C. and Sylvia LeRoy (2007). Questioning the Legality of Equalization, in Clemens and Veldhuis, *Beyond Equalization: Examining Fiscal Transfers in a Broader Context*. Fraser Institute.

8. Commonwealth Grants Commission (1993), *Report on General Revenue Grant Relativities 1993* (Australian Government Publishing Service): 6.

The Commission responsible for equalization attempts to identify and quantify factors outside the control of the states that influence their expenditure requirements and revenue raising capacity. This is distinct from their actual expenditures and revenues. It is this assessment of both expenditure needs and revenue raising capacity that makes the Australian approach to fiscal equalization unique internationally.

Like Canada's equalization program, the process of identifying and quantifying the factors that determine equalization grants in Australia is extremely complex. A wide range of factors are taken into account including population size, age, and structure, per-capita income, the impact of geography on costs, the presence of indigenous peoples, English fluency, and the capacity of various tax bases. Indigeneity is the single largest source of equalization on the expenditure side while mining revenue is the main source of equalization on the revenue side.

Interestingly, Australia does not assess fiscal *need* in calculating equalization. According to Kirchner, it is not uncommon for Australian states with strong fiscal positions (budget surpluses or low debt levels, for example) to receive equalization funds from states with weaker fiscal positions.

GST and Equalization in Australia

The Australian federal and state governments agreed in 1999 that the distribution of revenue from the new GST—similar to Canada's GST—that was collected by the federal government would be based on fiscal equalization principles. In return for the GST revenue, the states agreed to abolish a number of inefficient state-level taxes such as taxes on financial account transactions.

This marks a material change in the equalization program in Australia. Whereas the amount transferred to the states under the previous system was largely determined by political decisions of the federal government, the amount available for equalization is now determined by the amount of GST revenue. Competition between the states for revenue through the equalization process is now a zero-sum game because the equalization pool is determined, in part, by the size of the GST revenues. In addition, the GST rate and the base upon which it is levied can only be changed with the agreement of state governments and the federal parliament.

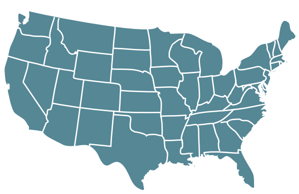
Each state receives a per-capita share of the GST revenue plus an offset amount that reflects different expenditure and revenue needs and capacities relative to the average of all the states. On average, GST revenue that is linked to equalization makes up around 25 percent of state government revenues. The federal government's special purpose payments to the states are included in this assessment on the assumption that revenue available to the states from most sources is fungible.

Concluding Thoughts

According to the review of the empirical literature on Australia's equalization completed by Kirchner, it suggests that the current system of fiscal equalization in Australia reduces economic efficiency. The dollar value of these efficiency costs is thought to be small as a share of GDP, although there are concerns that the long-run efficiency costs due to perverse incentives faced by the states could be larger.

This has led to various proposals for reform. The most promising would involve a system of equal per-capita grants for GST revenue coupled with an equal lump-sum payment to cover the core costs of government. The principal lesson from the Australian experience is that overly ambitious attempts at fiscal equalization are unlikely to prove successful in promoting either efficiency or equity objectives. These goals are likely best pursued through other alternative mechanisms.

Two key insights emerge for Canada that should be pursued in greater detail in the future. One, Australia considers both expenditure requirements and revenue-raising abilities when setting equalization payments. Some experts in Canada have argued that expenditure requirements should similarly be included here. It is, therefore, worthwhile to explore the costs and benefits of such an approach based on the Australian experience. Two, Australia constrains the total amount of funding available through equalization based on the revenues raised by the GST. Again, the costs and benefits of this constraint should be assessed given the parallels between the two systems.



3. Federalism and Fiscal Transfers in United States

An interesting case of federal-state relations exists in the form of our neighbor to the south. Unlike Canada and Australia, the United States has no formal system like Equalization to transfer resources from prosperous states to less prosperous ones. As the Canadian-born Chris Edwards, Director of Tax Policy Studies at the Cato Institute, explains, however, the United States has developed a hugely complex financial relationship between the federal government and the states through the Grants-in-Aid system.

Grants-in-Aid: Federal Transfers to the States

The US system has grown steadily for more than a century as the federal government has become involved in an increasing array of state and local activities. Currently, there are more than 1,100 federal aid programs for the states, with each program having its own rules and regulations.

Grants-in-aid are a key mechanism that the federal government has used to extend its power into state and local affairs. Grant programs are subsidies from the federal government that are accompanied by federal regulations designed to micromanage state and local activities in funded areas.

Most federal aid is distributed by formulas, which are based on such factors as state populations, income levels, and poverty levels. Medicaid funding, for example, is distributed based on each states' average personal income compared to the US average. Thus, poorer states generally receive a higher federal match, although there are many complexities to the Medicaid allocation system.

The US federal government is expected to spend a little more than $561 billion in 2013 on aid to the states, making aid the third largest item in the federal budget after Social Security and national defense. Some of the major federal aid programs are in the areas of education, health care, housing, and transportation.

History of Aid to the States

From the beginning, many aid programs required states to match federal funds on a dollar-for-dollar basis. Unfortunately, matching requirements have induced excessive state spending and continuous program expansion. Federal aid has also prompted the growth in state bureaucracies, partly because aid programs have often required that states set up new agencies to oversee spending in the prescribed activities.

There was initial resistance to the expansion of federal aid, but it was politically difficult for states to opt out of new aid programs because, if they did, their residents would still have to pay federal taxes to support federal aid spending in other states.

There is no overall plan to the system; instead, it has grown in an ad-hoc manner over many decades. The number of Grants-in-Aid programs rose from 15 in 1930 to 132 by 1960. The largest expansion of federal granting during this period was the 1956 law authorizing the building of the interstate highway system. However, it was during the 1960s that federal aid really exploded. Under President Lyndon Johnson, aid programs were added for housing, urban renewal, education, health care, and many other activities. The number of aid programs quadrupled from 132 in 1960 to 530 by 1970. According to Edwards' analysis, the number of aid programs soared from 653 in 2000 to 1,122 in 2010.

Federal aid spending is expected to reach $561 billion in fiscal year 2013, of which $286 billion are health grants and $275 billion are non-health grants. Federal aid programs range from the giant $267 billion Medicaid to hundreds of more obscure programs, such as a $15 million grant for Nursing Workforce Diversity, a $116 million grant for Boating Safety Financial Assistance, and a $125 million grant for Healthy Marriages.

While most aid programs are project grants, most aid spending is on formula grants. That is because many of the largest aid programs, including Medicaid, are formula grants. Under formula grants, legislation spells out how much funding each state receives based on factors such as state income and population. The states are often required to match some portion of the federal government's aid with their own funding.

Problems with Aid to the States

Edwards identified eight major problems with the US approach, ranging from spurring wasteful spending to inconsistent matching between state grants and financial needs to reducing policy diversity at the state level to expanding both state and federal bureaucracies. In many critical ways, the Canadian approach is superior and certainly more transparent than the US approach to transfers between the federal and subnational levels of government. Put differently, the lessons for Canada from the United States with respect to fiscal transfers seems largely to be what to avoid rather than what to adopt as a means to reform. Indeed, there appear to be clear lessons for the United States showing ways of simplifying and improving their system of transfers to the states based on the Canadian model.

4. Federalism and Fiscal Transfers in Switzerland

Two federalist countries in Europe offer insights into transfers between different levels of government. Pierre Bessard, the president and executive trustee of the Liberal Institute, Switzerland's oldest independent educational foundation, was asked to summarize the fiscal arrangements present in Switzerland.

Switzerland's system of federalism is unique in two ways. First, it is significantly fragmented compared to other federalist countries: 26 federated states (cantons) and 2,500 local communities with a total population of 8 million people. Second, Switzerland, like Canada, is relatively decentralized, with a larger role for the cantons and less for the federal government. For example, the federal government in Switzerland accounts for roughly 30 percent of spending, while the remaining 70 percent is the responsibility of the cantons and local communities.

Fiscal Equalization

Fiscal equalization in Switzerland was implemented in 1959. In the 1990s, the system was evaluated for the first time and the review concluded that the system was in need of serious reform. According to the review, fiscal equalization had not only failed to reduce disparities between regions, but had, on the contrary, reinforced them. Moreover, it had led to negative incentives for political governance and public spending.

The Swiss system of equalization was overhauled in 2008. A number of improvements in equalization have been recognized since the reform. First, the new system better defined the functions carried out by the federal government and cantons. Of the 31 functions where tasks were carried out jointly, 15 were placed under exclusive cantonal jurisdiction and six under federal jurisdiction. The new separation of tasks is not yet fully completed but first evaluations have identified positive results, such as lower costs for national roads. According to reports, in a single year, savings of 120 to 205 million Swiss francs were realized thanks to lower construction prices.

Second, fiscal capacity equalization, the main redistribution mechanism, is now based on cantonal tax potential, defined by standardized tax revenues on income, wealth, and profit in relation to taxable income and wealth. The evaluation of financing needs is based on a set of specific, transparent factors.

It is divided into three main areas: equalization for geographic and topographic factors, in particular for mountainous cantons; equalization for socio-economic factors faced by urban agglomerations, such as costs arising from their population structure, the costs of high density; and finally equalization for the typical functions of large city centers.

Third, it is now up to the cantons to decide which expenditures they wish to carry out with the funds redistributed by the fiscal equalization system. This has created an incentive to provide more efficient public services. The former earmarking of federal subsidies to specific expenditures and their calculation based on cost evaluations and financial capacity led cantons to strive for the largest subsidies possible rather than fulfill their tasks in a cost-effective manner.

In absolute and relative terms, fiscal equalization is relatively modest compared to public budgets. In 2013, it represented 2.5% of the total federal, cantonal, and communal budgets, and 6% of cantonal budgets. Total payments amounted to 4.7 billion Swiss francs: 3.7 billion as general resources equalization, 365 million for geo-topographic charges (in particular, for mountainous cantons), 243 million for socio-demographic charges (in particular, to aid with costs of poverty, old age, and migrant integration), and finally 122 million for city centers (which mainly concerns Zurich, Geneva, and Basel). In addition, 239 million are earmarked for so-called hardship, in order to ease the transition from the old to the new system.

Concluding Thoughts

Overall, Bessard cites and agrees with assessments that the reforms have improved the system of fiscal transfers in Switzerland, particularly with respect to cantonal financial autonomy. The economic analysis, however, is less satisfying than the political analysis. Like all subsidies, fiscal equalization still leads to substantial distortions among cantons. Instead of letting unsustainable public entities reform themselves (or merge), it may maintain inefficient structures that would not subsist without support. This may be especially true for a number of small rural or mountainous cantons with comparatively high tax rates. Also, the amount of redistribution involved and the burden imposed on the contributing cantons are still subject to controversy. A possible reform would be to cap the amounts, in order to prevent over time the many cantons on the receiving side from outvoting their donors on plans to redistribute ever more funds in their favour.

There are two insights for Canada worth noting. First, the Swiss experience demonstrates the benefits from clearly delineating the roles and responsibilities of the federal and cantonal governments, which reinforces many of the reforms implemented in the 1990s by Canada to achieve a similar demarcation of responsibilities between the federal and provincial governments in Canada. Second, the Swiss system of calculating transfers assesses both spending and revenue needs, a procedure that to some extent mirrors the Australian approach.

As discussed in the Australian section, a number of analysts in Canada have called for the consideration of spending needs to be included in the equalization process. A more detailed, technical analysis of both Australia and Switzerland should be undertaken to better understand how such considerations are incorporated along with the costs and benefits of such an approach.

5. Federalism and Fiscal Transfers in Germany

The final essay, by Professor Charles Blankart of Humboldt University (Berlin) and the University of Lucerne (Switzerland), examines the German fiscal system with particular emphasis on the mechanism by which resources are transferred from the federal government to the state and local governments.

A defining characteristic of the German tax system is that it is largely a system of joint taxes. The three main taxes, namely the personal and corporate income taxes and the VAT are joint taxes. This means the federal, state, and local governments have shared rights. According to Blankart, these taxes are legislated at the federal level (rates and tax base) by the *Bundestag* (federal assembly) and the *Bundesrat* (federal council). The revenues from these three sources are divided between the federal government and the state and local governments.

Dividing the Revenue

The division of tax revenues in Germany takes place through a five-step process, which is informative about the mechanisms for equalizing revenue capacity.

First, the German constitution requires that personal income tax revenues are allocated to the federal, state and local levels in the following percentages: 42.5%, 42.5%, 15%, respectively. The corporate income tax is divided 50-50 between the federal and state governments.

The second step ensures that personal and corporate income taxes are allocated to the appropriate state. Personal income tax revenues, for instance, are allocated to states based on the residence of individuals. Corporate taxes are paid to states based largely on the location of employees in the company. This process is simply meant to ensure that states receive the proper allocation of the revenues raised jointly. The VAT is distributed in two steps. First, one quarter of VAT revenues are retained by the federal government. The remaining three quarters are divided into two parts: (1) 75 percent is paid out to the states on a per-capita basis, and (2) the remaining 25 percent (of the three quarters) are distributed to states deemed "poor" based on the difference between personal and corporate tax revenues raised per capita in the state compared to the national average.

The third step incorporates transfers from well-off states to the less well-off states. These transfers are unique because they are between states (horizontal transfers). They are federal only insofar as they are determined by federal law. A state is defined as well-off if its effective fiscal capacity (EFC), measured by its total actual tax revenues, is larger than what the state would receive with an average fiscal capacity. The average fiscal capacity (AFC) of a state is defined as the total tax revenue of all states weighted by their population.[9, 10] This system is similar to Canada's system of equalization, although it is much less complicated and therefore more transparent.

The fourth step in the process is to provide certain poor states with a secondary federal equalization payment. These payments are made to states that remain under a prescribed threshold of AFC compared to EFC after the transfers from step three. In other words, when states still lack the fiscal capacity required after receiving a transfer as outlined in step three, they become eligible for a supplemental payment.

Finally, there is a special secondary federal equalization transfer that is provided to states whose economies are simply too small and poor to reach parity in the calculations outlined above and/or those still suffering from the financial burden of the former communist regime.

Note that all allocations and transfers from one to five above are untied and non-earmarked, which means the states are free to use them at their discretion. The federal government is not allowed to use (or misuse) federal transfers for any micromanagement of the states. This is an important limit to federal power in Germany. The German federal transfer system is, therefore, fundamentally different from the United States's Grants-in-Aid system and programs of other countries such as Canada that use tied grants (in Canada, there is both the Canada Health Transfer and the Canada Social Transfer).

Problematic Incentives

Professor Blankart spends some time in his essay explaining the incentive problems linked with Germany's system of fiscal transfers, many of which are easily applicable to other countries with such transfers, including Canada. He discusses a number of disincentives that are almost unique to the German system. The disincentives to improve a state's economic circumstances through better policies, however, is one of the more important common failings identified and explained by Professor Blankart. Simply put, when a state receives benefits from underperforming and risks losing such benefits through improvement, there are clear disincentives to improve both in the short and long term.

Conclusion

This collection of essays with contributions from leading thinkers in Australia, the United States, Switzerland, and Germany offers current-day insights into other federalist countries and the process by which they transfer resources from the federal government to subnational levels of government as well as between subnational levels of government.

9. In a mathematical sense, AFC = (EFC) (popstate/Germany's pop). A state is a payer state if its (EFC) > (AFC). It is a receiver state if its (EFC) < (AFC).

10. The analysis disregards adjustment factors for city states.

There are several important insights to be found in the essays. First, all four countries experience incentive problems with respect to their fiscal transfer programs, particularly the three countries—Australia, Switzerland, and Germany—that have formal mechanisms to equalize revenues among subnational jurisdictions. A key disincentive discussed by all three authors was the barrier discouraging poorer jurisdictions from improving their economic position through better policies. All of the authors discussed how improving the subnational level of government led to reduced transfers, which creates a disincentive to improve. The same phenomenon has been observed and criticized in Canada.

Another common observation was the complex and often opaque nature of these transfer mechanisms. This was particularly true of the US system of transfers, which according to the author now maintains over 1,100 separate transfer programs. A key implication of the analysis, backed by the reform experiences in Australia and Switzerland as well as Canada's own experience, is that simplifying transfer programs yields enormous benefits.

A related successful reform, which again supports changes made to Canada's own transfer programs in the 1990s, is providing subnational levels of government autonomy in how they use the resources. The experiences of Australia, Switzerland, and Germany as well as Canada demonstrate the benefits of block grants or untied transfers wherein the subnational level of government is afforded increased flexibility in how to use the resources. The experience of the United States, which provides a counter-example, buttresses the fact that heavy-handed regulation coupled with narrowly defined, earmarked funding by the central government impedes innovation, responsiveness, and ultimately effectiveness on the part of subnational governments.

Two areas of research identified by the essays for Canada focus on equalization. One, greater research should be undertaken into the benefits and costs, particularly the incentive effects of including spending considerations in the calculation of equalization. Both Australia and Switzerland include such calculations and it would be worthwhile to understand clearly the potential for improvement from such reforms in Canada.

Two, the Australian experience with equalization indicates that capping the total amount of equalization transfers available by linking the resources available to a specific tax may yield further improvements in the Canadian system. Again, specific and empirical research is required to determine whether reforms along these lines offer clear net benefits to Canadians.

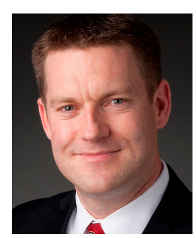
These essays are a first step in identifying areas for possible improvement in Canada's Equalization Program by observing comparable mechanisms in other federalist countries. There are clearly current lessons to be garnered from countries like Australia, Switzerland, and Germany, with additional research identified for the future.

1. Introduction
Federalism and Fiscal Transfers in Canada

Jason Clemens and Niels Veldhius

One of the constant pressures within countries organized along federalist grounds, like Canada, is the balance of power between the central and sub-national levels of governments—provinces or states. Federalism is a political system whereby a group of jurisdictions has chosen to bind themselves together by covenant. In Canada's case, provinces voluntarily decided to join the Canadian confederation. Federalism is characterized by a constitution or other binding agreement regarding the rights and powers of each level of government. Disputes regarding tax powers, spending authority, legislated mandates, and regulatory encroachment are but a sample of the many struggles observed on an ongoing basis in federalist countries between the two levels of government.

Jason Clemens is the Executive Vice President of the Fraser Institute and the President of the Fraser Institute Foundation. Before rejoining the Fraser Institute in 2012, he was the director of research and managing editor at the Ottawa-based Macdonald-Laurier Institute and, prior to joining the MLI, spent a little over three years in the United States with the San Francisco-based Pacific Research Institute. He has an Honors Bachelors Degree of Commerce and a Masters' Degree in Business Administration from the University of Windsor as well as a Post Baccalaureate Degree in Economics from Simon Fraser University. He has published over 70 major studies and 300 shorter articles on a wide range of topics, including taxation, government spending, labor market regulation, banking, welfare reform, health care, productivity, and entrepreneurship.



Niels Veldhuis is Fraser Institute President and one of Canada's most-read private-sector economists. Niels has written six books, more than 50 comprehensive studies and more than 200 commentaries on a wide range of economic topics including taxation, banking, productivity, investment, entrepreneurship, labour markets and government finances. He also writes a bi-weekly column for the *Financial Post*. Niels is regularly asked to appear before committees of both the House of Commons and the Senate as an expert witness and, in 2011, led a discussion between former presidents Bill Clinton and George W. Bush at the Surrey Economic Forum. He holds a Bachelor degree in Business Administration and a Master Degree in Economics from Simon Fraser University.

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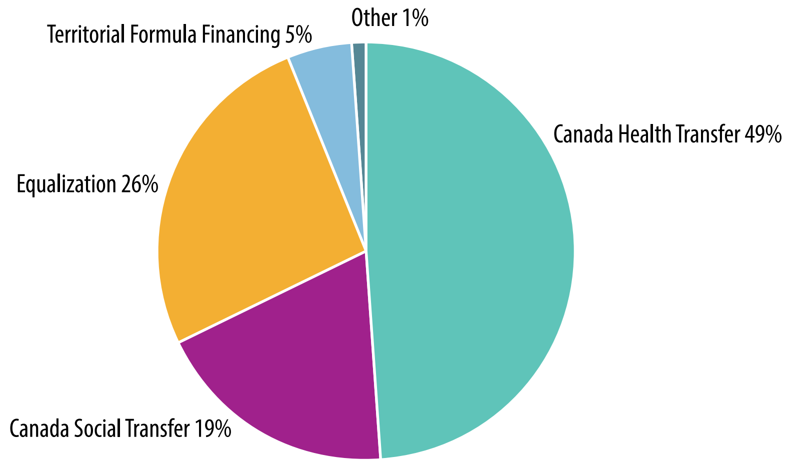
1. The federal department of finance has a section on its website explaining federal transfers to the provinces and territories that provides interested readers with a reasonable overview. Please see <http://www.fin.gc.ca/access/fedprov-eng.asp>.

2. For an overview of both the CHT and the Canada Health Act, please see Jason Clemens and Nadeem Esmail (2012). *First, Do No Harm: How the Canada Health Act Obstructs Reform and Innovation*. Macdonald-Laurier Institute. <http://www.macdonaldlaurier.ca/files/pdf/How-the-Canada-Health-Act-Obstructs-Reform-and-Innovation-June-2012.pdf>. A succinct summary of the study is available at <http://www.macdonaldlaurier.ca/calgary-herald-let%E2%80%99s-remove-barriers-to-health-care-reform/>.

3. We purposefully use the term "formally" when describing these transfers because there are a number of informal mechanisms through which the federal government transfers resources to the provinces and regions. A forthcoming paper entitled *Unseen Equalization: An Overview of Provincial Subsidies in Federal Programs* by David Mackinnon with Jane Loyer, Frazier Fathers, and Milagros Palacios, to be published by the Fraser Institute, explores these informal but nonetheless important mechanisms for redistributing federal resources to the provinces.

Figure 1.1: Federal Transfers to Canadian Provinces and Territories (2013-14)



Sources: Canada, Department of Finance (2012). *Federal Support to Provinces and Territories*. Department of Finance. <http://www.fin.gc.ca/fedprov/mtp-eng.asp>, as of April 16, 2013.

Health and Social Transfer.[4] The CST is a federal block grant to the provinces to support post-secondary education, social assistance, early childhood development, early learning, and childcare. The fungible nature of the grant means that the provinces have a great deal of flexibility in using these funds for various social programs. The total cash transfer for the CST in 2013-14 is expected to reach $12.2 billion.

Equalization

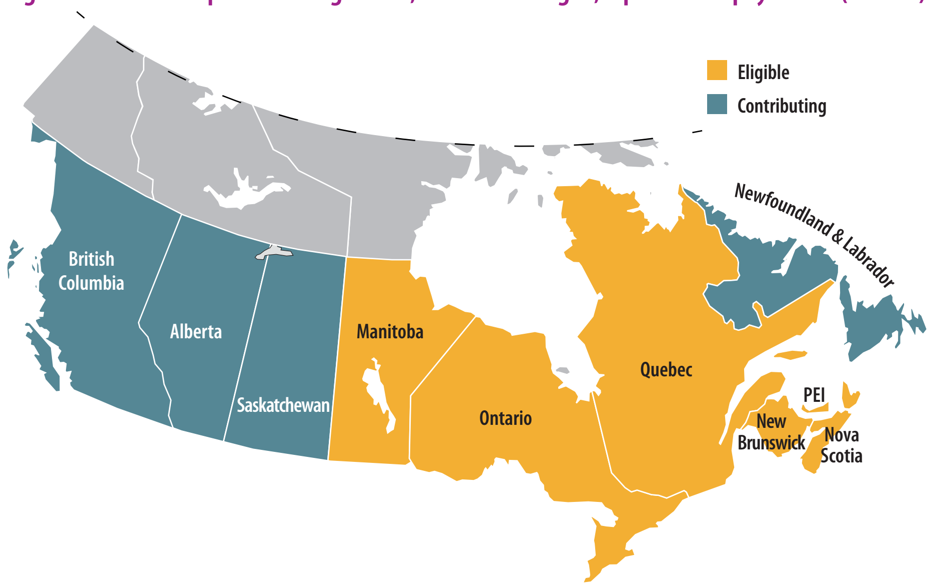
By far the most controversial of the major transfer programs to the provinces is Equalization. It is intended to address fiscal disparities between the provinces and theoretically allows payments to be made to less prosperous provinces to ensure their public services are comparable with those in other more prosperous provinces at reasonably comparable levels of taxation. Equalization payments to the provinces are unconditional, meaning that the recipient provinces have full discretion over the use of the funds.

Equalization payments represent a little over one-quarter of the total transfers made to the provinces (figure 1.1), behind only the Canada Health Transfer (CHT). Unlike the CHT and CST, however, equalization is only distributed to provinces deemed to be "have-not", which refers to their ability to raise revenues compared to other provinces. In other words, not every province is eligible for equalization whereas all provinces receive CHT and CST payments. In addition, Equalization is also unique in that it is formally part of the Canadian Constitution (subsection 36 (2)).

4. For a brief history of the CHT and CST, please see <http://www.fin.gc.ca/fedprov/his-eng.asp>.

Equalization is an extraordinarily technical and complicated program, with an enormously elaborate calculation used to determine eligibility and payments.[5] In 2013-14, equalization payments were expected to reach $16.1 billion with six provinces eligible for equalization payments: Manitoba ($1.8 billion), Ontario ($3.2 billion), Quebec ($7.8 billion), New Brunswick ($1.5 billion), Nova Scotia ($1.5 billion), and Prince Edward Island (PEI) ($340 million). The remaining four provinces were contributors to equalization (figure 1.2).[6]

Figure 1.2: Canadian provinces eligible for, or contributing to, Equalization payments (2013-14)



5. For information on the calculations used and the system of equalization, please see the Expert Panel on Equalization and Territorial Formula Financing at <http://www.eqtff-pfft.ca/english/index.asp>; in addition, for a broader overview of both equalization and transfers, see Jason Clemens and Niels Veldhuis (2007). *Beyond Equalization: Examining Fiscal Transfers in a Broader Context*. Fraser Institute.
6. See <http://www.fin.gc.ca/fedprov/eqp-eng.asp> for additional information on equalization in 2013-14.

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2. Lessons from the Australian Experience

Stephen Kirchner

Introduction

Australia's federation is notable for having the world's most comprehensive and complex system for the equalization of fiscal capacity via fiscal transfers from the federal government to state governments. This is despite the fact that Australia has the smallest disparities in income and economic conditions among its constituent states of any comparable federation. Australian federal-state financial relations are also notable internationally for the centralisation of revenue-raising in the hands of the federal government relative to its expenditure responsibilities. The federal government raises around 80 percent of revenue, but is responsible for only just over half of public expenditures by all levels of government. The centralisation of revenue-raising increases the size and potential economic significance of federal fiscal equalization transfers to the states.

In designing Australia's federal system, the founders put in place arrangements through which the federal government could provide financial assistance to the states should they encounter fiscal difficulties. Federal payments to the states were an important transitional measure by which the former colonies adjusted to the new economic realities of federation in 1901. They were also seen as an important mechanism to hold the new federation and currency union together against future adversity.

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Over time, federal payments to the states have evolved from *ad hoc* financial assistance based on fiscal need to a complex system of "full equalization" of fiscal capacity. Fiscal capacity refers to revenue-raising ability and expenditure needs based on factors deemed to be beyond the control of state governments and the equalization of fiscal capacity aims to improve the provision of public services in states that might otherwise be at a disadvantage. However, while the principle of fiscal equalization is widely accepted, there is considerable disagreement over what this should mean in practice.

The implications for economic efficiency of these equalization transfers have been extensively studied and widely debated, although with little consensus achieved. The empirical literature suggests that the current system of fiscal equalization reduces economic efficiency. The dollar value of these efficiency costs is thought to be small as a share of GDP, although there are concerns that the long-run efficiency costs due to perverse incentives faced by the states could be larger. To the extent that the efficiency and equity implications of fiscal equalization transfers are ambiguous, this in itself is an argument against overly ambitious or precise attempts at equalization. The efficiency costs would be more defensible if the equalization of fiscal capacity demonstrably improved equity in service provision, but there is no necessary relationship between the equalization of fiscal capacity and actual provision of services. Compared to other policies pursued by both federal and state governments, fiscal equalization has only modest implications for the economic circumstances of individuals and households.

The evolution of fiscal equalization in Australia has been coupled with persistent dissatisfaction with its operation, especially on the part of those states that are net contributors rather than recipients of equalization transfers. This has led to various proposals for reform. The most promising would involve a system of equal per-capita grants for GST revenue, coupled with an equal lump-sum payment to cover the core costs of government. However, the political economy of fiscal equalization does not generate strong incentives for the federal government and the states to reach agreement on further fundamental reform of federal-state financial relations, including fiscal equalization. The principal lesson from the Australian experience is that overly ambitious attempts at fiscal equalization are unlikely to prove successful in promoting either efficiency or equity objectives. These goals are best pursued through other mechanisms.

The Evolution of Horizontal Fiscal Equalization

Australia's 1901 Constitution specified the powers of the newly created federal government, but was largely silent on the powers of the states. It was assumed by the founders that each level of government would have access to the revenue needed to perform its responsibilities. The provisions of the Constitution dealing with federal-state financial relations were designed mainly as transitional arrangements to compensate the states for the loss of customs and excise revenue, which was reserved for the federal government after federation.[1]

However, section 96 of the Constitution also provided for the federal government to "grant financial assistance to any State on such terms and conditions as [federal] Parliament thinks fit". Unlike Canada's 1982 Constitution Act, Australia's Constitution does not otherwise or specifically provide for fiscal equalization. Section 96 was intended as a safety net to assist states that might encounter financial difficulty and possibly compromise the integrity of the federation. Over time, this constitutional head of power has allowed the federal government to assume financial dominance over the states and take over or intrude into state-level constitutional responsibilities.

Following the expiration of the transitional provisions of the Constitution, a system of equal per-capita grants from the federal government to the states was in place from 1909 to 1927. There was a move away from this system in the late 1920s and early 1930s in response to the financial problems experienced by Western Australia and Tasmania in the first decades of federation and a strong secessionist movement in Western Australia in the early 1930s.[2] Whereas the states had been expected to converge in their economic circumstances, significant differences persisted in the decades after federation. Since 1960, however, Australia has seen greater convergence in per-capita incomes than comparable federations, including Canada.[3]

Commonwealth Grants Commission

The Commonwealth Grants Commission was created in 1933 as an independent body to evaluate the needs of "claimant" states for federal financial assistance. The original role of the Commission was to preside over a less *ad hoc* approach to assisting distressed states rather than fiscal equalization.

Prior to World War II, federal payments to the states were only around one third of the revenue from state taxes. During World War II, the federal government assumed the income tax powers of the states to enable it to better prosecute the war effort. The 1942 uniform tax measures established the federal government's financial dominance of the states and provided the fiscal basis for growing federal intrusion into their traditional responsibilities.

The Commonwealth Grants Commission was given a new legislative basis in 1973 by the Whitlam Labor government. The legislation provided for financial assistance grants "for the purpose of making it possible for the State, by

1. Denis Warwick James (2000), *Federal-State Financial Relations: The Deakin Prophesy* (Department of the Parliamentary Library): 1.
2. Vincent W. FitzGerald and Ross Garnaut (2002), *Review of Commonwealth-State Funding: Final Report* (Review of Commonwealth–State Funding): 24.
3. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 95.

reasonable effort, to function at a standard not appreciably below the standards of other states".[4] Federal payments to the states were thus increasingly motivated by the desire to equalise fiscal capacity and the ability to deliver public services.

The "new federalism" policy of the Fraser government from 1975 until the early 1980s saw fiscal equalization increasingly replace financial need as the basis for federal payments to the states. The new federalism policy also allowed the states to impose their own income taxes on top of federal taxes. However, the federal government's failure to "make room" by lowering its own income tax rates meant that this opportunity was not used by the states.

The Hawke-Keating Labor government from 1983 to 1996 also embarked on a "new federalism" policy that led to a more comprehensive approach to fiscal equalization. In its 1993 report, the Commonwealth Grants Commission introduced the principle of "full" fiscal equalization, which is quite similar to the equalization principles in Canada. The Commission defined the principle of "full" fiscal equalization as follows: "The principle of fiscal equalisation is that each State should be given the capacity to provide the same standard of State-type public services as the other states, if it makes the same effort to raise revenues from its own sources and conducts its affairs with an average level of operational efficiency".[5]

Payments to the states are based on assessed fiscal capacity on both the revenue and expenditure side of state budgets and not fiscal need. For example, it is not uncommon for states with strong actual fiscal positions measured by their budget balance or the level of state debt to receive funds from states with weaker fiscal positions based on their assessed fiscal capacity.

Introduction of Australia's GST Complicates an Already Complicated Situation

A significant change in federal-state financial relations occurred in 1999 ahead of the introduction of the goods and service tax (GST) by the federal government in 2000. The federal government and the states entered into an Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations. The Agreement provided for the distribution of the GST revenue collected by the federal government to the states based on the principles of fiscal equalization. However, the agreement did not attempt to define these principles or the methodology for their implementation. The Agreement has no constitutional or legal status and a number of states now dispute what they signed up for in agreeing to have the GST revenue distributed on the basis of fiscal equalization.[6]

4. Ross Williams (2005), Fiscal Federalism: Aims, Instruments and Outcomes, *Australian Economic Review* 38, 4: 361.

5. Commonwealth Grants Commission (1993), *Report on General Revenue Grant Relativities 1993* (Australian Government Publishing Service): 6.

6. Commonwealth Grants Commission (1993), *Report on General Revenue …* : 37.

In return for the GST revenue, the states agreed to abolish various inefficient state-level taxes such as taxes on financial account transactions and stamp duties on marketable securities. This had the effect of further increasing the imbalance between the federal government's revenue-raising and expenditure responsibilities and the size of federal transfers to the states. The pool of funds available for equalization increased by 32 percent between 1999-2000 and the introduction of the GST in the 2000-01 financial year.[7]

The decision to return GST revenue to the states gave the states access to a tax that would grow with the size of the economy, but would also fluctuate with economic conditions. GST revenue has grown by around 6 percent per year since its introduction, although it has slowed more recently with more subdued economic conditions and with shifts in the composition of consumer spending.[8] Whereas the amount transferred to the states was previously determined by political decisions of the federal government, the amount available for equalization is now determined by the amount of GST revenue. Competition between the states for revenue through the equalization process is now a zero-sum game because the equalization pool is determined by factors such as the strength of the economy that are outside political control.[9]

The GST rate and base can only be changed with the agreement of state governments and the federal parliament. Returning the GST revenue to the states on the basis of fiscal equalization was an effective way of locking the states into a tax reform process initiated by the federal government. However, it also served to bind the states into a federal-state revenue-raising cartel that limits the scope for competition between the states to lower taxes. As Williams notes, "the political incentives for the [federal] government are to freeze the GST parameters and meet the resultant increase in federal-state fiscal imbalances by taking over state government functions".[10]

The Current System of Fiscal Equalization

The fiscal equalization process is administered by the Commonwealth Grants Commission (CGC), an independent statutory advisory body with members appointed by the federal government that makes recommendations in consultation with the federal government and the states. The Commission aims to identify and then quantify those factors outside the control of the states that affect their expenditure requirements and revenue-raising capacity, as opposed to their actual expenditure and revenue or fiscal position. It is this assessment of both expenditure needs and revenue-raising capacity that makes the Australian approach to fiscal equalization internationally unique in its comprehensiveness

7. Williams (2005), Fiscal Federalism: 147.

8. Commonwealth of Australia (2012), *GST Distribution Review: Final Report*: 3.

9. Ross Williams (2012), History of Federal–State Fiscal Relations in Australia: A Review of the Methodologies Used, *Australian Economic Review* 45, 2: 153.

10. Williams (2012), History of Federal–State Fiscal Relations in Australia: 153

(one could also argue internationally anomalous). The process equalises fiscal capacity, not fiscal outcomes. It also tries to avoid distorting decision-making by the states and the creation of perverse incentives to manipulate the system to obtain a larger grant share.

Each state receives a per-capita share of the GST revenue, plus an offset that reflects different expenditure and revenue needs and capacities relative to the average of all the states. The federal government's special purpose payments to the states are included in this assessment on the assumption that revenue available to the states from most sources is fungible. Special purpose payments are grants from the federal government to the states subject to conditions as to how the money is spent in areas such as health and education that are otherwise the responsibility of the states. These payments serve as a mechanism through which the federal government can exert increased control over state responsibilities.

National Partnership project payments are grants to the states to deliver specific projects in areas such as health and housing that are not subject to equalization. The process of fiscal equalization thus effectively overrides the allocation of special-purposes payments by the federal government.

Relativities for the equalization of GST revenue are updated every financial year and the fiscal equalization methodology is reviewed every five years, with the most recent review completed in 2010. Like Canada's process of equalization, the process of identifying and quantifying the factors that determine grant relativities in Australia is extremely complex and lacking in transparency. A wide range of factors are taken into account including population size, age and structure, the level of per-capita incomes, the impact of geography on costs, the presence of indigenous peoples, low English fluency, and the capacity of various tax bases. Indigeneity is the single largest source of equalization on the expenditure side, while mining revenue is the main source of equalization on the revenue side.

Data in relation to many of these factors are often lagging and so historical averages are used. Where these factors cannot be quantified, judgement is often substituted. The process involves some 2,000 pages of annual reports and working papers and consumes significant resources on the part of the state and federal public service.[11] It was estimated to cost around $10 million per year in 2002.[12] Adjusted for inflation, it is unlikely these administrative costs have changed significantly in the period since. The CGC has a budget of $6.5 million in 2012-13 and a staff of 42. These administrative costs should be viewed as part of the overall efficiency cost of fiscal equalization.

In the 2012-13 financial year, the federal government in Australia budgeted to make $90.4 billion in total payments to the states, equal to 24 percent of federal government expenditure or 5.8 percent of gross domestic product.

11. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 55.
12. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 146.

Around 80 percent of this funding is in the form of untied grants, with the remaining reflecting special purpose and other payments.[13] On average, GST revenue makes up around 25 percent of state government revenues.[14] The distribution of federal government payments to the states by state and type of payment in the most recent federal budget is shown in **table 2.1** and illustrated in **figure 2.1**. Just over half of federal payments to the states represent untied GST revenue. Special purpose payments (SPP) are factored into the equalization process for GST revenue, but other payments are not.[15]

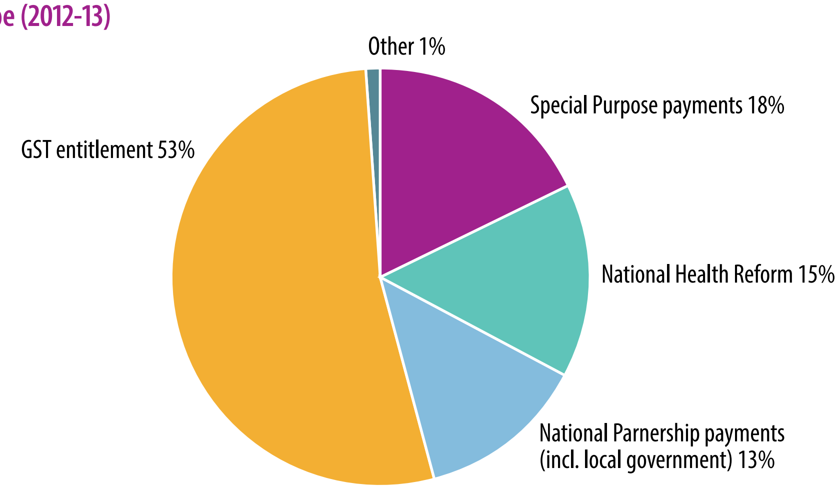
Table 2.1: Total payments (AU$ millions) from Australian Commonwealth to the States, by type and share of GDP

	Special Purpose payments	National Health Reform	National Partnership payments*	GST entitlement	Other	Total	Percent of GDP
2012-13	16,105	13,518	11,365	48,200	1,181	90,370	5.8
2013-14	17,160	14,383	12,836	50,900	1,139	96,418	5.9
2014-15	18,325	15,944	9,918	53,500	1,132	98,819	5.8
2015-16	19,561	17,639	10,072	56,075	1,139	104,487	5.8

Note *: including local government.

Source: Commonwealth of Australia (2012), *Australia's Federal Relations*, Budget Paper No. 3, 2012-13 (May 8): 17.

Figure 2.1: Payments (AU$ millions) from Australian Commonwealth to the states, by type (2012-13)



Source: Commonwealth of Australia (2012), *Australia's Federal Relations*, Budget Paper No. 3, 2012-13 (May 8): 17.

13. Commonwealth of Australia (2012), *Australia's Federal Relations*, Budget Paper No. 3, 2012-13 (May 8).
14. Commonwealth of Australia (2012), *GST Distribution Review*: 172.
15. Commonwealth of Australia (2012), *GST Distribution Review*: 85.

The GST relativities for each state, which represent the level of receipt from, or contribution to, equalization at the state level, are shown in table 2.2. The relativities determine how much GST revenue each state receives relative to an equal per-capita share. States with a relativity greater than one are net recipients of fiscal equalization; states with a relativity less than one are donor states (figure 2.3). The relativities lead to around 8 percent of total GST revenue being equalized while the remainder is effectively a per-capita (uniform) grant. However, the percentage of GST revenue redistributed by equalization is expected to rise significantly in future years as strong growth in state mining royalties in Western Australia (iron ore) and Queensland (coal) is equalized. Unlike Canada, there are no discounts applied to mining revenue in the equalization process. Mining royalties are fully equalized.[16]

Table 2.2: GST Relativities, 2012-13

Northern Territory	5.52818
Tasmania	1.58088
South Australia	1.28472
Australian Capital Territory	1.19757
Queensland	0.98477
New South Wales	0.95312
Victoria	0.92106
Western Australia	0.55105

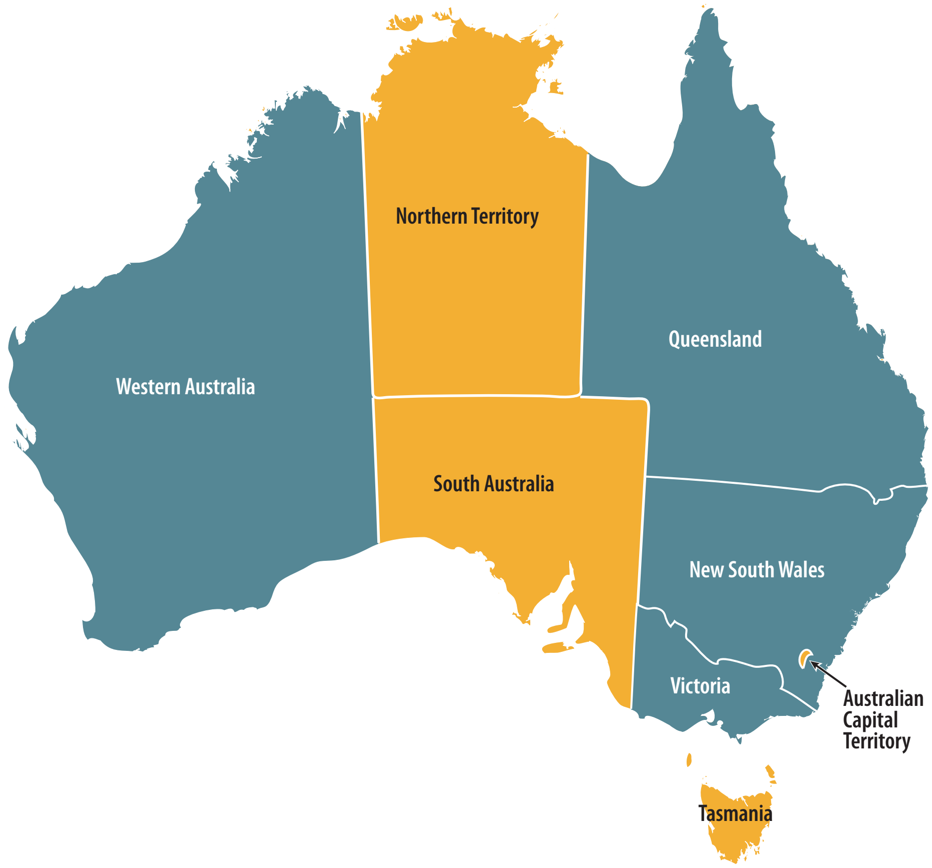
Source: Australia's Federal Relations, Budget Paper No. 3, 2012-13, p. 123.

Efficiency Implications of Fiscal Equalization in Australia

The implications of fiscal equalization for economic efficiency have been extensively debated and studied in Australia. The efficiency case for fiscal equalization was made by James Buchanan in 1950, who noted that federal political structures could impose unequal fiscal burdens and create incentives for inefficient internal migration.[17] Later work by Buchanan and Goetz found that the "efficiency in migration" case for fiscal equalization was theoretically much more ambiguous than Buchanan originally argued.[18] Reviewing the literature in the Australian context, Petchey and Levtchenkova note that "there seems to be no consensus on the efficiency debate, with conclusions depending on

16. Commonwealth of Australia (2012), *GST Distribution Review*: 52.
17. James Buchanan (1950), Federalism and Fiscal Equity, *American Economic Review* 40, 4: 583–599.
18. James M. Buchanan and Charles J. Goetz (1972), Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model, *Journal of Public Economics* 1, 1 (April): 25–43.

Figure 2.3: Australian states eligible for, and contributing to, Equalization payments (2013-14)



particular lines of argument taken, assumptions made and modelling structures adopted".[19] They nonetheless argue that fiscal equalization in Australia should aim to promote economic efficiency by generating appropriate incentives instead of equalizing fiscal capacity.[20]

As Buchanan would later concede, his early work on the subject of fiscal equalization assumed a government motivated by public rather than private interests, a view that would later be over-turned by his own development of "public choice" theory. Public choice theory would lead us to doubt whether an idealized model of fiscal equalization based on efficiency or equity considerations could emerge or be sustained undistorted by ordinary politics.[21] The independence of the Commonwealth Grants Commission has insulated it somewhat from political pressure, but no government body can be completely independent.

19. Jeffrey Petchey and Sophia Levtchenkova (2007), Fiscal Capacity Equalisation and Economic Efficiency: The Case of Australia, in J. Martinez-Vazquez and B. Searle, eds., *Fiscal Equalization: Challenges in the Design of Intergovernmental Transfers* (Springer): 15.
20. Petchey and Levtchenkova (2007), *Fiscal Capacity Equalisation and Economic Efficiency*: 29.
21. James M. Buchanan (2002), *Fiscal Equalisation Revisited, Equalization: Welfare Trap or Helping Hand?* (Atlantic Institute for Market Studies).

Buchanan also later noted the importance of international migration and foreign investment in dominating outcomes from fiscal equalization. In Australia, there has been concern that fiscal transfers away from the traditional destinations for migrants and foreign investment, New South Wales and Victoria, may hinder the ability of those states to capture the benefits from these inflows of foreign labour and capital. This is potentially an economic detriment, not only for donor but also recipient states.[22] Australia's high level of internal and external economic integration means that efficiency losses in one state are likely to impose costs on other states as well. The long-run economic benefits from population growth and international immigration are frequently underestimated or ignored by Australian policymakers.[23] The focus is often on short-run costs such as congestion. Donor and recipient states may be discouraged from pursuing pro-growth and development policies if these gains are re-distributed to other states. Garnaut and FitzGerald found that anywhere from 64 to 90 cents of an extra dollar in revenue generated by economic development was taken away by equalization.[24] This may help explain the policies of state governments that are hostile to economic development. For example, Bob Carr, the premier of the state of New South Wales between 1995 and 2005, was notoriously hostile to immigration, maintaining the state capital Sydney was "full".

Another efficiency consideration is the so-called "flypaper effect", or the idea that money "sticks where it hits". There is evidence to suggest that fiscal transfers lead to larger public sectors in recipient states, to the detriment of economic efficiency and service provision. For example, Garnaut and FitzGerald found that the ratio of private employment to population is lower in South Australia and Tasmania than in other states.[25]

Other efficiency costs associated with fiscal equalization are the potential for duplication and lack of coordination in service provision between the federal government and the states, grant-seeking behaviour, reduced incentives for cost-reducing reforms, and the previously mentioned overhead and transaction costs of administering the grant system.[26]

Various attempts have been made at quantifying the efficiency implications of fiscal equalization, yielding widely varying estimates. In 2002, Garnaut and FitzGerald put the economic efficiency costs at $150 million to $280 million, not including what they considered to be an even larger cost of administering the system.[27] They claimed that "all studies point to net efficiency costs

22. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 135.
23. Stephen Kirchner (2011), *Hands, Mouths and Minds: Three Perspectives on Population Growth and Living Standards*. Centre for Independent Studies Policy Monograph No. 12 (September).
24. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 151.
25. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 145.
26. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 135.
27. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 133.

and none to net benefits".[28] This may be over-stating the efficiency case against fiscal equalization. The final report of the *2012 GST Distribution Review* contains a more contemporary review of the theoretical and empirical literature, including modelling for the review itself that took a more sympathetic view of the efficiency case for fiscal equalization, although it stopped short of arguing there were net benefits.[29] The ambiguous implications for economic efficiency are in themselves a strong argument against overly ambitious or precise attempts at fiscal equalization. They also suggest that "the chance of a citizen at the border correctly identifying a difference in fiscal capacity that could be attained by migration is slim,"[30] undermining the "efficiency in migration" case for fiscal equalization.

Implications for Equity

Buchanan's seminal argument for fiscal equalization was also based on equity considerations or "equal fiscal treatment for equals".[31] It is arguably inequitable for individuals with similar characteristics to be treated differently in a fiscal sense simply because they reside in one state rather than another. However, Buchanan also stressed that this concept of horizontal equity should apply to individuals rather than governments. Australia's system of fiscal equalization equalizes state fiscal capacities and the capacity to provide services with little regard for its implications for individuals or households. Due to the "flypaper effect" noted above, there is no guarantee that recipient states will spend transfers in ways that improve the circumstances of individuals or households. Fiscal equalization also does not equalize actual service provision as opposed to the fiscal capacity to provide services. The equalization of fiscal capacity leads to seemingly perverse results. For example, the Australian Capital Territory is a recipient of fiscal transfers, despite having Australia's highest per-capita incomes. Garnaut and FitzGerald found that fiscal equalization in Australia made "the distribution of income among Australian individuals and households slightly more unequal" compared to an equal per-capita distribution.[32]

The implications of fiscal equalization for both individuals and households are also over-whelmed by the extensive redistributive tax and spending policies of the federal government. A more efficient way of addressing concerns about equity that avoids the flypaper effect would be for the federal government to make transfer payments directly to individuals and households to target specific areas of disadvantage, although attention would need to be paid to the efficiency and other implications of such direct transfers.

28. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 141.
29. Commonwealth of Australia (2012), *GST Distribution Review: Final Report*.
30. Commonwealth of Australia (2012), *GST Distribution Review*: 40.
31. Buchanan (1950), Federalism and Fiscal Equity: 588.
32. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 123.

Reform Proposals

Persistent dissatisfaction with the process for fiscal equalization has led to various reform proposals, mostly at the instigation of the donor states. Support for the *status quo* has come, not surprisingly, from the recipient states. Reform of fiscal equalization is inevitably bound up with the arguably more important issue of the mismatch between the federal government's revenue-raising and expenditure responsibilities. This argues for the devolution of revenue-raising powers back to the states that would in turn reduce the need for federal transfers. However, the tax reform process led by the federal government has tended to increase rather than decrease the centralization of revenue-raising capacity. This has been matched by a tendency for the federal government to take over responsibilities that were traditionally the preserve of the states. Federal-state relations have thus moved away from a model of competitive federalism to a more centralist model that has increasingly cartelized revenue-raising and service provision, reducing the scope for competition between the states for domestic and international labour and investment. This reduction in jurisdictional competition reduces long-run economic efficiency.

The governments of New South Wales, Victoria, and Western Australia initiated a review of Commonwealth-state funding in 2002. The review's authors, Garnaut and FitzGerald, recommended an equal per-capita share regime for the distribution of GST revenue, coupled with a side payment to cover the "inescapable fixed costs that are required to facilitate the delivery of services".[33] They put this cost at $98 million in 2002 dollars. They also recommended the rationalization of other payments to the states to directly target areas of disadvantage. The Commonwealth Grants Commission would return to its original role of assessing claims for financial assistance. This arguably remains the most compelling reform proposed, although it has not been acted upon 10 years later, pointing to how resistant federal-state financial relations remain to fundamental reform.

More recently, the 2012 GST Distribution Review found "no end of 'simpler' ways to allocate [federal] grants to the states", but none that were consistent with the Review's heavily constrained terms of reference that took the desirability of fiscal equalization as given.[34] This may also explain the overly benign view the Review adopted in relation to the possible efficiency costs associated with fiscal equalization. It would be difficult to acknowledge these costs while arguing for little change in the *status quo*. The Review claimed that efficiency gains were not possible without "significant reductions in equalization outcomes".[35] However, the review also noted that "inequality is tolerated

33. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 219.
34. Commonwealth of Australia (2012), *GST Distribution Review*: 6.
35. Commonwealth of Australia (2012), *GST Distribution Review*: 7.

in many features of government if there are identifiable benefits".[36] The Review did recommend that the Commonwealth Grants Commission avoid excessive precision in its implementation of fiscal equalization.

Resistence to reform

Fiscal equalization is resistant to fundamental reform because the Commonwealth and the various states have misaligned incentives and because fiscal equalization remains bound-up with the problem of excessive centralization of revenue raising in the hands of the federal government. The states are reluctant to reclaim revenue-raising powers that would see them bear the political cost of raising taxes. Reform of fiscal equalization is also bound up with the issue of tax reform. There is considerable scope to use changes to the GST rate or base to fund the abolition of a raft of inefficient state taxes, but only at the cost of further centralization of revenue raising and the pool of funds subject to equalization. Only a comprehensive compact between the Federal government and the states to reform intergovernmental financial relations and the tax system would seem to be capable of addressing these interconnected policy issues. However, the political obstacles to striking such a grand bargain are considerable. Even if such a compact could be achieved, it is far from clear that this would deliver a new model of competitive federalism as opposed to a further consolidation of the federal government's financial dominance over the states.

Lessons from the Australian Experience

Garnaut and FitzGerald noted "Australia's genius for almost infinite bureaucratic elaboration of less or more soundly based principles under the banner of equity …: the old system of made-to-measure tariff protection; the arbitration system; the Income Tax Act 1986; superannuation; the social security system; and much business regulation".[37] Australia's comprehensive approach to fiscal equalization might be viewed as an outgrowth of Australia's notoriously egalitarian culture. Yet full equalization of fiscal capacities is a relatively recent innovation in federal-state financial relations. Even in the early years of federation, Australia was able to maintain a regime of equal per-capita payments, albeit coupled with *ad hoc* side payments to states in financial difficulty. While federal-state financial relations have been successful in holding the federation together for more than a century, fiscal equalization (as opposed to *ad hoc* financial assistance) was not essential to this outcome and has been a source of tension as much as unity within the federation.

The efficiency case for fiscal equalization remains theoretically and empirically ambiguous. Its implementation is costly, complex, and lacking in

36. Commonwealth of Australia (2012), *GST Distribution Review*: 9.
37. FitzGerald and Garnaut (2002), *Review of Commonwealth-State Funding*: 4.

transparency, undermining democratic accountability for public expenditure at all levels of government. Fiscal equalization reduces economic efficiency but without necessarily equalizing the circumstances of individuals and households. The implications of equalization transfers for equity on the part of individuals and households are almost certainly swamped by the federal government's redistributive tax and spending policies. Direct fiscal transfers to individuals and households are a far more efficient and transparent way of addressing equity concerns, although also require careful attention to possible disincentive effects.

Australia's internationally unique experience with comprehensive fiscal equalization is thus not encouraging. The informational requirements for the successful implementation of full fiscal equalization in a way that maximizes efficiency and improves equity may simply be too great. An idealized system of fiscal equalization from the standpoints of efficiency or equity is unlikely to emerge or be sustained by the processes of ordinary politics. The scope for creating perverse incentives and unintended consequences is large. That the system remains resistant to fundamental reform is symptomatic of these problems, rather than its success. A system of equal per-capita shares for GST revenue coupled with side payments to equalize the capacity to provide the irreducible core functions of government is the most promising reform option, but remains bound-up with the problem of the centralization of revenue-raisings in the hands of the federal government and the need for further reform of the tax system to abolish inefficient state taxes. The near-term prospects for fundamental reform by way of a comprehensive federal-state financial compact are not great.

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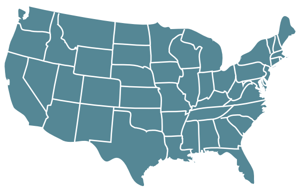

3. Fiscal Federalism in the United States

Chris Edwards

Introduction

In the United States, the federal government has developed a highly complex financial relationship with state governments through the Grants-in-Aid system. The system has grown steadily for more than a century as the federal government has become involved in an increasing array of state and local activities. Today there are more than 1,100 aid programs for the states, with each program having its own rules and regulations. The system is a complicated mess, and it is getting worse all the time.

This was not the intention of the founders. Under the US Constitution, the federal government was assigned specific, limited powers and most government functions were left to the states. To ensure that people understood the limits on federal power, the nation's founders added the Constitution's Tenth Amendment: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people".

The Tenth Amendment embodies federalism, the idea that federal and state governments have separate areas of activity and that federal responsibilities were "few and defined", as James Madison noted. Historically, federalism acted as a safeguard of American freedoms. President Ronald Reagan noted in a 1987 executive order: "Federalism is rooted in the knowledge that our political liberties are best assured by limiting the size and scope of the national

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government".[1] Unfortunately, policymakers and courts have mainly discarded federalism in recent decades. Congress has undertaken many activities that were traditionally reserved to the states and the private sector. The Grants-in-Aid program is a key mechanism that the federal government has used to extend its power into state and local affairs: part and parcel with these subsidies come federal regulations designed to micromanage state and local activities. The federal government will spend US$561 billion on aid to the states this year, making aid the third largest item in the federal budget after Social Security and national defense.[2] Some of the major federal aid programs are in the areas of education, health care, housing, and transportation.

There are few, if any, advantages of federalizing state and local activities through grant programs, but many disadvantages. The aid system encourages excessive spending and bureaucratic waste, creates a lack of political accountability, and stifles policy diversity and innovation in the states. With the ongoing flood of red ink in Washington, now would be a good time to begin cutting the vastly overgrown Grants-in-Aid system.

Growth in Aid to the States

Prior to the Civil War, proposals to subsidize state and local activities were occasionally introduced in Congress, but they were routinely voted down or vetoed by presidents for being unconstitutional. In 1817, for example, President James Madison vetoed a bill that would have provided federal aid to construct roads and canals.[3] In 1830, President Andrew Jackson vetoed a bill to provide aid for a road project in Kentucky arguing that it was of "purely local character" and that funding would be a "subversion of the federal system".[4]

The resistance to federal funding of state activities started to weaken toward the end of the 19th century. The Morrill Act of 1862 provided grants of federal land to the states for the establishment of colleges that focused on agriculture, mechanical studies, and the military. This was the first grant program with "strings attached". It included detailed rules for recipients to follow and required them to submit regular reports to the federal government. Federal aid increased substantially in the early 20th century. When the income tax was introduced in 1913, it provided the means for policy makers to finance a range of new federal aid programs. From the beginning, many aid programs required states to match federal funds dollar for dollar. Unfortunately, matching requirements have induced excessive state spending and continuous program expansion. Federal aid has also prompted the growth

1. Ronald Reagan (1987), Executive Order 12612 (October 26), <www.reagan.utexas.edu/archives/speeches/1987/102687d.htm>.

2. United States, Office of Management and Budget (2013), *Budget of the U.S. Government, FY 2014, Analytical Perspectives* (US Government Printing Office): 301.

3. James Madison (1817), Veto Message for the Bonus Bill (March 13), available at <www.constitution.org/jm/18170303_veto.htm>.

4. Andrew Jackson (1830), Veto Message for the Maysville Road Bill (May 27), available at <www.gutenberg.org/files/10858/10858-h/10858-h.htm>.

in state bureaucracies, partly because aid programs have often required that states set up new agencies to oversee spending in the prescribed activities.

There was initial resistance to the expansion of federal aid, but it was politically difficult for states to opt out of new aid programs, because, if they did so, their residents would still have to pay federal taxes to support federal aid spending in other states. Also, various sleights of hand were used to get around constitutional concerns about rising federal power. For example, a 1916 law that created a new federal program for road subsidies was premised on the constitutional power to fund "post roads" (roads used for mail delivery), which Congress defined very broadly.[5] Another example was 1911 legislation to fund state prevention of forest fires. The aid was to pay for forest activities near navigable rivers, which thus could be said to be related to interstate commerce.[6]

The number of Grants-in-Aid programs rose from 15 in 1930 to 132 by 1960. The largest expansion of federal granting during this period was the 1956 law authorizing the building of the interstate highway system. However, it was during the 1960s that federal aid really exploded. Under President Lyndon Johnson, aid programs were added for housing, urban renewal, education, health care, and many other activities. The number of aid programs quadrupled from 132 in 1960 to 530 by 1970.[7]

In the 1960s, policymakers were optimistic that federal experts could solve local problems such as urban decay with aid programs. But the optimism had begun to diminish even by the early 1970s. President Richard Nixon argued that federal aid was a "terrible tangle" of overlap and inefficiency.[8] In his 1971 State of the Union address, he lambasted "the idea that a bureaucratic elite in Washington knows best what is best for people everywhere", and said that he wanted to "reverse the flow of power and resources from the states and communities to Washington".[9] For his part, President Jimmy Carter proposed a "concentrated attack on red tape and confusion in the federal grant-in-aid system".[10] Unfortunately, Nixon and Carter made little progress on reforms.

Ronald Reagan had more success at sorting out the "confused mess" of federal grants, as he called it.[11] In a 1981 budget law, dozens of grant programs

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5. Austin F. MacDonald (1928), *Federal Aid: A Study of the American Subsidy System* (Thomas Y. Crowell): 90. See also Richard F. Weingroff (2001), For the Common Good: The 85th Anniversary of a Historic Partnership, *Public Roads* 64, 5 (March/April) [Federal Highway Administration].

6. MacDonald (1928), *Federal Aid*: 30.

7. Chris Edwards (2007), *Federal Aid to the States: Historical Cause of Government Growth and Bureaucracy*, Cato Institute Policy Analysis no. 593 (May 22).

8. Quoted in Ben Canada (2003), *Federal Grants to State and Local Governments: A Brief History*, Congressional Research Service, RL-30705 (February 19): 9.

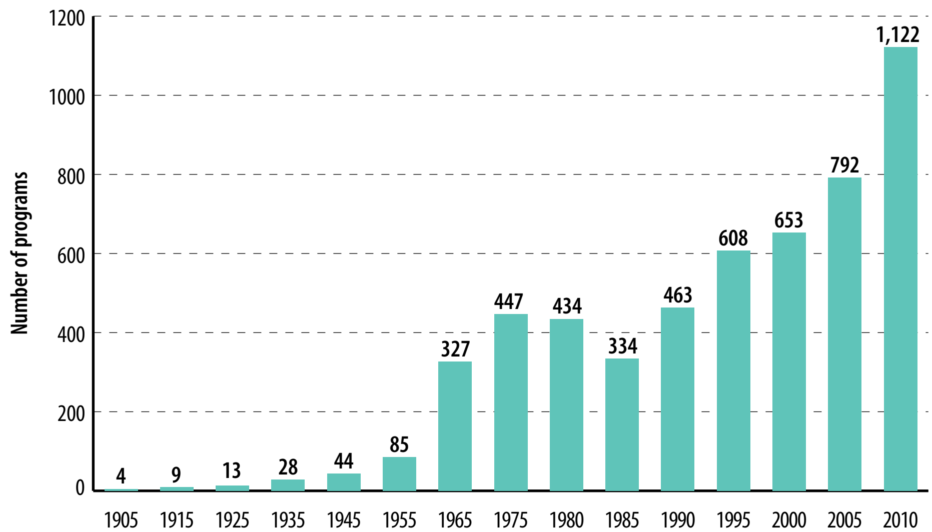
9. Richard Nixon (1971), Annual Message to the Congress on the State of the Union (January 22), available at <www.nixonlibrary.org>.

10. Advisory Commission on Intergovernmental Relations (1978), The Intergovernmental Grant System: An Assessment and Proposed Policies (January): 24.

11. United States, Bureau of the Budget (1982), Budget Message of the President, *Budget of the U.S. Government, FY 1983-1984* (US Government Printing Office): M22.

were eliminated, and many others were consolidated into broader block grants. **Figure 3.1** shows that the number of grant programs fell during the early 1980s. Reagan's "new federalism" attempted to re-sort federal and state activities so that each level of government would have responsibility for financing its own programs. But Reagan's progress at trimming the federal aid empire was reversed after he left office, and there have been no major efforts to reform or cut the federal aid system since the mid-1990s.

Figure 3.1: US Federal Aid to the States, Number of Programs (1905–2010)



Source: General Services Administration (US) (2013), *Catalog of Federal Domestic Assistance*, <www.cfda.gov>; Government Accountability Office; Advisory Commission on Intergovernmental Relations; author's analysis.

The aid system's many failings have become more acute as hundreds of programs have been added in recent years. According to my analysis, the number of aid programs soared from 653 in 2000 to 1,122 in 2010.[12] President Obama's health-care law of 2010 added a range of new aid programs and it also involved a huge expansion in Medicaid, which is the largest federal aid program.

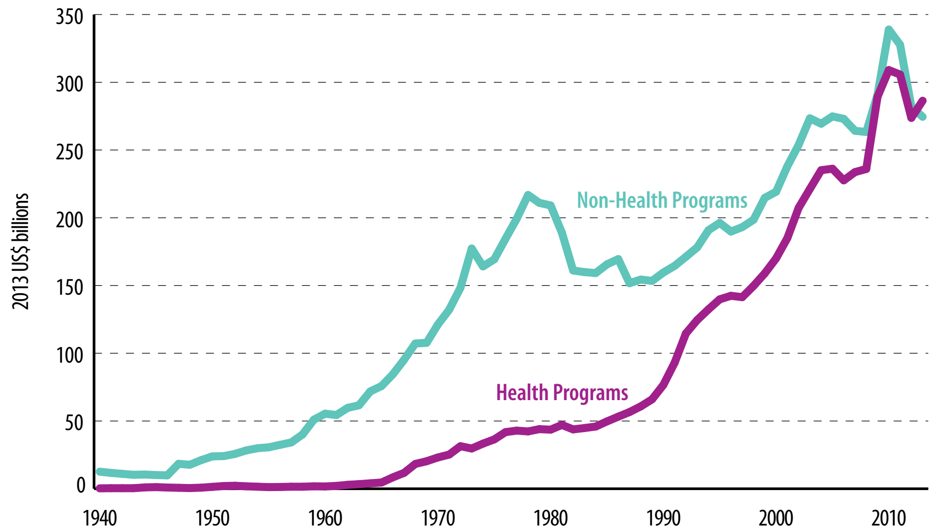
The Federal Aid System Today

Today, the number of federal aid programs for the states is more than triple the number just 25 years ago. Federal aid spending is expected to be US$561 billion in fiscal 2013, of which US$286 billion are health grants and US$275 billion are non-health grants.[13] **Figure 3.2** shows the growth in aid over the decades. President Reagan's cutting of non-health grants is evident in the early 1980s, but since then both health and non-health grant spending has soared.

12. Chris Edwards (2011), *Federal Aid-to-State Programs Top 1,100*, Cato Institute Tax and Budget Bulletin no. 63 (February).

13. United States, Office of Management and Budget (2013), *Budget of the U.S. Government, FY2014 …* : 301.

Figure 3.2: US Federal Aid to the States,Spending on Health and non-Health Programs, 2013 US$ billions (1940–2013)



Source: United States, Office of Budget and Management (2013), *Budget of the United States Government, Fiscal Year 2014* (Government Printing Office).

Federal aid programs range from the giant US$267 billion Medicaid to hundreds of more obscure programs, such as a US$15 million grant for "Nursing Workforce Diversity", a US$116 million grant for "Boating Safety Financial Assistance", and a US$125 million grant for "Healthy Marriages". Table 3.1 shows aid spending for each major federal department.

Table 3.1: Federal Aid to the States by Department, 2013

US Federal Department	Outlays (US$ billions)	US Federal Department	Outlays (US$ billions)
Agriculture	39.0	Justice	4.8
Commerce	0.6	Labor	7.0
Education	47.2	Transportation	62.7
Energy	0.8	Treasury	1.7
Health and Human Services	337.7	Veterans Affairs	1.1
Homeland Security	7.2	EPA	4.8
Housing and Urban Development	36.9	All other agencies	4.1
Interior	5.3	**Total**	561.0

Source: General Services Administration (US) (2013), *Catalog of Federal Domestic Assistance*, <www.cfda.gov>; author's analysis.

Types of grants

Federal aid can be distributed in the form of project grants or formula grants. Under project grants, federal agencies distribute funding to particular state and local agencies after a detailed review of specific proposals. Project grants can also be "earmarked" or directed to favoured activities by members of Congress. Project grants generally require grantees to submit proposals, detailed work plans, regular reports, and other paperwork regarding their use of federal dollars.

While most aid programs are project grants, most aid spending is through formula grants. That is because many of the largest aid programs, including Medicaid, are formula grants. Under formula grants, legislation spells out how much funding each state receives based on factors such as state income and population. The states are often required to match some portion of the federal government's aid with their own funding.

Aid programs can also be categorized as either categorical grants or block grants. The bulk of grants are categorical, which generally target a narrow range of eligible activities and include detailed regulations that states must follow. By contrast, block grants fund a broader range of activities and generally give states more flexibility on the activities funded.

Budget experts have long proposed that the vast number of categorical grants be consolidated into fewer and simpler block grants. However, there are strong political incentives against such reforms. One factor is that members of Congress can target their favoured special interests more easily using categorical grants. Categorical grants also match the fragmented committee structure in Congress since each of the dozens of committees and subcommittees in Congress want their own realm of grant programs to preside over. If grants were consolidated, members would lose some of their power to direct and control federal hand-outs.

Redistribution

One question that arises about the federal aid system is how it redistributes resources among the 50 states. The system involves the raising of hundreds of billions of dollars a year in taxes from individuals and businesses across the nation, channeling the money through the bureaucracy in Washington, and then back to government agencies in the states.[14] There is no overall plan to the system; instead, it has grown in an *ad hoc* manner over many decades. The aid system is mainly financed by the general fund of the federal budget, of which the largest revenue source is the personal income tax.[15] The income tax is highly graduated or "progressive" and, as a result, states with large concentrations of higher-income residents pay a large bulk of the nation's income taxes and thus finance a large share of the Grants-in-Aid system. As an illustration, consider

14. The system could also be said to funded by federal borrowing, in which case the cost to taxpayers is deferred.
15. The main exception are federal highway grants, which are mainly funded by the federal gasoline tax.

the two states that contribute overall the most in per-capita federal taxes—Connecticut and New Jersey. They pay more than twice as much in per-capita taxes as the two states contributing the least, West Virginia and Mississippi.[16]

Looking at the spending side, aid received by the states varies widely. In 2010, for example, average Grants-in-Aid spending was US$2,187 per capita. The state receiving the greatest per-capita amount was Alaska at US$4,879, while the state receiving the least amount was Florida at US$1,492.[17] The reasons for these variations in aid spending are complex. Project grants are generally distributed on a discretionary basis. But most federal aid is distributed by formulas, which are based on such factors as state populations, income levels, and poverty levels. Medicaid funding, for example, is distributed based on each state's average personal income compared to the US average. Thus, poorer states generally receive a higher federal match, although there are many complexities to the Medicaid allocation system.[18]

With open-ended matching grants, the expansiveness of each state's spending affects the amount of funding drawn from Washington. Medicaid, for example, allows states substantial flexibility in structuring benefits, and thus those states that have more generous benefits will gain more federal matching dollars. New York has an expansive benefit structure, and it receives 12 percent of all federal Medicaid dollars even though the state has just 6 percent of the U.S. population.[19]

Some grant programs have complex formulas to distribute funding, which sets up political struggles to tweak the allocations. Consider the Community Development Block Grant (CDBG) program, which funds local development projects. One item in the formula that distributes funding to the states is "housing built before 1940". How did this obscure provision get into the CDBG formula? A lobby group convinced some members of Congress to insert it into legislation in order to tilt aid toward older cities.[20]

Politics often stands in the way of allocating grant funds in a way that even aid supporters would think is rational. After 9/11, for example, the federal government created numerous homeland security aid programs to help those areas of the country at higher risks of terrorism. But members of Congress from lower-risk and more rural states have battled to distribute these grants based on metrics unrelated to risk.[21]

16. Curtis Dubay (2006), *Federal Tax Burdens and Expenditures by State* (Tax Foundation): table 4.
17. US Bureau of the Census (2011), *Consolidated Federal Funds Report for Fiscal Year 2010* (September): table 10.
18. For background, see Kaiser Family Foundation (2012), *Medicaid Financing: An Overview of the Federal Medicaid Matching Rate* (September).
19. United States, Office of Management and Budget (2013), *Budget of the U.S. Government, FY2014 …* : 318.
20. Rochelle L. Standfield (1985), Playing Computer Politics with Local Aid Formulas, in Laurence J. O'Toole, ed., *American Intergovernmental Relations* (Congressional Quarterly): 175.
21. Chris Strohm (2007), Senate Fight Looms over Revising Security Grant Formula, *Congress Daily* (February 16: 9. See also Veronique de Rugy (2004), *What Does Homeland Security Spending Buy* (American Enterprise Institute).

In sum, there is no overall strategy that guides the Grants-in-Aid system. Instead, it has been jerry-built over the decades as politicians have responded to special-interest pressures and tried to fix state and local problems with federal rules and subsidies. Liberal policymakers have supported the federalizing of state activities because the federal tax system is more graduated or "progressive" than state tax systems. And conservative policymakers have usually gone along with expansions to federal aid because they can reap the political benefits of steering funding to their congressional districts. While the growth in federal aid can be explained by politics, the next section explains that there has never been a good rationale for aid from the perspective of efficient and responsible governance.

Eight Problems with Federal Aid

The theory behind grants-in-aid is that the federal government can create subsidy programs in the national interest to solve local problems efficiently. The belief is that policy makers can dispassionately allocate large sums of money across hundreds of activities based on a rational plan designed in Washington.

The federal aid system does not work that way in practice. Most federal politicians are not inclined to pursue broad, national goals, but are consumed by the competitive scramble to secure subsidies for their states. At the same time, federal aid stimulates overspending by state governments and creates a web of top-down rules that destroy state innovation. At all levels of the aid system, the focus is on maximizing the money spent and regulatory compliance, not on delivering quality services. Following are eight reasons that the federal aid system does not make any economic or practical sense and ought to be reduced or eliminated.

1. No magical source of federal funds

Aid supporters bemoan the "lack of resources" at the state level and believe that the federal government has endlessly deep pockets to help out. But every dollar of federal aid sent to the states is ultimately taken from federal taxpayers who live in the 50 states. It is true that the federal government has a greater ability to run deficits than state governments, but that is an argument against the aid system not in favour of it. By moving the funding of state activities up to the federal level, the aid system has tilted American government toward unsustainable deficit financing.

2. Grants spur wasteful spending

The basic incentive structure of aid programs encourages overspending by federal and state policy makers. One reason is that policy makers at both levels can claim credit for spending on a program, while relying on the other level of government to collect part of the tax bill. Another cause of overspending is that federal policy makers create program structures, such as the matching grant, that prompt the states to increase spending. A typical matching grant is 50 percent, which means that for every US$2 million a state expands a program, the federal government chips in US$1 million. Matching grants reduce the "price" of states' added spending, thus prompting them to expand programs. Most federal aid is for programs that have matching requirements, with Medicaid being the largest such program.

One way to reduce spending incentives is to convert open-ended matching grants to block grants. Block grants provide a fixed sum to states and give them flexibility on program design. The best example of such a reform was the 1996 welfare overhaul, which turned Aid to Families with Dependent Children (an open-ended matching grant) into Temporary Assistance for Needy Families (a lump-sum block grant). Similar reforms that convert aid programs to block grants should be pursued for Medicaid and other programs. Doing so would reduce incentives for states to overspend, and it would make it easier for Congress to cut federal spending in the future.

3. Aid allocation does not match need

Supporters of federal grants assume that funding can be optimally distributed to those activities and states with the greatest needs. But even if such redistribution were a good idea, the aid system has never worked that way in practice. A 1940 article in *Congressional Quarterly* lamented: "The grants-in-aid system in the United States has developed in a haphazard fashion. Particular services have been singled out for subsidy at the behest of pressure groups, and little attention has been given to national and state interests as a whole".[22] And a 1981 report by the Advisory Commission on Intergovernmental Relations concluded that "federal grant-in-aid programs have never reflected any consistent or coherent interpretation of national needs".[23] The same situation holds today. With highway aid, for example, some states with greater needs due to growing populations—such as Texas—consistently get the short end of the stick on funding.[24]

Even if funds were allocated to the states based on need, state-level decisions can nullify federal efforts. For example, the largest education grant program, Title I, is supposed to target aid to the poorest school districts. But evidence indicates that state and local governments use Title I funds to displace their own funding of poor schools, thus making poor schools no further ahead than without federal aid.[25]

4. Grants reduce innovation and policy diversity

Federal grants reduce state diversity and innovation because they come with one-size-fits-all mandates. A good example is the 55-mile-per-hour national

22. B. Putney (1940), Federal-State Relations Under Grants-In-Aid, *Congressional Quarterly* (July 30).
23. Advisory Commission on Intergovernmental Relations (1981), *The Federal Role in the Federal System: The Dynamics of Growth*, Vol. X (June): 94.
24. Ronald Utt (2012), *Turn Back Transportation to the States* (Heritage Foundation): 2.
25. Nora Gordon (2002), Do Federal Grants Boost School Spending? Evidence from Title I, Working Paper (September) (Department of Economics, University of California, San Diego).

speed limit, which was enforced between 1974 and 1995 by federal threats of withdrawing highway grant money. It never made sense that the same speed should be imposed in uncongested rural states and congested urban states, and Congress finally listened to motorists and repealed the law.

Another example of top-down federal rules is the education law of 2002, No Child Left Behind (NCLB). To receive NCLB grant funding, the law required states to meet federal mandates, such as ensuring that all teachers were "highly qualified", that Spanish-language versions of tests be administered, and that certain children be tutored after school. Many states passed resolutions attacking NCLB for undermining states' rights.

The Davis-Bacon labor rules are another example of harmful regulations tied to federal aid. State public-works projects that receive federal aid must pay workers "prevailing wages". Since that is generally interpreted to mean higher union-level wages, Davis-Bacon rules increase construction costs on government investments, such as highway projects.

5. Grant regulations breed bureaucracy

Federal aid is not a costless injection of funding to the states. Federal taxpayers pay the direct costs of the grants, but taxpayers at all levels of government are burdened by the costly bureaucracy needed to support the system. The aid system engulfs government workers with unproductive activities such as writing proposals, reporting on programs, regulatory compliance, auditing, and litigation.

Many of the 16 million people employed by state and local governments must deal with complex federal regulations related to hundreds of aid programs. There are specific rules for each program, which may be hundreds or even thousands of pages in length. There are "crosscutting requirements", which are provisions that apply across aid programs, such as labor-market rules. And there are "crossover sanctions", which are the penalties imposed on the states if they do not meet federal requirements.

Each of the more than 1,100 aid programs have different rules, and the activities funded by the programs often overlap, which causes more confusion. For example, state and local officials deal with 16 federal programs that fund first responders, such as firefighters.[26] That tangle of programs not only creates a lot of paperwork, it may also lead to more fragmented planning of disaster response.

6. Grants cause policy-making overload

One consequence of the large aid system is that the time spent by federal politicians on state and local issues takes away from their focus on truly national

26. Government Accountability Office (2003), *Federal Assistance: Grant System Continues to Be Highly Fragmented*, GAO-03-718T (April 29): 13, 14.

issues. In the years after 9/11, for example, investigations revealed that most members of the House and Senate intelligence committees did not bother, or did not have time, to read crucial intelligence reports.[27]

The federal involvement in hundreds of non-federal policy areas overloads Washington's policy agenda. President Calvin Coolidge was right when he argued in 1925 that aid to the states should be cut because it was "encumbering the national government beyond its wisdom to comprehend, or its ability to administer" its proper roles.[28]

7. Grants make government responsibilities unclear

The three layers of government in the United States no longer resemble the tidy layer cake that existed in the 19th century. Instead, they are like a jumbled marble cake with responsibilities fragmented across multiple layers. Federal aid has made it difficult for citizens to figure out which level of government is responsible for particular policy outcomes. All three levels of government play big roles in such areas as transportation and education, thus making accountability difficult. To make matters worse, politicians have become skilled at pointing fingers of blame at other levels of government, as was evident in the aftermath of Hurricane Katrina in 2005. When every government is responsible for an activity, no government is responsible.

8. Common problems are not necessarily national priorities

Policymakers often argue that various state, local, and private activities require federal intervention because they are "national priorities". But as President Reagan noted in a 1987 executive order: "It is important to recognize the distinction between problems of national scope (which may justify federal action) and problems that are merely common to the states (which will not justify federal action because individual states, acting individually or together, can effectively deal with them)".[29]

Consider education. It is a priority of many people but that does not mean that the federal government has to get involved. State and local governments should be free to innovate in education and share best practices with each other, but there is no reason for top-down controls or funding from Washington. Or, consider federal aid for homeland security, which became popular after 9/11. Much of the federal funding in that area goes for items that could be funded locally, such as bulletproof vests for police officers.

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27. Dana Priest (2004), Congressional Oversight of Intelligence Criticized, *Washington Post* (April 27): A1. Also see: Victoria Toensing (2004), Oversee? More Like Overlook, *Washington Post* (June 13): op-ed.

28. Quoted in Charles Warren (1978), *Congress as Santa Claus or National Donations and the General Welfare Clause of the Constitution* (Arno Press): 103. Originally published in 1932 by the Michie Company, Charlottesville, Virginia.

29. Ronald Reagan (1987), Executive Order 12612 (October 26), <www.reagan.utexas.edu/archives/speeches/1987/102687d.htm>.

There is no reason for federalizing spending on local activities such as police and education—it just creates added bureaucracy and a tug of war over funding allocations. By contrast, when funding and spending decisions are made together at the state or local levels, policy trade-offs will reflect more clearly the preferences of citizens within a jurisdiction.

Conclusions

The federal aid system is a roundabout way to fund state and local activities and it serves no important economic or practical purpose. The system has many widely recognized failings, but a web of special-interest groups block reforms. Those groups include the hundreds of trade associations that represent the recipients of federal aid and the millions of state and local employees that depend on federal aid to pay their salaries.

The aid system thrives not because it creates good governance, but because it maximizes benefits to politicians. The system allows politicians at each level of government to take credit for spending, while blaming other levels of government for program failures and high tax burdens. The federal aid system is a triumph of expenditure without responsibility.

The aid system should be dramatically scaled back or phased-out altogether. With today's huge federal budget deficits, now is a good time to start cutting federal spending on state and local activities. By federalizing so many state and local activities in recent decades, we are asking polic makers in Washington to do the impossible—plan efficiently for the competing needs of a vast and diverse country of 315 million people.

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4. Switzerland's Reformed Fiscal Equalization System

Still Substantial Room for Improvement

Pierre Bessard

Introduction

Swiss federalism is unique on two accounts: the first is its substantial fragmentation, with 26 federated states, or cantons, and 2,500 local communities for a total population of only eight million people; the second is the relatively low degree of centralization, the federal government accounting for roughly 30% of spending and tax revenues, whereas 70% is under the responsibility of the federated states and the local communities. A key feature of the Swiss system and its economic implications is, therefore, its very high degree of diversity. Although regional differences are also found in other countries, it is certainly unusual that in such a small jurisdiction both GDP per person and the tax burden can vary by a factor of one to three depending on the location (see figure 4.1 and table 4.1). Although Switzerland is one of the most prosperous countries in the world (and the wealthiest country in terms of accumulated wealth per capita), it is also one of the least egalitarian, with regard both to persons and to regions.

The small size of political jurisdictions in Switzerland (the smallest canton counts just over 15,000 residents, the largest 1.4 million) supports the insight that there are no economies of scale stemming from the size of a government's

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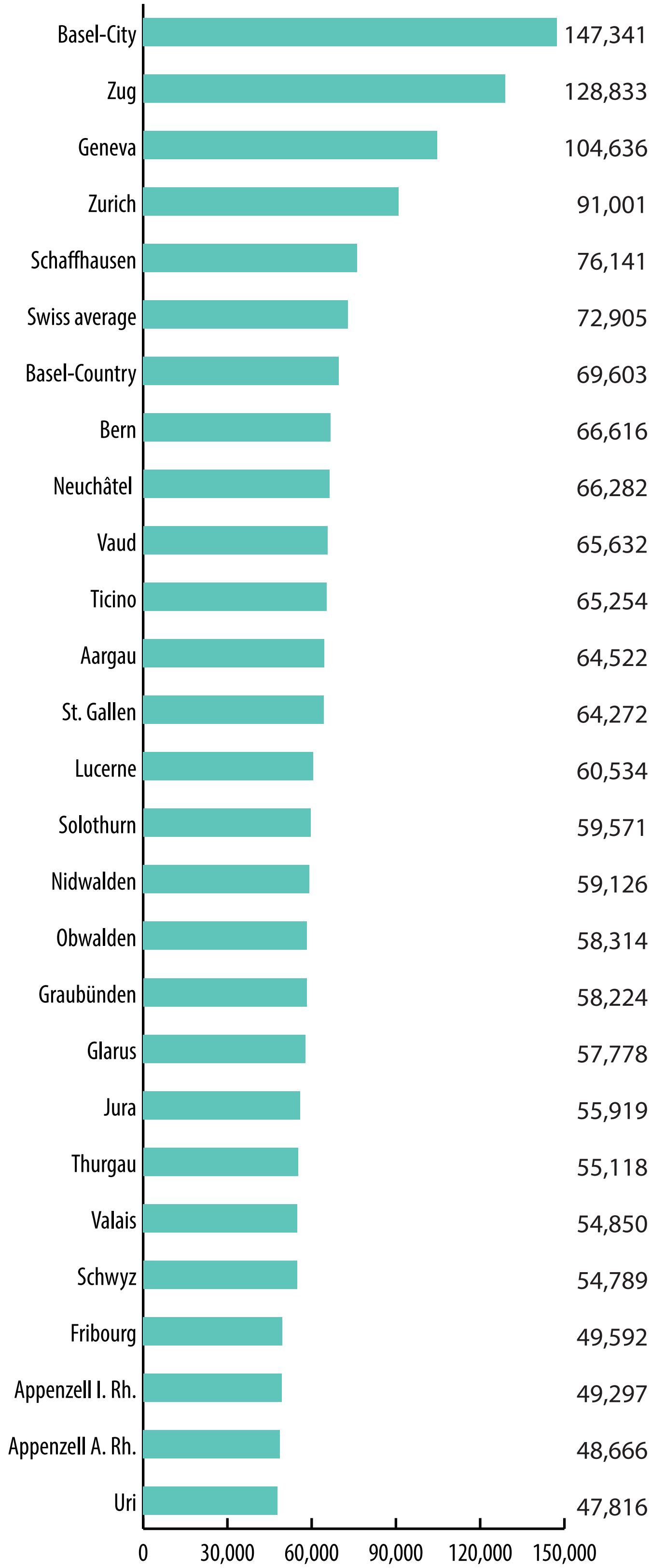
Figure 4.1: GDP per Person, in CHF, in the Swiss Cantons (2010)



Source: Swiss Federal Statistical Office (reference year 2010).

Table 4.1: Tax Burden Index* for the Swiss Cantons

Schwyz	49.1
Zug	51.2
Nidwalden	60.6
Appenzell I. Rh.	70.6
Obwalden	72.8
Schaffhausen	79.1
Zurich	86.6
Aargau	88.3
Uri	89.7
Appenzell A. Rh.	90.6
Thurgau	92.0
Basel-Country	95.9
Ticino	95.9
Glarus	96.4
Lucerne	97.4
Swiss indexed average	**100 .0**
St. Gallen	100.6
Solothurn	106.2
Basel-City	108.9
Fribourg	109.2
Graubünden	110.0
Valais	111.5
Neuchâtel	113.2
Vaud	116.3
Bern	119.2
Jura	129.0
Geneva	134.6

Note *: The tax burden index is based on the relation between tax revenues in a canton and the canton's resources potential, that is, its tax base, as calculated from taxable income and wealth. The 2013 index is based on data for the period from 2007 to 2009.

Source: Federal Tax Administration (reference year 2013).

territorial monopoly. On the contrary, the Swiss experience seems to corroborate the idea that a high level of proximity and competition among smaller entities leads to greater prosperity. Another insight is that inequality tends to lead to higher levels of prosperity. In other words, all regions are rich, but some are richer, as opposed to the egalitarian idea, pushed to the extreme, that every region should be equally poor.

There are historic explanations for this situation, in particular in the traditional business and industrial centers of Geneva, Basel, and Zurich, but there is also a strong political background, given the autonomy of the federated states. Some cantons have attracted highly productive economic and entrepreneurial activities within their borders by deliberately pursuing competitive policies. The small canton of Zug in central Switzerland, which boasts one of the highest levels of GDP per head, was one of the pioneers in this jurisdictional competition that is a landmark of Switzerland. The canton of Zug has a rural background and used to rank among the poorest and most highly indebted cantons before political leaders implemented innovative tax reforms in the 1960s, in particular by adopting very low rates for holding and domicile companies and significantly reducing overall tax rates as well as progressivity to the lowest level in Switzerland. This transformed Zug into one of the most attractive locations in Europe not only for corporations, but also for individual residents and families, who enjoy more disposable income than elsewhere. Zug today has the most favourable demographics in Switzerland, with a comparatively young population, which in other cantons would be an excuse to opt for higher taxes and more public services (child daycare and schools, for example). "Shaking the tree every day" is the best-known political practice in Zug, used to curb spending and keep taxes low, about half the Swiss average (**table 4.1**).

The Failure of the Old Fiscal Equalization System

Fiscal equalization in Switzerland is a relatively new phenomenon; it was implemented for the first time in 1959, over 100 years after the current political structures with a federal government and 26 cantons were adopted in 1848 (there had been previously some forms of intercantonal redistributions from 1938). In the 1990s, the system was evaluated for the first time and the review came to clearly unfavourable conclusions. Fiscal equalization had not only failed to reduce disparities between regions, but had reinforced them. Moreover, it had led to bad incentives in terms of governance and public spending.

A good illustration of the adverse effects of fiscal equalization is provided by the example of the two cantons Nidwalden and Obwalden, two neighbouring valleys in central Switzerland. Both cantons are practically identical in terms of population, topography, and geographic situation. Yet the canton of Nidwalden had an income per person significantly higher than the canton of Obwalden, almost twice as much up to the mid-1990s. The canton of Obwalden was not only unattractive, but was losing population. Young people moved to other places to find jobs and often chose to leave for residential reasons as well. Today Obwalden has practically caught up with its wealthier neighbor. What has happened? Nidwalden was a traditional contributing canton in the fiscal equalization system. It had relatively low taxes for corporate and individual residents, which made it a preferred location for business and residential purposes. Obwalden, on the other hand, was heavily dependent on fiscal redistribution and belonged to the category of high-tax, unattractive cantons. Yet just before the new fiscal equalization system came into force in 2008, modifying incentives in governance and public policies, Obwalden adopted a bold tax reform that slashed rates for corporations by half and significantly reduced the burden for individuals and families, with a flat-rate tax of approximately 12% and high personal deductions. Overall, the tax burden was cut almost by half, which made Obwalden one of the most competitive cantons in a very short period of time. The tax reform was approved in a referendum by 86% of the voters, giving it unprecedented democratic legitimacy and providing this small canton in central Switzerland with a new sense of purpose. It was leaving its lethargy and rising from its permanent status as a heavily subsidized, unattractive location. As could be expected from economic theory and experience, the canton did not lose any significant tax revenues with the bold slashing of its tax rates but, on the contrary, stopped the emigration of its population and attracted more residents and a very high number of new businesses (the increase in registrations in its Commercial Registry was 560% following the tax reform). Obwalden, by the standards of fiscal equalization, still is a receiving canton, but subsidies per person have come down from 1,534 Swiss francs in 2000 to 1,063 in 2013. As a result, its aggresive tax reforms also benefit contributing cantons.

This tale of two valleys perfectly illustrates that, more often than not, fiscal weakness gives rise to equalization subsidies because of homemade problems, in particular because of bad policies such as high tax rates. It is no wonder that the evaluations of the fiscal equalization system in the 1990s concluded that the system suffered from "an inconsistent mix of objectives, an overly centralized regime, and inefficient transfer mechanisms" (Federal Council, 2001: 2177).

Reform of Fiscal Equalization

The new fiscal equalization system came into force in 2008. Overall, it is a complex system not only designed to compensate excess public spending but ideally also to provide incentives for efficient budgeting and a cost-effective provision of public services. The somewhat contradictory objectives of the reform were to strengthen the autonomy of cantons, reduce the differences of their fiscal capacities, increase the efficiency of government functions and provide "fair" conditions for tax competition between cantons. Establishing "equal" standards of living, as required, for example, by the German constitution, however, has never been an objective of the Swiss fiscal equalization system. The reform did not only seek to level out the cantons to some extent but also strove for a better division of functions between the federal government and the cantons.

The new system was eventually approved in a referendum by approximately 65% of voters and 23 cantons out of 26. The competitive contributing cantons of Nidwalden, Schwyz, and Zug refused it, considering the amounts of redistribution (which were due to increase under the new system) unacceptable. In terms of redistribution per person, these three cantons were indeed the most penalized. From both a moral and utilitarian standpoint, the political right felt that it was wrong to punish some cantons for their good and forward-looking policies, while the political left feared that the new system would lead to more tax competition and tax reductions. Despite criticism from both sides, the reform took into account most interests to ensure adoption by most cantons and a majority of the population. Its acceptance could also be viewed as an uncompetitive majority outvoting a competitive minority, according to the well-known strategy among federated states of raising their rivals' costs. In any event, the reform is clearly a political compromise and should not be viewed as an ideal conceptual model.

Generally, fiscal equalization in Switzerland has also been advanced as a traditional argument over controversies around tax competition and the significant diversity of tax burdens within Switzerland depending on the location. Fiscal equalization balances fears on the political left that tax competition could lead to "a race to the bottom" (which is clearly not the case, since cantons also compete on the services they provide) and possibly also concerns of exaggerated "inequality" in the population at large. Tax competition is largely considered as a positive force preventing excessive tax burdens and encouraging reasonable expenditure policies. It also leads to institutional innovations in terms of spending and tax systems. From that perspective, the fiscal equalization reform was considered one of the most important institutional reforms of the century as one of its major political goals was to prevent a formal harmonization and standardization of tax rates within Switzerland by acting as a mild substitute.

Separation of federal and cantonal functions

As a first improvement, the reform disentangled some functions that used to be carried out commonly by the federal government and the cantons. Over time, the political process had led to many tasks being carried out by both levels of government, with the consequence of reducing the autonomy of the cantons and weakening the accountability and efficiency of the public sector. Of the 31 functions where tasks were carried out jointly, 15 were placed under exclusive cantonal jurisdiction, and six under federal jurisdiction. The new repartition of tasks is not yet fully completed but first evaluations have identified positive results, such as lower costs for national roads: in a single year, savings of as much as 120 to 205 million Swiss francs were realized thanks to lower construction prices and dispensing with needless additional features that used to increase costs.

Resources equalization based on cantonal tax potential

Second, resources equalization, or fiscal capacity equalization, the main redistribution mechanism, is now based on cantonal tax potential, defined by standardized tax revenues on income, wealth, and profit in relation to taxable income and wealth. Financially "weak" cantons are supposed to reach 85% of the Swiss average in terms of financing capacity through resources equalization. Under the old system, equalization was based on a combination of GDP per person, tax revenues per resident, tax rates, and the proportion of mountainous territory. The reform separated most of these factors from the main equalization mechanism; they are now taken into account under the heading of charges equalization, which in absolute terms represents a third of the funds allocated to resources equalization (see below). Cantons therefore are no longer able to influence their fiscal capacity negatively by simply fixing artificially high tax rates and penalizing productive activity in order to maximize subsidies. This measure also revived the incentives for tax reductions in many cantons.

Charges equalization based on geography, population, and urbanization

Third, charges equalization, which, as mentioned, was separated from resources equalization, is based on an evaluation of financing needs according to a range of specific factors. It is divided into three main areas: equalization for geographic and topographic factors, in particular for mountainous cantons, which face low density and difficult natural conditions; equalization for socio-economic factors faced by urban agglomerations, such as costs arising from their population structure, the costs of high density; and finally equalization for the typical functions of large city centers (large, by Swiss standards, given that the largest city, Zurich, has 380,000 residents, followed by Geneva with 195,000 and Basel with 170,000). The basis for assessing these factors and these costs is the result of political bargaining, and it is doubtful whether it truly reflects actual charges. Moreover, the center regions facing socio-economic charges are also the wealthier economically, and it is not clear to what extent additional charges result from deliberate policy choices (given that large cities are mostly dominated by the political left) or from actual population structure. Also subject to discussion is the division of funds between geo-topographic and socio-economic factors. Currently, they are divided equally (including city center equalization). An independent study (Ecoplan, 2010), however, came to the conclusion that geo-topographic factors should rather account for 30% and socio-demographic factors for 70%. Yet again, this is a political decision, which says as much about the special, emotional significance the Swiss place on their mountainous regions as anything else.

Earmarks removed from federal subsidies

Fourth, it is now up to the cantons to decide which expenditures they wish to pay for with the funds redistributed by the fiscal equalization system. This has created an incentive to provide more efficient public services. The former earmarking of federal subsidies to specific expenditures and their calculation based on cost evaluations and financial capacity led cantons to strive for the largest subsidies possible rather than to fulfill their tasks in a cost-effective manner. Under the new system, cantons also have the option to use the funds to lower their tax burden or pay off their debts, which some have done with good results and positive economic implications for the entire country.

New model for intercantonal cooperation

Fifth, given the mobility of users of public services, and in particular the separation of workplace and residence, a challenge was to take into account intercantonal cross-border relations. Usually, cantons deal among themselves to solve such issues. There is a range of bilateral compensatory financial agreements between the canton of Zug, for example, and the larger neighbouring cantons of Zurich and Lucerne, which provide cultural and other infrastructures used by Zug residents. To facilitate such intercantonal cooperation, the fiscal equalization reform provided the cantons with a newly designed cooperation model. The results are not yet very conclusive and there are different views on the model's usefulness and effectiveness.

Transition funds for "hardship" cases

Finally, for political reasons and to ensure acceptance of the reform in the ballot box, transition funds were foreseen for "hardship" cases, that is, for the cantons that would receive less federal funding. The term "hardship", reminiscent of absolute poverty, is testimony to the political pampering Swiss cantons enjoy. "Hardship" cases still include some of the wealthiest cantons; only seven are left in this category. The transition is long enough to allow for any needed adjustments, since it is scheduled to last a maximum of 28 years. From 2015, however, seven years after the introduction of the new system, "hardship" funds are due to decrease by 5% a year. In absolute terms, "hardship" compensation represents 7.5% of total equalization payments or 10.8% of resources equalization. In 2013, the small canton of Schaffhausen in northern Switzerland, which has an above-average GDP per person, left the "hardship" category, as it became a net contributing canton thanks to favourable tax reforms attracting new businesses and allowing existing businesses to expand and grow. This led to savings of approximately 7 million Swiss francs from one year to the next.

In absolute and relative terms, fiscal equalization is relatively modest compared to public budgets. In 2013, it represented 2.5% of the total federal, cantonal, and communal budgets, and 6% of cantonal budgets. Total payments amounted to 4.7 billion Swiss francs: 3.7 billion as general resources equalization, 365 million for geo-topographic charges (in particular, for mountainous cantons), 243 million for socio-demographic charges (in particular, to aid with costs of poverty, old age, and migrant integration), and finally 122 million for city centers (which mainly concerns Zurich, Geneva, and Basel). In addition, 239 million are earmarked for so-called hardship, in order to ease the transition from the old to the new system. Overall, the small low-tax and wealthy cantons of Zug, Schwyz, and Nidwalden pay the most per person into the system, together with the large industrial and business centers of Basel, the Lake Geneva region (Geneva and Vaud) and Zurich (table 4.2). However, cantons redistribute among themselves 40 percent of resources equalization and one third of "hardship" compensation. The rest of all equalization payments—roughly two thirds of the total—is redistributed directly through the federal government.

Room for improvement

According to the new fiscal equalization law, the federal government has to evaluate the system every four years and, if necessary, make proposals for improvements to Parliament. The first official evaluation in the year 2010 for the period from 2008 to 2011 came to largely positive conclusions. The reform's objectives had been largely reached, according to the government: Cantonal financial autonomy had been strengthened, resources equalization functioned well, and, despite the additional financial burden, the contributing cantons had been able to maintain and often lower their tax rates (Federal Council, 2010).

The economic analysis, however, is less satisfying than the political analysis. Like all subsidies, fiscal equalization still leads to substantial distortions among cantons. Instead of letting unsustainable public entities reform themselves (or merge), it may maintain inefficient structures that would not subsist without support. This may be especially true for a number of small rural or mountainous cantons with comparatively high tax rates. Also, the degree of redistribution involved and the burden imposed on the contributing cantons are still subject to controversy. A possible reform would be to cap the amounts, in order to prevent over time the many cantons on the receiving side from outvoting their donors on plans to redistribute ever more funds in their favour. This would require reaching political consensus based on the idea that fiscal equalization, as it is, may hold back receiving cantons more than it helps them. On the other hand, given that fiscal equalization currently redistributes the equivalent of 6% of cantonal budgets, it may be viewed as the price to be paid to keep the political peace, ensure that tax competition among cantons remains lively, and prevent further centralization.

The new fiscal equalization system undoubtedly brought improvements compared to the old system. It discontinued decades of unchecked redistributive policies between cantons, whereby the effects were often clearly counterproductive. The former system contained incentives for receiving cantons to overspend in specific areas, not because of an identified need or preference expressed by citizens, but simply because these areas were subsidized. In addition, the criteria for qualification for subsidies could be easily manipulated by

Table 4.2: Fiscal equalization amounts contributed and received in Swiss cantons, per person, in CHF

Contributing Cantons	Zug	2,499
	Schwyz	931
	Basel-City	598
	Geneva	577
	Nidwalden	418
	Zurich	281
	Vaud	79
	Schaffhausen	35
	Basel-Country	13
Receiving Cantons	Ticino	−69
	Aargau	−309
	Solothurn	−818
	St. Gallen	−825
	Thurgau	−920
	Neuchâtel	−982
	Lucerne	−1,011
	Appenzell A. Rh.	−1,021
	Appenzell I. Rh.	−1,035
	Obwalden	−1,063
	Bern	−1,193
	Graubünden	−1,394
	Fribourg	−1,697
	Valais	−1,742
	Glarus	−2,079
	Jura	−2,317
	Uri	−2,498

Swiss average: −411

Source: Federal Finance Administration, 2012 (year of reference 2013).

the receiving cantons. There was no methodological transparency as to the calculation of the amount a canton would receive. This led to a high degree of administrative arbitrariness and political opportunism. The new system is comparatively transparent and no longer leads to specific spending decisions, given that allocated funds are no longer earmarked.

The new system is established on at least politically objective criteria that can be verified, and is no longer based directly on the fiscal policies and prerogatives of individual cantons. Nevertheless, these criteria remain political, whether it is the resources potential, the additional infrastructure costs induced by the natural environment, or the additional social welfare costs in agglomerations. It could be argued for example that the geographical and topographical environment is not so much a burden as an advantage, in particular for tourism, and that each canton should take advantage of its environment to make to best out of it. From an economic viewpoint, it is unclear why differences between regions should be equalized, given that geography is clearly not a sufficient factor to explain any differences in prosperity and economic development. This is best exemplified in Switzerland by peripheral regions that have become competitive by adopting an attractive tax and legal framework conducive to entrepreneurial activity. On top of this, so-called hardship equalization for those cantons deemed to lose out with the new system adds a layer of subsidies that seems to undo the benefits of the new system.

Essentially, fiscal equalization might be in itself contrary to sound governance, which would imply that each canton finances and carries out the activities it deems necessary. Accordingly, if equalization served a targeted purpose, the number of receiving cantons would be very small, that is, it would only include those with severe structural problems, such as some mountainous cantons reliant in the past on few industries that may not be easy to replace in the event of changes in the economic structure. Equalization would be the exception rather than the rule. The fact that there are typically less than 10 contributing cantons and over 15 receiving cantons seems to systemize redistribution for the sake of redistribution; it does not address difficult situations due to a set of specific causes. Fiscal equalization may therefore weaken the principle of accountability.

The main moral hazard of a fiscal equalization system arises because the majority of receiving cantons can outvote the contributing few, with all the excesses that this may lead to. There is no built-in mechanism to ensure fairness toward the contributing cantons: what gets redistributed is based on a political rule by a majority. The system may not take it sufficiently into account that the economic situation of any given canton is to a large extent the result of policies that are more or less friendly to development. The canton of Zug, as mentioned, was one of the poorest cantons before it changed its political course. The fundamental problem of a federal fiscal equalization program is, therefore, that it may all too often reward bad policies and penalize good ones.

It is also unclear whether the funds allocated are used to improve the situation in the receiving cantons and thereby help them to move away from their receiving status, or simply to keep them there forever. One solution advanced to circumvent this problem would be to gradually reduce and let expire the funds allocated to fiscal equalization (except in the case of severe structural difficulties), so that receiving cantons would have both the incentive to adopt better policies and the time to adjust. As such, the new fiscal equalization system is still inefficient from an economic point of view, although it has brought welcome improvements compared to the old, defective system. Until recently, fiscal equalization has been a history of failure in Switzerland. It has encouraged dependency and discouraged the adoption of policies more friendly to development. Whether the new system will bring long-lasting positive results is still an open question.

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5. Federal Transfer Programs in Germany

Charles B. Blankart

1. Aim and Purpose

This chapter explains the rules and effects of the German federal transfer system and its alternatives. Section 2 describes the rules of the German federal transfer system step by step. Its problematic effects will be considered in section 3 and, as a result, it will be clear that the German federal transfer system could be considerably improved and that Canada might learn from its shortcomings rather than from its success.

But what are the alternatives? If Germany's federalism works poorly, what alternative systems might there be that work better? In section 4, I shall briefly discuss three systems of multilevel public finance: a confederation, a unitary state, and a federal state in their relation to federal transfers. Section 5 provides a digression into the problem of federal purchases of public services and the "informal transfers" implied. Conclusions are proposed in section 6.

2. The Federal Tax-Transfer System in Germany

At first glance, Germany's fiscal system seems to be very similar to Canada's. Germany, like Canada, has a personal and corporate income tax. It has a turnover tax in the form of a value-added tax (VAT) and several excise taxes, mainly on tobacco, alcohol, and energy. A local business tax is raised in a way similar to the corporation income tax.

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These similarities, however, vanish at second glance, which reveals that the German taxation system is mainly a system of joint taxes. Only the excise taxes (on tobacco, liquor, energy, and so on) and the income tax surcharge are federal in the sense that they are legislated and collected by the federal government; and only the local business tax belongs (in its primary legislation and collection) to the local governments. The three large taxes, personal income tax, corporate income tax, and the VAT are joint taxes. They are legislated at the federal level (rates and tax base) by the *Bundestag* (federal assembly) and the *Bundesrat* (federal council). But, the revenues are divided between the federal government and the state and local governments. Without understanding the combination between federal legislation on the one hand and distribution of revenues to federal, state, local levels of government on the other, one cannot understand the economic characteristics of the German federal transfer system as a whole. The reader may find a quantitative break-down of the joint taxes in the upper part of **table 5.1**. Joint taxes encompass about 70 percent of the total tax revenue in Germany. The lower part of table 5.1 contains the federal and local taxes levied by each jurisdiction separately (that is, tax legislation and tax revenue belong to the same level of government). The reader may be surprised to see that the states levy practically no separate taxes of their own. An exception is the land purchase tax, which is of minor importance.

In Germany, the federal, state, and local governments have shared rights in the joint taxes. This means that the tax revenues have to be distributed among the different governments of the country. The designated government collects the tax and then transfers part of the revenue to the government that is entitled to receive a designated quota. Often the federal government is made politically responsible for the level of taxation while a large part of the revenue is spent by subnational governments.

Dividing Tax Revenues among German Jurisdictions

The repartition of the tax revenues takes place in *five steps* in Germany. The main problem of the German transfer system is to find out which jurisdiction obtains how much of the whole tax revenue. As the majority of the German taxes are joint, much more legislation is needed in Germany than in Canada to arrive at the final allocation of resources.[1]

Step 1. Allocate joint taxes to federal, state, and local levels of government

First, before any *re*-distribution begins, the joint taxes have to be allocated to particular levels of government. The constitution requires that the revenues of the personal income tax are allocated to the federal, state, and local levels in relation of 42,5% : 42,5% : 15% (since 1969). The corporation income tax is divided

1. For the subsequent steps, see: L. Feld, H. Kube, and J. Schnellenbach (2013), Optionen für eine Reform des bundesdeutschen Finanzausgleichs, mimeo (University of Freiburg).

Table 5.1: Main taxes in Germany 1980–2011

	1980 %	2011 € billions	2011 %
Joint Taxes	73.3	404	70.4
personal income tax	40.6	172	30
non-personal tax on profits	1.1	18	3.2
corporate income tax	5.9	16	2.7
sales tax / value added tax (VAT)	14.4	139	24.2
VAT on imports	11.2	51	8.9
Federal state taxes	12.8	99	17.3
tobacco tax	3.2	14	2.5
liquor tax	1.1	2	0.4
energy tax	5.9	40	7
solidarity surcharge	—	13	2.2
State taxes	4.3	14	2.2
Municipal taxes	9.6	53	9.2
(local) business tax	7.5	40	7.1
Total	100	573	100

Source: Blankart (2011).

50:50 between the federal and the state governments. The local business tax is raised by the local communities. Its revenues are partially redistributed among local communities but on the whole remain on the local level. See **table 5.2** for historical allocations of main taxes in Germany.

Step 2. Allocate personal and corporate income taxes and VAT to designated states

Second, a supplementary primary, horizontal fiscal allocation makes sure that the states' shares of personal and corporate income taxes are allocated to designated states. The personal income-tax yields have to go to the state of residence. This is not self-evident as the income tax is deducted from wages at the working place and the state where the working place is located often differs from the state where the workers have their homes. The corporation income tax is often paid to the fiscal authorities of the state of the headquarters of the firm but it has to flow to the state where the plant that creates the profits is situated. As this is not immediately visible, overall profits are distributed according to the number of personnel in a plant though, of course, the size of the local labour

Table 5.2: Primary Vertical Fiscal Allocation (%) of the Tax Revenue in Germany, 1949–2010

	1949			1955			1969			2010		
	federal	state	local	federal	state	local	federal	state	local	federal	State	local
Personal income tax	—	100	—	33⅓	66⅔	—	43	43	14	42.5	42.5	15
Corporate income tax	—	100	—	33⅓	66⅔	—	50	50	—	50	50	—
Sales tax/value added tax	100	—	—	100	—	—	70	30	—	52	45.9	2.1
Local business tax	—	—	100	—	—	—	—	—	100	—	—	100

Source: Blankart (2011).

force is an imperfect proxy for local profits.[2] Up to this point, states with a high economic capacity obtained more, those with a low economic capacity obtained less, tax revenue per capita. The former states are said to be "rich" states; the latter are designated as "poor" states. This distinction between "rich" and "poor" is necessary to understand the following steps three to five of the German federal transfer system.

The VAT is distributed in two steps: ¼ of the VAT revenue is retained by the central government. Of the remaining ¾, 75 percent is paid out to the states on a per-capita basis. The remaining 25 percent is redistributed without earmarks to the poorer states according to how far they fall below the national average for personal and corporate income-tax revenue per capita (without VAT). While all the elements of steps one and two above may be considered to reflect the economic capacity of a state, this last 25 percent of the states' VAT share clearly has the effect of redistributing wealth from the rich to the poor states. It encompasses about €11 billion.

Step 3. Transfer fiscal resources from "rich" to "poor" states

Third, an important secondary horizontal fiscal equalization takes place between states. The fiscal need of a state is calculated from the average fiscal capacity (AFC) measured as:

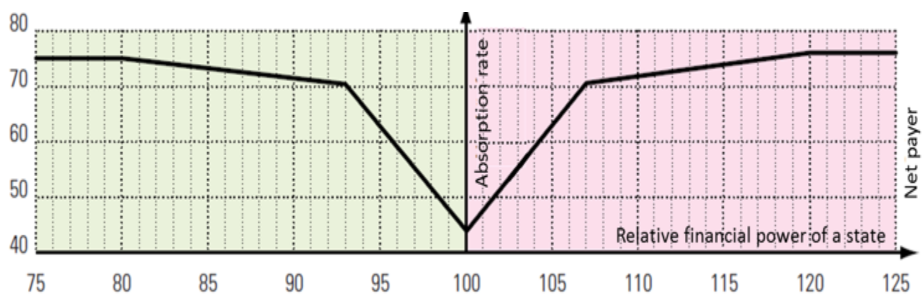
[(national tax revenues)/(national population)] × population of the state in question.

Remember, AFC stands for the "need" for tax revenue of a state compared to the national average. The effective fiscal capacity (EFC) of a state is defined by its actual tax revenues. Remember also that the tax bases and tax rates of the taxes are assessed uniformly by the federal legislation. The states have no tax autonomy. If a state's average fiscal capacity (AFC "need") is larger than the effective

2. Other possible distortions such as those by artificial transfer prices may be mentioned, but are not of importance because the corporation income tax is raised at the same rate everywhere in Germany.

fiscal capacity (EFC), the state is a poor state that is entitled to a fiscal subsidy without earmarks. If a state's EFC is larger than its AFC, the state has a surplus of fiscal capacity. It is "rich" and supposed to pay non-earmarked transfers out of its own resources into a fund. **Figure 5.1** shows how equalization works: a state with an EFC/AFC ratio of 120 has to give up 75 percent of its excess fiscal resources into an equalization fund. A state that has a fiscal-capacity EFC/AFC ratio of 80 percent receives a subsidy of 75 percent of its fiscal capacity deficit out of the equalization fund.[3]

Figure 5.1: Marginal fiscal equalization schedule for below- and above-average revenue states in Germany. 100 where (EFC/AFC = 1), 2012



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Step 4. Allocate federal equalization transfers to "poor" states

Fourth, secondary federal equalization payments are provided by the federal government to those states whose EFC is still under 99.5 percent of the AFC. For these states, the remaining gap will be filled up to 77.5 percent by federal transfers. After these transfers, all states' AFC/EFC ratio is nearly 1. Those who were rich are down to average and those who were poor are up to average (**Figure 5.2**). Surprisingly, the rules do not allow "leap-frogging". The rank order of rich and poor states has not been changed up to this point because the Federal Constitutional Court has prohibited leap-frogging transfers whatever the majorities in the Houses of parliament had would prefer.[4]

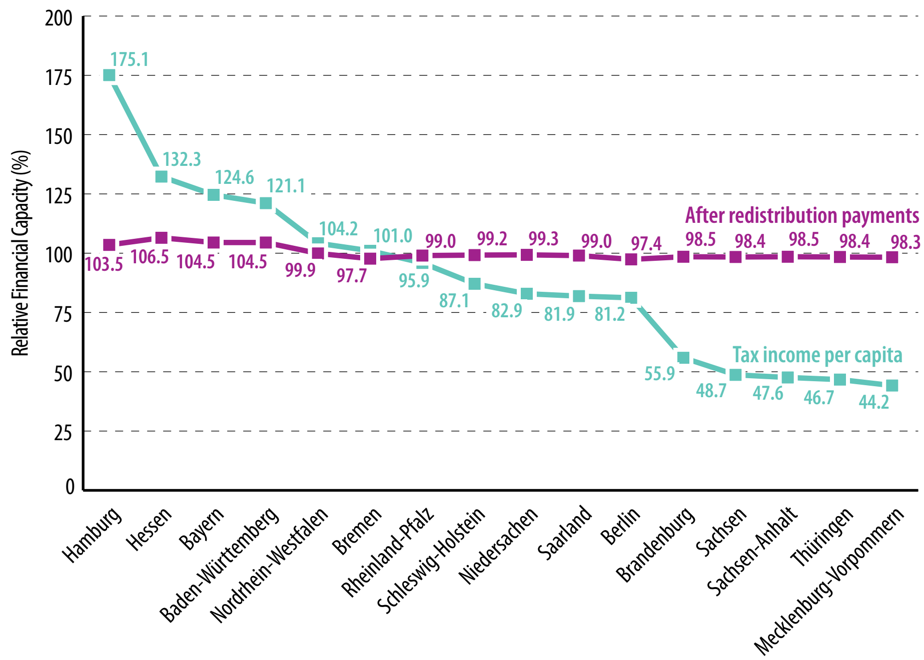
Step 5. Allocate secondary federal equalization transfers to states in special circumstances

Fifth, special secondary federal equalization transfers are provided to states that are too small to break even and, up to 2019, to those states that still suffer from the burdensome effects of the former communist regime. Some states

3. It should be noted that AFC and EFC are not based on effective population figures (as assumed here for simplicity). The population figures of the city states (Hamburg, Bremen, and Berlin) are inflated by 35 percent (because of the alleged higher costs of urbanization). So they appear poorer than they actually are. Moreover state tax revenues (according to 1 and 2) include local governments' tax revenues only up to 64 percent.

4. Federal constitutional court 86, 148 (250 sqq.).

Figure 5.2: Relative Fiscal Capacity (EFC/AFC) before and after Steps 1 to 4 of the Redistribution Payments



Note: Hamburg's population is inflated by 35% according to footnote 3 so that it is rich in this figure and becomes relatively poor in figure 5.3.
Source: Blankart (2011).

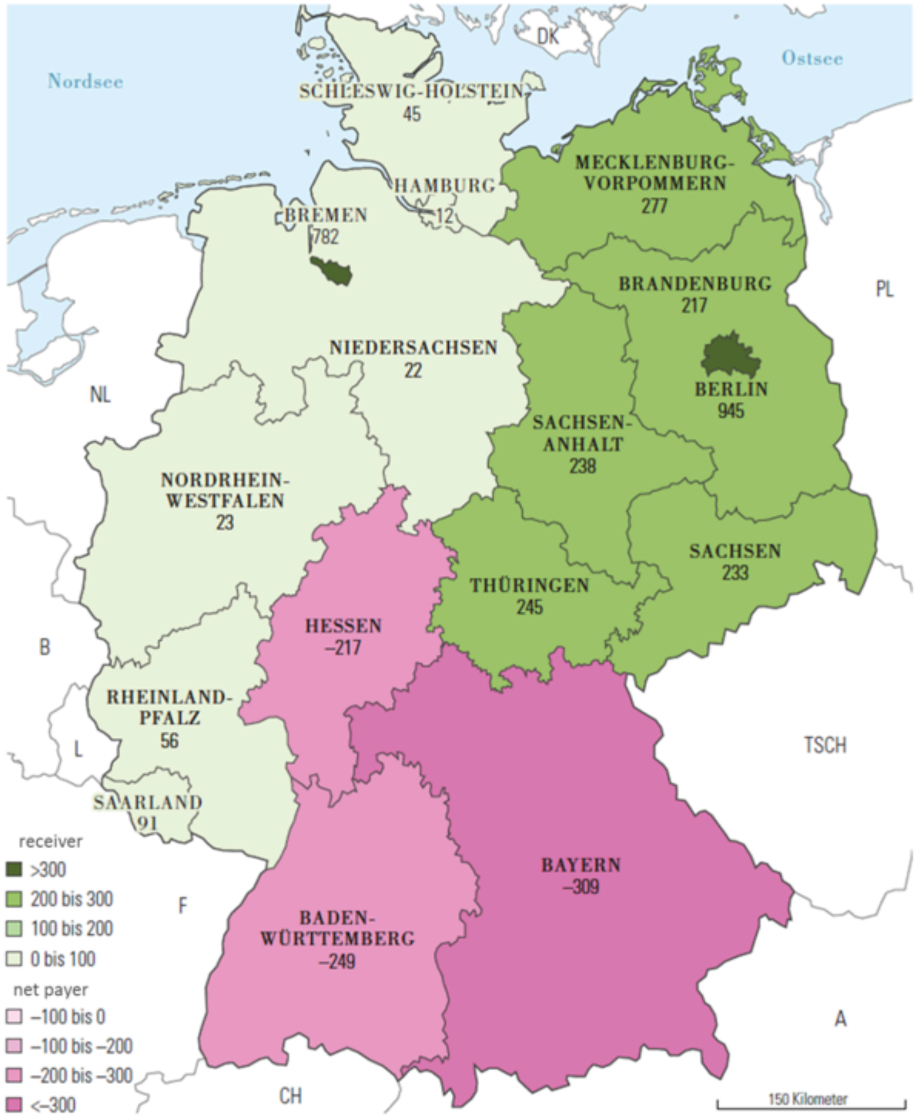
receive "special" payments because of their high structural unemployment and some receive outright bailout payments to cover their budget deficits. As these transfers are said to be "special", they are exempted from the judicial constraint on leap-frogging.

Figure 5.3 shows geographically which states are net payer states and which are receiver states, and to what extent. Those states that made efforts to maintain or improve their economic conditions such as Bavaria, Baden-Württemberg, and Hassia obtain high per-capita tax revenues in steps 1 and 2 above. Thereafter, they are punished and have to pay high fiscal transfers in steps 3 to 5. Astonishingly, states that received high subsidies have not been able to improve their ranking in the last decades. Therefore, figure 5.3 provides a long-run, and not only a short-run, drama of the German federal transfer system.

3. Problematic Incentive Effects

Obviously the incentive effects generated by transfers are much different in a country like Canada where taxes are levied by each jurisdiction separately compared to a system with joint taxes as in Germany. Only a few points shall be mentioned:

Figure 5.3: Net payer states and net receiver states (2012)



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1. A state government considering whether to attract a firm from abroad has to take into account that only a part of the acquired tax revenues will remain with its own fisc: 42.5 percent of the income tax generated and 50 percent of the corporation income tax generated have to be transferred to the federal government because personal and corporation income taxes are joint taxes (see **step 1** above). The federal participation in a state's tax revenues can be understood as a tax on a tax.

2. As Germany is a densely populated country, it has many transborder commuters. Often the state where the working place is located differs from the state where the workers reside. As the law requires tax revenues to be allocated to the state of residence, it is relatively more attractive for a state government to attract residents than workers and to invest in infrastructure for "sleeping towns" rather than in production sites.

3. As the law requires the allocation of the tax revenues of a corporation according to the number of local employees in a plant (and not according to the wages paid), the community where the plant is located has only a reduced incentive to attract jobs that pay a high income.

4. A fall in the EFC/AFC ratio entitles a state to horizontal and vertical transfers (in step 3 and step 4 above) and hence reduces its incentives to improve its economic situation.

5. Finally points 1 to 4 have to be seen in combination. A state government that attracts a firm not only loses roughly one half of the incremental tax revenue in step 1 (tax on the tax), but may also drop out of a transfer program in step 4 because of its slightly increased tax revenues and therefore end up with fewer net tax and transfer revenues than if it stays idle and does nothing.

6. It is often argued that the redistribution quota is relatively small compared to the total tax revenues in Germany. Indeed, the sum of all tax revenues amounts €555 billion in 2011 while redistribution by VAT (step 2) amounts to only €11 billion and redistribution by secondary horizontal payments (step 3, step 4, and step 5) only €7.3 billion (or €18.3 billion altogether), the marginal effect is very substantial since it leads to a full equalization of the post-redistribution per-capita tax revenues, as depicted in figure 5.2. Therefore, the incentives are rather strong.

4. Efficiency among Rules—Different Transfer Systems Compared

The German federal transfer system is often criticized as working badly and in need of improvement. Feld et al.[5] suggest that redistribution via VAT (step 2) should be abolished and the rest of the transfers (step 3, step 4, and step 5) should be based on the tax base, not on the tax revenues per capita, and that the states should have their own taxes with autonomy over tax legislation and tax revenue. They also write correctly that equal tax revenue per capita is not a useful criterion for providing incentives to make economical use of resources in a federal transfer system. For, where the costs of public services are high, the taxes should be high; where they are low, taxes should be low.

But what could be the alternatives for Germany and implicitly also for Canada? A confederation, a unitary state, or a federal state?

5. Feld, Kube, and Schnellenbach (2013), Optionen für eine Reform des bundesdeutschen Finanzausgleichs.

Confederation A confederation is a system of sovereign states tied together by contracts. Issues become decisions when all states or the assembly of their governments approve the issues unanimously. Transfers in favour of some states at a cost to other states are unlikely to be approved unanimously. Therefore, few vertical or horizontal intergovernmental transfers will be observed in a confederation.

Unitary State A unitary state, in contrast, has no independent, subsidiary governments but only a central government, where all power is concentrated. This government is likely to maintain and to expand its power and to prevent any regional or local autonomy. Support to regional and local authorities, if any, will therefore take the form of matching grants that prescribe to regional and local authorities what they have to spend rather than of taxation rights (and block grants) that they could spend as efficiently as possible in their view.

Federal State A federal state is a blend between a confederation and a unitary state. Subsidiary governments have a veto power only if they can establish a blocking minority. For the future of the federal state, it is important what these minority rights imply. Reserved rights—in particular, to taxes and tax revenues—induce the subsidiary governments to use their means efficiently, especially if they are in competition with each other. Rights in subsidies from the federal government in contrast rather distort regional decision-making and promote excessive spending.

Germany is a federal state situated between a confederation and a unitary state. Its advantage is that its state and local governments have firm rights in taxes whose revenues they can use autonomously. Its disadvantage is that they also have rights in federal transfers that distort their marginal choices and generate the inefficiencies describes in sections 2 and 3 above.

5. Government Purchases

The vertical and horizontal transfers described up to this point are unilateral. They generate a burden for the payer states and a benefit for the receiving state. Government purchases are different. If, for example, the federal government operates a military base in a state, it obtains a service for the money paid to the state and to the local procurement firms. On principle, the federal government has to choose the least-cost supplier and to compensate it for its opportunity costs only. So the state where the service is produced has neither an advantage nor a disadvantage, given full employment, and a rent is only generated if the federal government contracts above least costs.

The fact that states often engage in political competition (rent-seeking) for government contracts suggests that the federal government contracts for a price above least costs, which implies rents. These rents are unilateral and comparable to the unilateral vertical and horizontal transfers analyzed in sections 2 to 4 above. But actual figures are difficult to obtain. **Table 5.3** and **figure 5.4** provide

Table 5.3: Estimated military personnel costs in Germany (2011)

State	Population (2011)	Soldiers per 1,000 Inhabitants	Number of Soldiers	Estimated Cost (€ millions)
Baden-Württemberg	10,754,000	1.5	16,131.0	1,348
Bayern	12,539,000	2.5	31,347.5	2,619
Ber	3,461,000	1.5	5,191.5	434
Brandenburg	2,503,000	2.9	7,258.7	606
Bremen	661,000	1.1	727.1	61
Hamburg	1,786,000	1.4	2,500.4	209
Hessen	6,067,000	0.9	5,460.3	456
Mecklenburg-Vorpommern	1,642,000	6.4	10,508.8	878
Niedersachen	7,918,000	5.1	40,381.8	3,374
Nordrhein-Westfalen	17,845,000	1.5	26,767.5	2,236
Rheinland-Pfalz	4,004,000	5.1	20,420.4	1,706
Saarland	1,018,000	1.4	1,425.2	119
Sachsen	4,149,000	0.9	3,734.1	312
Sachsen-Anhalt	2,335,000	1.9	4,436.5	371
Schleswig-Holstein	2,834,000	5.4	15,303.6	1,279
Thüringen	2,235,000	2.8	6,258.0	523
Total	81,751,000		197852.4	16,530

Source: All data are private information provided by the Federal Ministry of Defense, processed by the author.

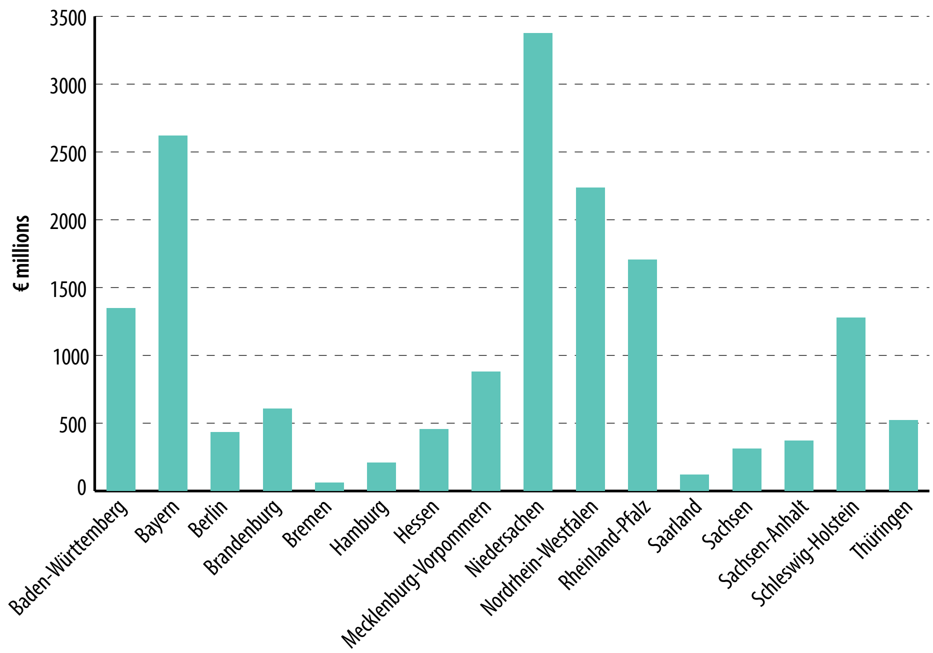
an estimation of the federal expenditures for military personnel in the German states. One can see that the amount of these expenditures is remarkable: €16.5 billion compared to €15 billion for the primary and secondary fiscal equalization from steps 1 to 5 in section 3. States with a large surface and states close to the sea benefit more than geographically small, inland states. But these figures are gross: they include the opportunity costs of the state plus the rents that accrue when the federal government has not contracted at least costs.

In a summary, it can be said that government contracts should be made at a state's opportunity costs. But, in the real world of rent-seeking, contracts have a large potential to become unilateral federal transfers. What the transfers really are remains unknown.

6. Conclusions

Earmarked federal subsidies to subsidiary governments are typical for unitary states. They help the unitary government to consolidate its power, but lack the capacity to provide incentives to subsidiary governments to use their resources efficiently. If, in contrast, the subsidiary governments are given rights in taxable

Figure 5.4: Estimate of federal expenditures, in € millions, for military personnel in the German states (2011)



Source: Table 5.5.

resources they have an incentive to use these rights efficiently. The German Constitution correctly provides rights in taxes to its subsidiary governments. But, over time, these rights in taxes have been supplemented and partially replaced by federal subsidies like those found in a unitary state. So, the original good idea of the German fiscal system has been submerged in an inefficient subsidy system whose ultimate goal is to give each state government the same per-capita quota in Germany's taxes. The lesson for Canada might be to rely more on subsidiary rights in taxes than on rights in federal subsidies.

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