1. Introduction to the volume

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1.1 BACKGROUND

This book intends to contribute to the definition of the frontiers of research in vertical and horizontal imbalances (VFI) in federations. It also looks ahead for opportunities and challenges and subsequent needs for future research and development. Whereas the second section of the volume includes theoretical and methodological contributions, much of the book is devoted to case studies that illustrate important policy or methodological lessons.

The most important lesson to be learned from the book is that there is no single or best way of addressing vertical and horizontal imbalances. That is because each country is different and policy objectives of intergovernmental transfers are different. More importantly, transfer system design in a country is a response to specific conditions that exist at that particular time in history.

The book is divided into four sections. After this brief introduction, the second section covers conceptual issues of principles of VFI and public finance and political economy considerations in addressing them. Then, the next three sections analyse how different federations address VFI.

1.2 CONCEPTUAL ISSUES

Much of the earlier literature on fiscal federalism revolved around studying departures from a model fiscal system whereby intergovernmental transfers played a benevolent role. However, in the 21st century, the federations seem to be recalibrating their fiscal architecture to address the needs of pluralistic communities and their large populace. More recently, the system of intergovernmental transfers is more actively used for restoring a balance in sharing of resources between the states (and local governments) and the national government for improving development outcomes. The chapters in the second section of the book delve into the various theoretical aspects

of VFI and political economy considerations in designing a transfer system in addressing them. The second chapter by Bahl offers explanations 'for why countries set up their grant systems in so many different ways, and to offer a set of principles that might enable low- and middle-income countries to do a better job with achieving the objectives they have set for their transfer systems'. The third chapter by Yilmaz and Zahir surveys the first-generation theory of fiscal federalism and the second-generation 'to summarize the theoretical conceptualization of intergovernmental transfer design . . . to present a case for the importance of political economy considerations in designing and analysing intergovernmental transfers systems'. The fourth chapter by Dafflon and Vaillancourt puts forward a fascinating reading of how the theory of fiscal equalization is an elusive goal for practitioners.

1.3 MATURE FEDERATIONS

A federation is a political union of partially or fully self-governing provinces, states or regions under a central/federal government. In a mature federation, the self-governing status of the constituent units, as well as the division of power between them and the central/federal government, is typically constitutionally entrenched and may not be altered by a unilateral decision of either party. The second section of the book focuses on five mature federations: Germany, United States, Canada, Switzerland and Australia. In this group of federations, sovereign power is formally divided between the federal government (centre) and the constituents of the federation (second tier) which retain some degree of control over its internal affairs. In mature federations, concurring sovereignties exist between the centre and constituent units of the federation, with full taxing and expenditure powers for each tier.

In Germany, each of three levels of government is autonomous in their expenditure and revenue responsibilities. Chapter 5 analyses the German equalization system which is characterized as one of the most generous ones in the world. The pending 2020 reforms in the intergovernmental transfer system have brought much anxiety among the stakeholders. According to Spahn, it is 'unlikely that the setup of the German financial constitution will change dramatically given that the majority of states, that exert strong legislative voting powers through the second chamber of parliament, are still at the receiving end of the scheme'.

The US, on the other hand, has a chaotic intergovernmental system with the judiciary playing a major role. In the US, Medicaid is the most important federal grant to states. Since its enactment, the Affordable Care

Act has been subject to several lawsuits. In Chapter 6, Chernick presents the intergovernmental grant system in the US which has a very high degree of conditionality. According to him, '[o]f the 1,714 authorized grant programs as of 2012, the vast majority are relatively narrow categorical grants, authorized for specific purposes'.

Unlike the US, in Canada the federal-provincial relationship is less confrontational. The federal government has the responsibility for standard sovereign functions, such as defence, foreign relations and monetary policy, and provinces are responsible for delivery of social services, such as health, education and welfare as well as infrastructure services. In Chapter 7, Joanis and Vaillancourt present the key aspects of fiscal federalism in this one of the oldest federations in the world. The chapter focuses on a contentious issue of how to incorporate provincial natural resource revenues into the equalization programme.

In the next chapter, Dafflon shows the constitutional and institutional complexities of VFI in Switzerland. Chapter 8 lays out the complex public finance arrangements to achieve national equalization through both revenue and expenditure equalization in the Swiss federation.

The last two chapters in this section are devoted to Australia. The six states in Australia, the original six British colonies, came together to form the Commonwealth, much like the US. Therefore, states have strong constitutional protection. However, the assignment of expenditure responsibilities and revenue capacities presents a large vertical imbalance question. In Chapter 9, Searle presents the complex architecture of Australian intergovernmental grant system and its institutional backbone. In the next chapter, Coppel examines the economic impacts of horizontal fiscal equalization (HFE) in Australia. He argues that HFE is functioning reasonably well, achieving a high degree of fiscal equality. However, he highlights the need for tax reforms, particularly for efficient taxation and extraction of mineral and energy resources. As the extraction activities are not evenly distributed across the country, the design of grants has distortionary effects on state level policies, much like Canada. He argues that '[i]f Western Australia raised royalties on iron ore, it would lose close to 90 per cent of the additional revenues to other states'.

1.4 EVOLVING FEDERATIONS

The third section of the book is devoted to evolving federations: Brazil, Argentina and India. In this group of federations, the balance of power between the centre and the constituent unit is evolving over time. As it stands today, the political and economic powers are concentrated in the

centre. In these countries, the centre has the constitutional authority to circumvent the powers of a constituent unit government. Furthermore, the centre has the constitutional authority to suspend a constituent government or create new constituent units. India, for example, got its newest 29th state in Telangana in 2014. In Brazil, which has experienced both the federal and the unitary state in its history, the latest state, Tocantins, was created in 1988 for mainly administrative reasons.

Chapter 11 provides an overview of Brazil's system of intergovernmental transfers and reviews three performance-based transfer programmes. Wetzel and Viñuela provide a critical review of the Bolsa Familia programme, that provides grants to both states and municipalities for administering one of the largest social protection programmes and performance-based transfers in Ceara and Rio de Janeiro states.

Argentina is an evolving federation with territorial heterogeneity. In Chapter 12, Larizza and Folgar describe the inequalities across provinces as huge. In their words, Argentina has 'areas as rich as developed nations, and provinces as poor as low middle-income countries'. At the heart of the Argentinian intergovernmental system are an automatic revenue-sharing scheme ('coparticipación') and discretionary transfers to address these inequalities. The conclusion of the chapter is that the system needs reforming 'to simplify its design and align it with international best practices to better achieve three fundamental objectives: closing the vertical gap, closing the horizontal gaps and promoting sectoral objectives'.

Chapter 13 reviews the evolving role of the Finance Commission in the world's largest federation, India. Zahir 'traces the history of the Finance Commissions in India over last two and a half decades in shaping the intergovernmental transfer system in India'. According to her, the Finance Commissions, a constitutional body established every five years to make recommendations to the government on intergovernmental transfers, shape and recalibrate 'the Indian federalism from time to time . . . in providing continuity that has been critical to the unity of the country'.

According to Martinez-Vazquez, India has 'an elaborate and complex system of resource transfers to the states'. In Chapter 14, he provides reform options for India's transfer system by drawing from international experience with the design and implementation of transfers systems.

1.5 UNITARY FEDERATIONS

The last section of the book covers unitary federations: Kenya and South Africa. In a federation sovereignty is shared between the centre and the constituent units of the federation, whereas in a unitary country

sovereignty rests with the central government. However, in unitary states autonomous self-governing regions may exist by the sufferance of the central government. We call these countries unitary federations. While federations are created by an agreement (Constitution) between the centre and a number of independent/autonomous regions, unitary federations are often created through a process of devolution, where the centre agrees to grant autonomy to regions that were previously entirely subordinate.

In Chapter 15, Boex and Smoke describe how Kenya, a unitary state, established a highly devolved system with the 2010 Constitution. They argue that ‘Kenya’s path towards devolution has in some ways been a “political” success’. However, they caution that transforming devolution into development outcomes requires ensuring ‘the development and use of an appropriate intergovernmental fiscal framework’. They seem to have faith in the Commission of Revenue Allocation to do just that.

Chapter 16 reviews the trajectory of intergovernmental fiscal reforms in South Africa since the end of the apartheid era. Savage characterizes the country as a ‘unitary state with federal characteristics’. The Constitution establishes three interdependent and interrelated spheres of government. As far as the transfer system is concerned, Savage argues that the recent reforms have created momentum in establishing a functioning performance-based transfer system.

1.6 CONCLUDING THOUGHTS

The best transfer system is the one that achieves the policy objectives set beforehand. The measurement of VFI is a scientific exercise; however, addressing them is a political choice. This book presents resource materials for researchers, practitioners, policymakers and students willing to understand the choices made by different countries against the overarching principles of needs, equity and efficiency for sharing of resources. The various chapters capture empirical, theoretical and methodological contributions, as well as case studies that illustrate important policy or methodological lessons for future work.