II. TAXING, SPENDING AND SHARING IN FEDERATIONS: EVIDENCE FROM AUSTRALIA AND CANADA

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PART 1: INTRODUCTION

In his 1963 classic work on federalism, K. C. Wheare argued that in order to exist, federations needed to satisfy three prerequisites. The first was that the communities concerned wanted a common government for some purposes, such as common defence, the reduction of trade barriers or to lessen the cost of providing some public services. The second was that the communities wanted to retain separate regional governments for other purposes, such as maintaining a distinct culture or language or advancing disparate economic interests. The third was that the communities must have the capacity to successfully operate a federation.

The subject of this short article is fiscal federalism: one of the key mechanisms that underpins the operation of federations around the world. In particular, I focus on two federations that have well-developed divisions of revenues and expenditures and ever-evolving systems for transferring resources to deal with imbalances between national and provincial governments as a whole and imbalances between individual provincial governments.[1]

The remainder of the article is organized as follows. In the next two sections, I look at the division of expenditures and revenues in the two federations. This is followed by a discussion of how each federation deals first with vertical imbalances – those between the national government and the provinces as a whole. A discussion of horizontal imbalances – imbalances between individual provinces – comes next. The article concludes with a brief summary.

PART 2: THE DIVISION OF EXPENDITURE RESPONSIBILITIES[2]

The division of spending and revenue-raising responsibilities is often laid out in a federation's constitution. While the constitution usually has an important part to play, the roles of national and provincial governments are constantly evolving as a result of changing external conditions and, in some cases, changing interpretations of the constitution and conventions by the courts.

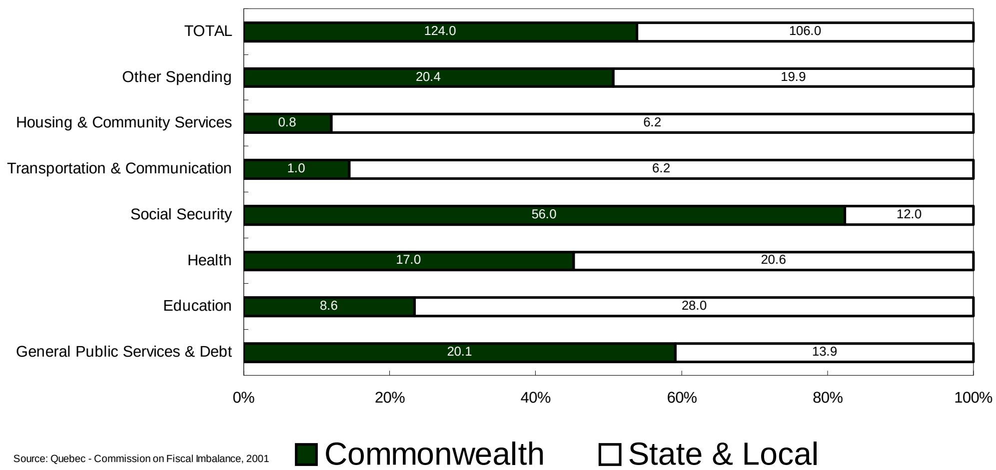
a) Australia

The Australian constitution gives the national government (the commonwealth) exclusive jurisdiction in areas such as foreign affairs, defense, immigration, trade, currency and a number of social programs including pensions, unemployment insurance and family allowances. Provincial governments (the states) retain jurisdiction over the matters they controlled before joining the federation, including public security, urban development, housing and transportation. Commonwealth and state governments share responsibility for funding health and education.

Australian courts have given a broad interpretation to the constitutional provision that allows the commonwealth to make grants to states under terms and conditions that it deems appropriate. This "spending power" is often used by the commonwealth to influence state spending priorities.[3]

In terms of direct program spending, the commonwealth spends about 54 per cent or $124 billion (AUD) of the $230 billion total, leaving 46 per cent or $106 billion for the combined state and local governments. Breaking spending down into various components (Figure 1) we see that the commonwealth's overall dominance in spending comes primarily from its expenditures in two categories: general public spending and debt and social security. State governments are responsible for more than two-thirds of spending in education, transportation and communications, and housing and community services. Thus, in the main, actual spending patterns are reasonably closely aligned with the division outlined in the Australian constitution.

Figure 1: Australia Expenditures
(1999-2000)



Source: Quebec - Commission on Fiscal Imbalance, 2001

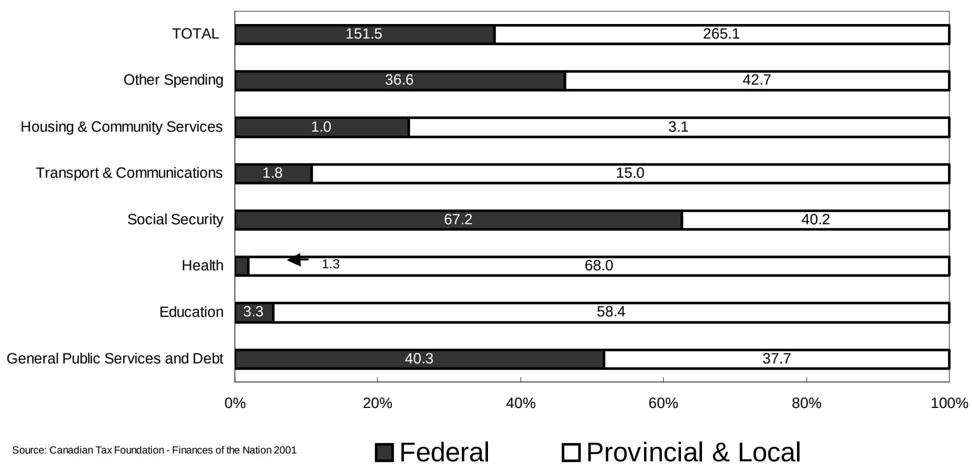
b) Canada

In Canada, the original constitution was established in 1867 and substantially revised in 1982. In the original constitution, the federal government was given responsibility for public debt, the regulation of trade and commerce, the postal services, national defence and currency and coinage. Provincial responsibilities included matters such as provincial borrowing, the management and sale of public lands (and hence control of natural resources), hospitals and education. Over time, the courts have affirmed the existence of the federal “spending power” that has allowed the federal government to become involved in areas of provincial jurisdiction such as health care.

One of the important revisions to the constitution in 1982 committed the federal and provincial governments to the reduction of regional disparities. Further, the federal government committed to the principle of making equalization payments to “ensure that provincial governments have sufficient resources to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." This gives constitutional status to the requirement, by the federal government, to address fiscal imbalances between provinces.

An examination of the division of spending responsibilities in Canada shows a pattern where provinces are much more important actors than their Australian counterparts. In contrast to Australia, provincial and local spending is a much larger proportion of the total, comprising 63 per cent (see Figure 2). Looking at the individual components of spending, one sees that only in the area of social services is the federal government dominant – and then with approximately 36 per cent of the total delivered by the provincial and local governments.

Figure 2: Canadian Expenditures
(2000-01)



Source: Canadian Tax Foundation - Finances of the Nation 2001

Provincial and local governments are overwhelmingly dominant in the areas of health and education. It is clear that the constitution writers of 1867 did not envision the modern welfare state and thus the importance of the spending responsibilities that were assigned to provincial governments and their "subsidiaries," the local governments. In fact, the major deviation from the original constitutional assignment of spending responsibilities comes in the federal role in social services – largely transfers to individuals in the form of pensions, child benefits and unemployment insurance.

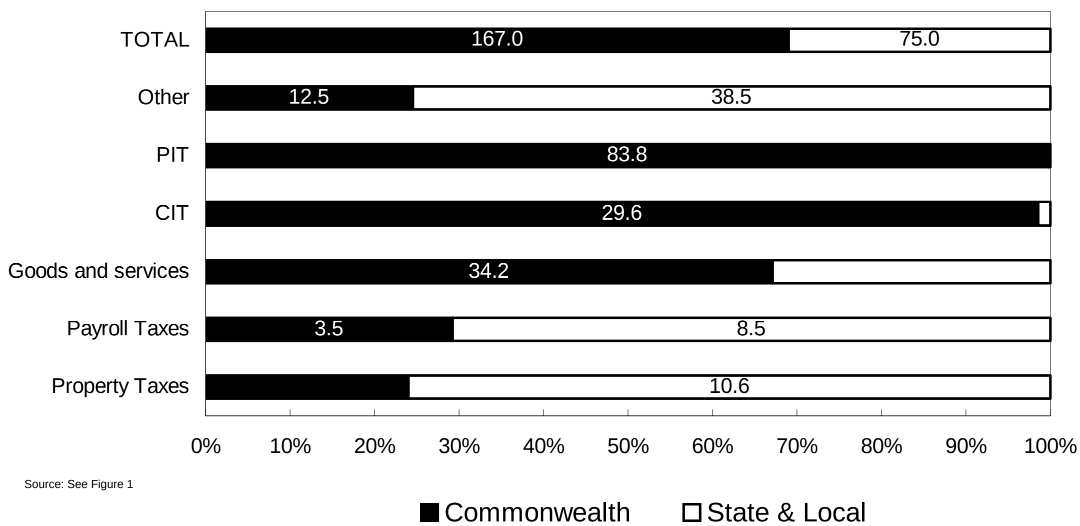
PART 3: THE DIVISION OF REVENUE RESPONSIBILITIES

Federal constitutions also often lay out the division of revenue responsibilities between national and provincial governments. Revenue responsibilities too can evolve over time because of external changes, convention or judicial decisions.

a) Australia

When compared with other mature federations, Australia's revenue collection is highly centralized. The commonwealth collects most of the revenues in the country (69 per cent; see Figure 3) and shares them with the states through conditional and unconditional grants. The commonwealth is sole occupant of the personal income tax and corporate income tax fields. Interestingly, state governments are not prohibited by the constitution from collecting personal income taxes. Rather, they transferred this power to the commonwealth at the time of World War II in return for grants from the commonwealth.

Figure 3: Australian Revenues
(1999-2000)



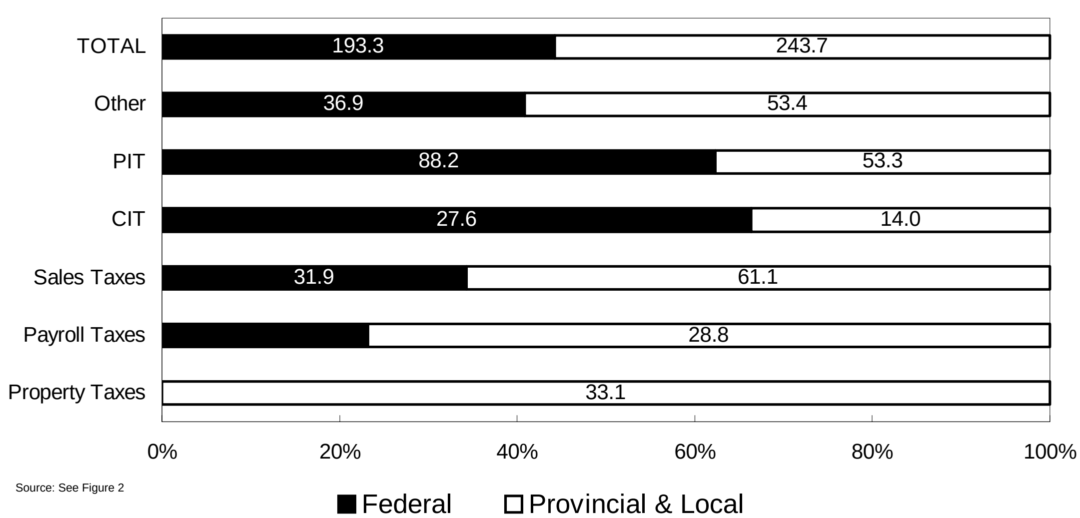
Source: See Figure 1

As part of the 2000 tax reform, the goods and services tax is collected by the commonwealth (for constitutional reasons) and then transferred to the states. State and local governments are sole occupants of the property-tax field and dominant in payroll taxes. Revenue from the sale of natural resources belongs to the states, except where the resources are on commonwealth lands or offshore.

b) Canada

While the Australian federation is highly centralized in revenue collection, the Canadian federation has one of the most decentralized revenue collection systems of any mature federation. Indeed, more than half (53 per cent; see Figure 4) of all revenues are collected by provincial and local governments. The federal government is dominant in the collection of both personal and corporate income taxes, while provincial and local governments are dominant in the fields of payroll and property taxes. The sales-tax base is shared between federal and provincial governments even though sales-tax systems and collection are not fully harmonized for seven of the ten provinces. Revenue from the sale of natural resources is included in the other revenue category and belongs to provincial governments if the resources are found on provincial lands, and the federal government if the resources are found on federal lands or offshore.

Figure 4: Canadian Revenues
(2000-01)



Source: See Figure 2

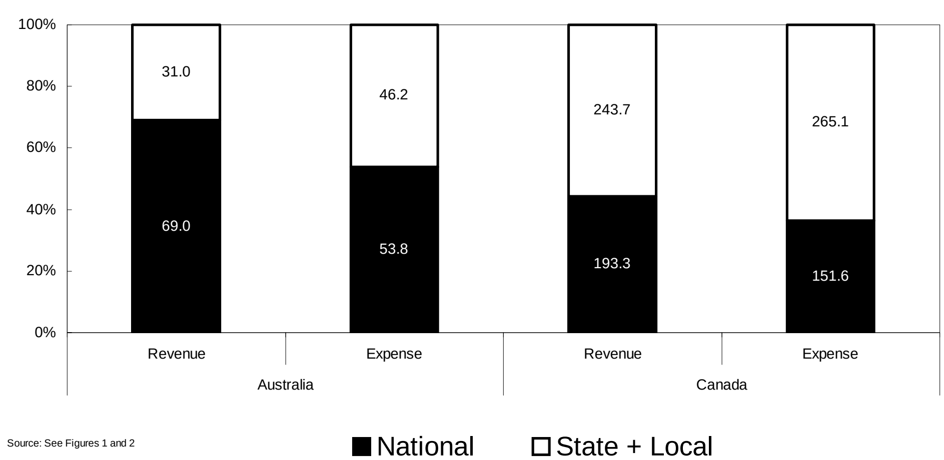
PART 4: DEALING WITH IMBALANCES BETWEEN NATIONAL AND PROVINCIAL GOVERNMENTS[4]

It is a fact of life in modern federations that the division of expenditure and revenue responsibilities is never such that both orders of government are fully self-financing. Indeed, there are many political and economic factors that must be considered in determining the actual division. When one order of government collects more revenue than it needs for its own expenditure responsibilities, a vertical imbalance is said to exist. Fiscal transfers from one order of government to another are used to deal with vertical imbalances. In some federations, specific transfers are designed to deal with both vertical imbalances and imbalances between provinces, i.e., horizontal imbalances.

a) Australia

As a result of the centralization of revenue responsibilities with commonwealth, Australia has a relatively large vertical imbalance (see Figure 5). Transfers to deal with vertical imbalances take two forms: conditional grants (called Specific Purpose Payments in Australia) that have specific conditions attached to how they can be spent, and unconditional grants (called Federal Assistance Grants). Total commonwealth transfers dealing with vertical imbalances were roughly equally split between conditional and unconditional grants. Since the tax reform of 2000, the unconditional grants have been replaced with an allocation to each state of a portion of the proceeds of the commonwealth-levied goods and services tax.

Figure 5: Vertical Fiscal Imbalance



b) Canada

Given the relative importance of revenue raising by provinces, vertical imbalances are much smaller in Canada than Australia (see Figure 5). The most important program dealing with vertical imbalances is the Canadian Health and Social Transfer (CHST), which is meant to contribute to the financing of health care, post-secondary education and social assistance programs. Although it is notionally targeted by the federal government, the program imposes few conditions on provinces and is often considered an unconditional grant program. The federal government also has a large number of smaller, conditional cost-share programs that deal with agriculture, transportation, housing and other issues. All require provincial participation and may or may not result in transfers rather than direct spending by the federal government.

PART 5: DEALING WITH IMBALANCES BETWEEN PROVINCIAL GOVERNMENTS

Imbalances between provincial governments may arise because of differences in revenue-raising capacity (fiscal capacity) or expenditure needs. These differences lead to horizontal imbalances. Transfer programs dealing with horizontal imbalances are an important part of many, but not all, mature federations. Australia and Canada are two federations that have well-developed "equalization" systems in place to deal with horizontal imbalances.

a) Australia

In Australia, the federation attempts to deal with differences among states that arise both because of differences in fiscal capacity and expenditure need. This is done by modifying allocations that each state receives from the proceeds of the GST relative to the amount of GST that is collected in each state. The Australian system of equalization is a "net" scheme, i.e., states' transfers are equalized both up and down to reach the desired amount of equalization.

The total size of the transfer to all states is limited by the size of the GST proceeds.[5] The division of the proceeds is determined by a complex (but well-defined) process of comparing forty-one expenditure and eighteen revenue categories in calculating the "relativity" of each state. This "pie-dividing" process is governed by a non-partisan body called the Commonwealth

Grants Commission, which ensures the accuracy and fairness of the process and reviews the methodology every five years.

b) Canada

Unlike Australia, the equalization program in Canada deals only with differences in provinces' revenue-raising capacity. This is done by comparing provinces' fiscal capacity in thirty-three revenue categories against a standard made up of five of Canada's ten provinces (the middle five in terms of revenue-raising capacity). Provinces that are below that standard fiscal capacity are given cash transfers from the federal government to raise their fiscal capacity up to the standard. Provinces that are above the standard do not receive equalization transfers. Thus, in contrast to the Australian system, the Canadian equalization scheme is a "gross" scheme – that is provinces below the standard are equalized up, but provinces above the standard do not have any corresponding reduction in transfers.

The distinction between gross and net equalization schemes has important implications for the fiscal "risk" faced by the national government. In a net scheme like Australia's, the size of the program is limited by the size of the proceeds of the GST and the equalization scheme is simply designed to divide the pie among the states. Canada's gross scheme determines both the size and division of the pie and is inherently more risky for the federal government. Specifically, if disparities between provinces grow, the size of federal equalization transfers also grows, increasing pressure on the federal treasury. In Australia's net scheme, increased equalization for one state is exactly offset by reduced equalization for another.

To deal with this risk, the Canadian federal government has put in place ad hoc measures to limit the growth of the program (the ceiling) and has moved from an all-province to a five-province standard, which has the effect of excluding the main energy-producing province. To offset revenue risks to the provinces, the program includes a floor provision that limits the amount that equalization transfers can drop in any one year.

Formally, the equalization program is the responsibility of the federal government and the program and its corresponding legislation is reviewed every five years. In the interim, officials from the federal government and the provinces meet on a regular basis to review the working of the program and to conduct ongoing research on possible modifications that may be discussed when federal and provincial ministers of finance meet.

PART 6: SUMMARY

The main findings of this brief essay are easily summarized. The division of spending and revenue responsibilities in mature federations are primarily determined by the federation's constitution and influenced by convention and the history of judicial interpretations. As Australia and Canada demonstrate, successful federations can operate with very different divisions of spending responsibilities and degrees of revenue centralization.

If revenue responsibilities are relatively centralized and spending responsibilities are not, significant vertical imbalances will exist. Imbalances between national and provincial governments as a whole are corrected with transfers that can take the form of conditional and unconditional grants. In Canada, where vertical imbalances are relatively small, such transfers (i.e., CHST) are generally unconditional. In Australia, where vertical imbalances are relatively large, such transfers are both conditional (i.e., Specific Purpose Payments) and unconditional (i.e., proceeds of the GST).

Horizontal imbalances, imbalances between provincial governments, are also an important issue in federations. Both Australia and Canada have well-developed schemes to address horizontal imbalances and such schemes are professionally administered and regularly reviewed. A key difference between the two schemes is the fact that Australia's is a net scheme while Canada's is a gross scheme. This difference has significant implications for the amount of "fiscal risk" faced by the national government. To deal with the extra risk inherent in a gross equalization scheme, the Canadian federal government has put in place a number of ad hoc features.

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1. Different federations use different names for national and regional governments. In this article I use the general term "provinces" to denote regional government.

2. A number of reference works were used in the development of this section. See Boadway (1999), Boothe (1996) and Commission on Fiscal Imbalance (2000).

3. See Watts (1999) for a discussion of the spending power in federations.

4. For a discussion of the Canadian transfer system, see Rosen et al. (1999), chap. 6. Serle (2002) gives an up-to-date account of the Australian system.

5. The 2000 tax reform also gave the states guarantees that transfers would not fall below specified levels.

IV. SUBNATIONAL GOVERNMENT BORROWING IN FEDERAL SYSTEMS: EVIDENCE FROM AGENTINA AND MEXICO

Stuart Landon

[From the book, *Fiscal Relations in Four Countries: Four Essays*, Paul Boothe, ed. Ottawa: Forum of Federations, 2003]

PART 1: INTRODUCTION

Subnational government borrowing has received relatively little attention in analyses of federal systems. This paper outlines the principal issues associated with subnational borrowing: the reasons a federation should be concerned with debt accumulation by its member governments, incentives for government borrowing that are specific to federations, and policies for the control of subnational government borrowing.

PART 2: THE EXTERNALITY EFFECT OF SUBNATIONAL BORROWING

Debt accumulation by one member of a federation has a negative externality if it imposes costs on the other members of the federation (such as a higher interest rate). Since the government generating the externality does not bear its cost, there is no incentive for it to take the externality into account when choosing how much to borrow. As a result, from the perspective of the federation as a whole, each federation government will borrow too much.

There are several reasons why the debt of one member of a federation can generate a negative externality for the other members of the federation.[1] Suppose lenders expect that the debt of each member of a federation is guaranteed, either implicitly or explicitly, by the other members of the federation. The creditworthiness of each member of the federation will then depend on the ability of the other members of the federation to act on this guarantee and this, in turn, will depend on the total quantity of federation debt. Thus, an increase in the debt of one member of the federation increases the liability of the federation as a whole and reduces the creditworthiness of all governments in the federation.

A central government that has guaranteed subnational debt, or does not wish to see a subnational government default, may attempt to reduce the real value of subnational debt, or meet its debt guarantee, through monetization (Beetsma and Uhlig 1999). Lenders will likely expect the probability of monetization to increase with the quantity of subnational debt. Thus, the greater the subnational debt, the larger the risk premium lenders will require on subnational government debt as protection against potential inflation. In this way, increases in the debt of one region raise the interest costs of all regions. Furthermore, if the central government monetizes the debt of one region, the real costs of the inflation caused by this monetization will extend to all regions. Similarly, if the central government assumes the debt obligations of a subnational government, the debt of the defaulting region is shifted onto the central government and, thus, the taxpayers of the federation as a whole.[2]

Since the liabilities of the member governments of a federation are often denominated in the same currency and have similar risk characteristics, lenders may view the debt of these governments as highly substitutable. As a result, individual federation governments will face an increasing supply of funds schedule that depends on the debt of the federation as a whole. Borrowing by one member government, by increasing the supply of federation debt, will increase the interest rate faced by all governments. This effect may be larger if government borrowing is uncoordinated, resulting in large quantities of debt coming on the market at the same time.

Debt repayment difficulties in one region of a federation may disrupt lending to other regions if lenders perceive problems in one region to be a signal that problems are more likely in other regions. In addition, default by one region, by threatening the solvency of the financial system, may impose real costs on all regions of a federation.

As the regions of federations are generally linked by interregional trade, changes to borrowing levels in one region can have inflation and real-output effects in other regions, particularly if the region making the changes is a large member of the federation. Furthermore, debt accumulation by the individual regions of a federation, particularly larger regions, can influence central government stabilization policy. For example, regional government borrowing, by expanding demand, can put upward pressure on prices and induce contractionary central government demand policies. The costs of these policies, although induced by one region, are imposed on all regions.

Box 1: Debt financed subnational unit spending
Debt financed expansionary policies in the province of Ontario may have induced a more restrictive demand policy on the part of the Canadian federal government during the late 1980s and early 1990s (Shah 1998). In Nigeria, because of the absence of limits on domestic borrowing by the states, central government stabilization policy has had to counter the stimulus of debt financed state spending (International Monetary Fund 2001b).

Discussions of debt accumulation in federal systems generally concentrate on subnational borrowing. However, central government debt accumulation can also generate large negative externalities. A central government that is more heavily in debt is less able to bail out subnational governments, even if it has committed to do so. Furthermore, as the central government debt accumulates, the need for funds to finance the associated debt-service payments may cause the central government to cut transfers to subnational governments. A central government that is heavily in debt is also less able to stabilize regional incomes. In addition, since the central government generally controls the monetary authority, central government debt accumulation raises the risk of debt monetization. Finally, subnational and central governments essentially share the same tax base from which to meet their debt-service commitments. All these factors are likely to cause lenders to demand a higher risk premium when lending to subnational governments, as the central government effectively increases the size of its debt.[3]

PART 3: INCENTIVES FOR SUBNATIONAL BORROWING IN FEDERATIONS

Some characteristics of federations can distort government borrowing decisions and encourage excessive borrowing. For example, bailout policies encourage subnational government borrowing by inducing lenders to require a smaller risk premium than in the absence of a guarantee. Debt guarantees and periodic bailouts may also encourage lenders to finance the unsustainable deficits of subnational governments, as in, for example, Brazil (International Monetary Fund 2001a).

The financial systems of some federations are characterized by close relations between subnational governments and financial institutions, some of which are owned by subnational governments. In several cases, this close relationship facilitates unsustainable borrowing by subnational governments that threatens the solvency of the lending institutions, and necessitates central bank intervention to protect the stability of the financial system.

Box 2: Central banks forced to assume subnational debts
In Brazil, for example, the state governments borrowed heavily from the major commercial banks that they owned. They subsequently defaulted, pushing the banks into insolvency and forcing the central bank to assume the debts of the banks in order to avoid the financial crisis that would have resulted had the banks defaulted (Wildasin 1997).

According to Ter-Minassian and Craig (1997), the growth of subnational debt has frequently been the result of the inappropriate design of federal fiscal arrangements. In particular, central governments have often transferred rigid spending responsibilities to the regions without also transferring sufficient revenue.[4] In some cases, this imbalance has precipitated structural deficits and large, unsustainable borrowing.

Aspects of intergovernmental transfer systems may also encourage subnational government borrowing. Ter-Minassian and Craig (1997) suggest that the growth of subnational debt is frequently the result of an ad hoc transfer system that appears to respond to the ex post financial needs of subnational governments. These types of transfers, by rewarding indebted governments, provide an incentive for debt accumulation and effectively penalize prudent governments. Unanticipated cuts in transfer payments may also lead to increases in subnational government debt since it is often difficult for subnational governments to immediately cut spending in response to a fall in transfers. Future transfer payments, and the proceeds from revenue sharing, can also be pledged as collateral for loans. This can allow subnational governments, as in Argentina and Mexico, to sustain large current borrowing programs.

Box 3: Federal transfers to indebted subnational governments

For example, Germany used federal grants to reduce the debt burdens of some highly indebted lander*, while in Italy at the end of the 1970s, the central government assumed responsibility for the debts of municipalities. In the 1980s in Argentina, the central government made discretionary transfers to some provinces, largely for political reasons, in order to finance subnational government deficits (Schwartz and Liuksila 1997). Discretionary transfers have also been used in, for example, Russia, Brazil and China.*

Central governments often do not consider the effect of their macroeconomic policies on subnational government finances, even though these policies can have a large impact on subnational budgets by altering output and real interest rates. Real interest rate increases, as a result of central government anti-inflationary policies, were a major factor contributing to the default of several Brazilian states in the mid-1990s (Dillinger and Webb 1999).

A variety of other policies have encouraged subnational borrowing in different federations. In the United States, the federal government subsidizes (and so encourages) state and local borrowing by exempting the interest on state and local bonds from federal income tax. In India, the central government has lent to the states at below-market rates and, thus, provided an incentive for debt accumulation (Wildasin 1998). In Argentina, provinces were allowed to borrow from provincial banks that would then rediscount the loans to the central bank, effectively giving the provinces access to seignorage (Dillinger and Webb 1999). Central governments have also established forced savings programs from which subnational governments can often borrow at reduced rates.

PART 4: MECHANISMS TO CONTROL SUBNATIONAL BORROWING

Ter-Minassian and Craig (1997) group the methods used to control subnational government borrowing into four broad categories: market discipline, co-operation, rules-based controls and administrative control by the central government.

a) Market discipline

Market discipline uses the free functioning of the market for subnational government debt to constrain subnational government borrowing. As a government increases its debt, the market perceives the risk of default to have risen and, thus, demands an interest rate that is higher than that charged more prudent borrowers. This interest rate increase provides governments with an incentive to limit debt accumulation.[5] Even if they do not, lenders will eventually refuse further lending as the risk of default rises too high. Thus, the natural operation of the market prevents unsustainable borrowing.

Several key prerequisites are required for market discipline to constrain borrowing (Lane 1993). First, information on the outstanding debt and repayment capacities of subnational governments must be available to lenders. This information is frequently unavailable in developing countries, and, in both developed and developing countries, governments have been adept at disguising the true level of their liabilities.[6] The undeveloped nature of the subnational government debt market in many countries means that observable yields on tradable debt and credit ratings, necessary signals for market discipline to be effective, are also unavailable.

Second, if interest rates are to reflect the risk of lending to subnational governments, capital markets should operate freely and regulations should not encourage lending to subnational governments.[7] In addition, subnational governments should generally be prevented from borrowing from the central bank or government-owned banks as these institutions often do not make market-based lending decisions. Third, there must be sufficient competition in financial markets to ensure that lenders make prudent decisions. Fourth, the financial system must be able to survive the failure of a major lender or borrower (Bayoumi et al. 1995). Finally, governments must respond to market signals, which they may not do if they have a short time-horizon or if political accountability is weak. In addition to the conditions cited above, market discipline requires, most importantly, a credible no-bailout policy so lenders have an incentive to impose discipline on subnational borrowers.[8] Credibility may, however, be difficult to establish if lenders and borrowers believe that the central government would not allow a subnational government to default, particularly the government of a large region.[9] If the no-bailout rule is not credible, lenders will be less prudent and market discipline less effective.

In addition to its stringent prerequisites, market discipline does not impose the cost of the externality associated with borrowing on the borrower and, therefore, does not yield the optimal level of debt, just a sustainable level (Lane 1993). Furthermore, as the Canadian case indicates, market discipline does not stop governments from amassing large quantities of debt (Canadian provincial debt was just under 25 per cent of GDP in the mid-1990s, a high level relative to countries with more direct controls on borrowing).

b) Co-operation

Under co-operation, the governments of a federation jointly decide on the level of borrowing that each member government will undertake. In some cases, in order to ensure that the agreement is maintained, all borrowing is carried out by the central government and the proceeds forwarded to the subnational authorities.[10] The benefits of the co-operative approach are that the timing of debt issues can be co-ordinated, and debt externalities and the macro consequences of borrowing decisions can be taken into account when determining subnational borrowing levels.

The success of co-operation depends on the willingness of governments to co-operate. If agreement is not reached, either the system will break down or the central government (or a large region) may impose an agreement (effectively centralizing the decision process). A further problem is that short-sighted governments may jointly agree to unsustainable increases in debt. Even if co-operation yields agreement on prudent levels of borrowing, as with all rules, governments can often use creative means, particularly off-budget accounting, to evade the agreed limit. The Australian states were so successful at avoiding the limits imposed on them that several experienced severe debt crises in the early 1990s.

c) Rules-based controls

Two types of rules-based controls, embedded in the constitutions or laws of national or subnational governments, have been used to control government borrowing. The first type of rule imposes a limit on the overall debt-GDP, deficit-GDP or debt service ratio. The second type of rule involves prohibitions on borrowing of certain types. These include subnational borrowing from abroad (as in India and Nigeria) or in foreign currency (as in Mexico), from the central bank (as in the European Monetary Union – EMU) or from state-owned banks (as in Brazil), or to cover current expenditures. While some rules specify procedures for dealing with violations, quite often requiring repayment in a year, only the EMU appears to have a mechanism that can fine member states, under certain circumstances, if they exceed the borrowing limit. The most successful rules are transparent and include a comprehensive and clear definition of debt, require adequate reporting of liabilities and impose strict limitations on the use of off-budget debt.

There are several advantages to rules-based controls. They avoid bargaining between governments and, if properly designed, can impose fiscal discipline. Since the verification of rules requires proper debt accounting, the fiscal position of governments is clear to both voters and the market. This may restrain demands for more services and promote market discipline.[11]

Rules-based borrowing controls are, however, beset by numerous difficulties. There are no well-defined criteria that can be used to determine the optimal borrowing limit. Rules may also induce governments to maintain large reserve accounts, a practice that may be less efficient than periodic borrowing to cover revenue shortfalls. Rules may constrain the ability of governments to smooth consumption and may encourage pro-cyclical behaviour on the part of subnational governments. The inflexibility of many subnational government spending commitments may cause cuts to be made on the basis of flexibility rather than efficiency. In addition, cash flow problems associated with stringent borrowing restrictions can disrupt government operations. Rules that restrict borrowing to investment finance require a precise definition of investment and may divert funds toward projects that have a lower return than current spending. If subnational governments provide transfers to local governments, rules that limit subnational borrowing can lead to cuts in local transfers, effectively shifting any revenue imbalance to the local level. If the rule is not comprehensive, it will be ineffective at controlling debt accumulation and may induce governments to borrow through more expensive channels. Finally, governments have been extremely adept at finding ways to circumvent most rules.

Box 4: Rules for controlling borrowing
Methods used include arrears to suppliers, borrowing from state-owned financial intermediaries or through government corporations, loan guarantees to private firms, bank loans to pseudo-government agencies that supply services to the government, contracting out of public investment and sale and lease-back arrangements. Note that New York City defaulted in the 1970s, despite having a constitutional balanced-budget rule (Lane 1993).

d) Administrative control by the central government

In some countries, the constitution gives the central government the power to control subnational government borrowing. The types of controls used are similar to the rules-based controls cited above. The principal differences are that central government administrative controls are often subject to change (either as a result of political pressure or to support central government macroeconomic policy[12]), the central government may require prior approval of all subnational government borrowing, or the central government may undertake all borrowing itself and then distribute the borrowed funds to subnational governments for purposes approved by the centre. Rather than being an objective constraint, central government controls may vary in response to need, ability to pay or political factors. Successful administrative controls operate quickly, are transparent, easy to understand and monitor, are not arbitrary and facilitate planning.

The advantages of centralized control are that it allows the externality associated with borrowing to be taken into account, it can co-ordinate borrowing and it can integrate subnational borrowing into national macroeconomic policy. As foreign lenders often require an explicit guarantee of subnational government debt by the central government, direct control lets the central government determine the debt for which it is ultimately responsible.

Most of the problems associated with rules-based controls also apply to administrative controls, although there are additional problems that are specific to these controls. The principal disadvantage of central government control is that it limits the decision-making power of subnational governments. This negates one of the important benefits of decentralization and, potentially, can retard the development of responsible subnational government. Furthermore, pre-approval of borrowing and centralized intermediation involves the central government in monitoring micro-level regional decisions. This is expensive, can lead to delays and is beyond the capabilities of many developing countries. Administrative control of borrowing is often not transparent or predictable and can make regional government planning uncertain and costly. Administrative controls may also be determined more by political than economic considerations. Furthermore, borrowing limits that are not embedded in strict laws can be perceived by subnational governments as being negotiable, causing them to act as if the limit is not binding.[13] Finally, by involving the central government directly in the subnational government borrowing process, administrative controls may be taken by lenders to be an implicit guarantee of subnational debt (Shah 1998).

PART 5: BEST PRACTICES

The available evidence indicates that subnational government debt accumulation can generate externalities, that specific characteristics of federations may encourage excessive borrowing and that there are significant shortcomings with the mechanisms typically used to control subnational borrowing. There do, however, appear to be some policies that can reduce the likelihood of excessive borrowing.

Since market discipline does not take account of debt externalities and, in most countries, the prerequisites for market discipline do not hold, some form of borrowing rule is required to limit subnational borrowing. As both the co-operative approach and administrative control by the central government are characterized by problems that make them unworkable or undesirable in most countries, a strict rules-based approach to subnational government debt control is likely to be most effective.

To be successful, any rule should incorporate a comprehensive and clear definition of debt and outline the required response (and penalty) if a subnational government fails to satisfy the rule. In order to increase the likelihood of success, as well as reduce the likelihood of inflation and instil market discipline, the rule should prohibit subnational government borrowing from the central bank or state-owned banks.[14] In many developing countries, this will require the simultaneous introduction of policies to develop a market for subnational government debt.

While it is less likely that subnational governments will default if their borrowing is limited by a debt accumulation rule, the central government should, nevertheless, introduce an explicit no-bailout policy. It may take time for this policy to become credible and governments may not be able to avoid a bailout in all circumstances. However, the central government should ensure that a bailout comes with significant costs for the defaulting regional government and, as a condition for bailout, should specify policies that will alleviate the factors that caused the default.

The intergovernmental transfer system should be modified to prevent large variations in transfers and eliminate discretionary transfers. The central government should also consider the impact of its macroeconomic policy on subnational government balance sheets and modify other policies that may subsidize or encourage subnational borrowing.[15]

In many developing countries, subnational governments have shortages of workers skilled in public expenditure and revenue management, and a major cause of unsustainable borrowing has been poor financial management, as in Brazil (Ter-Minassian 1997).

Improvements in financial management are, therefore, an important ingredient in the control of subnational borrowing.

Control of subnational borrowing, by a rule or any other means, is impossible if, as in many developing countries, information on subnational government finances is unavailable, out of date or of poor quality. Thus, it is imperative to improve access to this information. Adequate reporting of government liabilities would also support market discipline and improve government accountability. The problem of excessive subnational government borrowing, in many developing economies, may be more a problem of weak political institutions and accountability than a characteristic of the federal system. Improvements in accountability depend critically on the availability of information on government finances.

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1. See Ter-Minassian and Craig (1997) and Landon and Smith (2000) for further discussion.

2. As when the Brazilian government bailed out the state of Minas Gerais in 1999 (Giugale et al. 2000).

3. There is only a small empirical literature that attempts to verify the existence of debt externalities in federations. While Capeci (1991) finds no evidence of debt externalities using US municipal data, Landon and Smith (2000) find negative, but small, spillover effects between the Canadian provinces, except for borrowing by the largest province. Landon and Smith (2000) also find evidence that the growth of Canadian federal government debt had a strong negative effect on the creditworthiness of the provinces.

4. This was one problem afflicting the states in Brazil (International Monetary Fund 2001a).

5. While considerable evidence indicates that interest rates depend on debt levels (Bayoumi et al. 1995), Lane (1993) suggests that there is no strong evidence that governments reduce borrowing

in response to higher interest rates. However, studies of the US state and municipal bond market have found that the supply of bonds is quite interest-sensitive (Capeci 1994, Metcalf 1993).

6. While states in Nigeria can borrow without limit from domestic bank and non-bank sources, there is no reliable comprehensive data on the debt levels of the Nigerian states (International Monetary Fund 2001b).

7. These would include regulations that require financial intermediaries to hold a certain portion of their assets in government bonds or forced-savings programs that are required to invest in government assets.

8. In Argentina, previous bailouts gave lenders the impression that the provinces could not fail (Shah 1998). Similar impressions were left by central government bailouts in Brazil. In Mexico, states and banks had come to expect federal bailouts, as there had been many of these, and states perceived these bailouts as a way of extracting funds from the central government (Giugale et al. 2000).

9. The size of the Sau Paulo state debt made the Brazilian government unwilling to let it default, as default would have threatened the stability of the entire banking system (Dillinger and Webb 1999). Giugale et al. (2000) suggest that the externalities associated with default, the impact on the credit ratings of all governments in the federation and the risk to the financial system, make bailout inevitable in many cases.

10. Australia is the most frequently cited example of a country that used this approach. See Craig (1997) for details.

11. Poterba (1994) provides empirical evidence that US states with tighter constitutional or statutory rules adjust their spending more quickly to revenue shocks than do other states.

12. In federations, borrowing limits can be a major instrument of macroeconomic management (Potter 1997).

13. In China, the central bank imposes credit limits on the provinces at the beginning of the year, but these are often revised upward during the year under pressure from the local authorities (Shah 1998).

14. Brazil did this by passing a law that prevented the states from borrowing from their own banks.

15. Several of these policies have been introduced in Mexico (Giugale et al. 2000). The Mexican government imposed a no-bailout rule, renounced the use of discretionary transfers and linked the capital risk rating of banks to their subnational debt exposure and the credit ratings of the subnational governments.

IV. FISCAL MANAGEMENT AND STABILIZATION POLICY IN FEDERAL SYSTEMS: THE EXPERIENCE OF ARGENTINA AND MEXICO

Bradford G. Reid

[From the book, *Fiscal Relations in Four Countries: Four Essays*, Paul Boothe, ed. Ottawa: Forum of Federations, 2003]

PART 1: FISCAL MANAGEMENT

Prudent fiscal management requires a clear delineation between the long-run and short-run behaviour of the government's budget position. The long-run objective of the fiscal authority should be to achieve a sustainable fiscal position in which its budget is balanced. This requires a matching of expenditure responsibility with adequate revenue resources so that the "structural" budget position is one of balance. Long-run balanced budgets allow a separation of the fiscal authority from the monetary authority and give the monetary authority the necessary autonomy to pursue long-run price stabilization as its policy objective. Balanced budgets reduce or eliminate fiscal authority reliance on the inflation tax as a revenue source, and this in turn provides the monetary authority with the needed commitment and credibility to achieve an environment of long-run price stability.

If government revenues and/or expenditures are sensitive to cyclical fluctuations in economic activity then the budget position of the fiscal authority should respond to these fluctuations in the short run. Surplus budget positions should occur in business cycle upturns and deficit budget positions should occur in business cycle downturns. These short-run cyclical movements in the fiscal authority's budget are optimal both from the perspective of traditional Keynesian aggregate demand management models and from the perspective of minimizing dead-weight losses through expenditure and tax rate smoothing (Barro 1979).

Optimal fiscal management is thus composed of budgets that are structurally balanced in the long run but are also cyclically sensitive to short-run economic conditions. This requires an ability to borrow to finance fiscal deficits during business cycle downturns and a willingness to save fiscal surpluses during business cycle upturns. Achieving optimal short-run fiscal management objectives, in particular sustaining the ability to borrow during cyclical downturns, is ultimately contingent on achieving structural budget balance in the long-run. If the fiscal authority's budget is one of structural deficit then long-run borrowing and debt accumulation will occur. The market will eventually become reluctant to absorb additional debt, which will force the fiscal authority to abandon its structural deficit policy. However, this market-imposed borrowing constraint will also limit the fiscal authority's ability to finance cyclically occurring deficits and curtail its ability to follow an optimal short-run fiscal management policy. Gavin and Perotti (1997) have found that Latin American fiscal outcomes, in contrast to the fiscal outcomes of industrial economies, have been too "pro-cyclical" and that the lack of counter-cyclical response has been due, at least in part, to the existence of market-imposed borrowing constraints.

Fiscal management becomes a more complicated issue in federal systems of government where there is likely to be a substantial amount of interdependence between the national and subnational governments. This interdependence arises from shared revenue sources, from shared expenditure responsibilities and from intergovernmental transfers among different levels of government. Dillinger and Webb (1999) argue that the sustainability of both national and subnational government fiscal management practices in a federal system depends upon the existence of: (1) revenue autonomy and expenditure autonomy between different levels of government, and (2) market-imposed borrowing constraints, particularly on subnational government debt issue.

The amount of revenue and expenditure autonomy within a federal system will determine the amount of control that the various levels of government exert over their own budget positions. Unsustainable public sector budgets are less likely to occur when each level of government is allocated its own revenue sources with which to finance its own expenditures, and when these revenue sources are sufficient to meet the expenditure responsibility. With appropriate autonomy, each level of government can match the benefit stream associated with expenditures to the cost of funds required to finance that benefit stream.

Dillinger and Webb also argue that independence among different levels of government with respect to their borrowing decisions is an important element in achieving fiscal management sustainability in federal systems. Sustainable fiscal positions are more likely to occur when the national government does not bail out subnational governments and forces subnational governments to service their own debts. Without national government bailouts, creditors will be forced to accept any losses caused by the failure of subnational governments to service their debts and market discipline will be imposed on subnational debt issue.

PART 2: FISCAL MANAGEMENT CASE STUDIES

a) Argentina

Since the mid-1970s, Argentina has been characterized by a significant amount of decentralization of expenditure responsibility from the national government to provincial and local governments. Revenue-raising power has remained concentrated at the national level so that there is considerable reliance by provincial and local governments on transfers from the central government to finance subnational government expenditures. A clear imbalance exists between expenditures at the provincial and local government levels and the availability of own-source revenues at those levels.

Constitutional expenditure assignment provides the central government with exclusive responsibility for defence, foreign affairs, international trade, the regulation of interstate trade, monetary policy, immigration policy and the provision of unemployment insurance. Responsibility is shared between the federal and provincial governments in the areas of social welfare, police and highways and between the federal, provincial and local governments in the areas of health and education.

The Argentine constitution also assigns tax sources to the federal and provincial governments but, in practice, the provinces have delegated much of their responsibility for the legislation, administration and collection of their tax sources to the federal government. This delegation of taxing authority has been accompanied by the creation of a system of transfers from the national government to the provinces. There are three basic transfer mechanisms: (1) co-participation transfers that provide automatic, non-discretionary transfers to the provinces from income taxes, excise taxes and the value-added tax; (2) other automatic transfers that provide a sharing of revenue collected from the fuel tax, energy tax and wage tax; and (3) discretionary transfers. The co-participation transfers account for about two-thirds of all transfers from the federal government to the provincial governments.

While provincial dependence on transfers from the federal government is large, this in itself has not weakened provincial power relative to the federal government as much of the transferred amount is mandated and not at the discretion of the federal government. However, the federal government ultimately determines the total pool of funds available for transfer by setting the tax rates on those tax sources mandated for revenue sharing. The decentralization of expenditure responsibility with continued centralized revenue collection has created severe vertical imbalances between the national and subnational levels of government. Many of the provincial governments have encountered continuing fiscal management difficulties, giving rise to long-run structural deficits in their budget positions.

In Argentina all levels of government are allowed to borrow both domestically and internationally. Considerable amounts of subnational borrowing have occurred as the provinces have at times not been able to control the relationship between their expenditures and revenues. During the 1980s provincial borrowing was financed largely from two sources: central government loans to the provinces and loans from provincial government-owned banks to the provincial governments. The first of these lending relationships created a relationship between national and subnational fiscal positions and the second created a relationship between subnational fiscal positions and national monetary policy. Both of these relationships allowed provincial governments to avoid market-imposed discipline on their borrowing activities and encouraged subnational structural budget deficits.

Lending from banks owned by provincial governments to those provincial governments led to a monetary policy linkage as these loans were rediscounted by the central bank of Argentina prior to 1991. Thus provincial government debt issue influenced the rate of monetary expansion and the rediscounting gave provincial governments access to a share of national seignorage and inflation tax revenue. This in turn reduced the ability of the central bank to control the money supply and the rate of price inflation. In 1991 this linkage was ended by the convertibility law, which prohibited central bank rediscounting of provincial bank loans.

b) Brazil

The democratization process that occurred in Brazil during the 1980s was also accompanied by a process of decentralization in its federal system of government. In particular, decentralization on the revenue side has resulted in a greater degree of control over revenue sources by state and local governments than previously existed.

The 1988 constitution assigns relatively few expenditure responsibilities exclusively to particular levels of government. Most expenditure functions are shared responsibilities. With respect to actual spending, the federal government allocates most of its program spending to social security and social assistance. State program spending occurs primarily in the areas of education, social assistance and health. More exclusivity is found in the assignment of revenue sources. The national government collects its revenue from the personal and corporate income taxes, a selective value-added tax, payroll taxes associated with social security provision and taxes on foreign trade. The constitution assigns to the state governments revenue from a broad-based value-added tax, motor vehicle taxes and estate taxes. In recent years, growth has been stronger in those revenue sources assigned to the state governments.

The degree of revenue decentralization is understated by the constitutional assignment of revenue sources between levels of government in Brazil. There is an extensive array of intergovernmental grants from the national government to subnational governments. Among these grants are mandated transfers from the federal government to the states that result in the sharing of federal VAT revenue and federal income tax revenue. While the proportion of sharing is mandated, the federal government controls the pool of funds available for sharing by setting the rates of taxation on the shared tax bases. In recent years there has been a movement by the federal government away from raising funds using shared tax sources and toward raising funds from non-shared sources (like payroll taxes). This has created some concern about too heavy a reliance on taxes, like the payroll tax, that are more distortionary than other taxes.

The substantial decentralization of revenue to the state governments contained in the constitution of 1988 led to initial concern that this could create significant fiscal management problems for the federal government. In fact, the state governments have experienced the most difficulty in achieving long-run sustainability in their budget positions. With no clear boundary between federal and state expenditure responsibility, the federal government was able to adjust to the process of revenue decentralization through a combination of ad hoc expenditure off-loading to the state governments and a reduction in discretionary transfers to the states. This downloaded a structural deficit problem to the state level, which has not been successfully addressed by the state governments.

The state-level structural deficit problem has been exacerbated by an environment in which states have not faced an appropriate amount of market discipline in their borrowing to finance these deficits. States have been allowed to own commercial banks and to borrow from these banks. The federal government and the central bank have demonstrated a willingness to provide bailouts to these commercial banks in the event of default, so that state borrowing has been able to occur in a relatively unconstrained fashion.

c) Mexico

The Mexican federation is characterized by a relatively high degree of expenditure centralization combined with limited revenue-raising powers assigned to the state and municipal governments. The only sources of own-revenue for the state and local levels of government are property taxes, fees and user charges, with all other revenue sources assigned to the national government. The constitution mandates that state governments share in the revenues collected from specific tax sources but the size of that revenue sharing is determined by the federal government. Lower levels of government in Mexico rely heavily on this revenue sharing with the federal government to finance their expenditures. State and local governments have the authority to borrow in domestic capital markets. The ability to borrow internationally is limited to the central government.

During the 1990s state and local governments experienced problems with structural deficits. State governments have frequently borrowed in the domestic capital markets and have often "guaranteed" these loans by pledging future expected flows from revenue sharing with the federal government as collateral to the lending banks. This practice has generated concern at the federal level about the need for central government bailouts in the event that states become unable or unwilling to service their debts, both from the perspective of maintaining stability of the domestic banking system and from the perspective of maintaining the flow of public services.

PART 3: STABILIZATION POLICY

The traditional view of the public finance literature was that responsibility for the conduct of stabilization policy should be assigned to the national level of government. Clearly, if the federation is to be a monetary union, monetary policy must be conducted at a centralized level. However, fiscal policy could be conducted under either centralized or decentralized decision-making in a federation composed of higher and lower levels of government.

Several arguments have been advanced in favour of centralized fiscal policy for stabilization purposes. First, it has been argued that the primary sources of short-run cyclical fluctuations are shocks common to all regions of a country, rather than region-specific shocks, so that a national fiscal policy response is the appropriate policy tool. Second, when regional economies are more open than the national economy, regionally implemented fiscal policy will be subject to a higher leakage effect. This will reduce the incentive for lower levels of government to engage in counter-cyclical policies and increase the incentive to free-ride on the fiscal policies of others in the federation, ultimately resulting in a suboptimal amount of stabilization. Third, stabilization policy may be more expensive to conduct in a decentralization environment if the debt issued by lower levels of government is viewed by capital markets as being riskier than that issued by the national government. Finally, the co-ordination of policy may be easier to achieve when that policy originates from the national government rather than when that policy originates from several decentralized government units.

In contrast to the traditional view, it has more recently been argued that decentralized fiscal policy may be optimal. When the regions of a country are highly specialized in production and trade, the impact of relative price movements will fall differently on each of the regions. In this environment, regionally based shocks that have asymmetric effects across the regions will often dominate common nationally based shocks as a source of short-run business cycle fluctuations. The optimal policy response to these types of fluctuations is a regional response, allowing the decentralized policy to dominate centralized policy. Also, when regions are different in economic structure, the spillover and leakage effects among the regions will be smaller. The incentive effects for free-riding in the conduct of stabilization policy at the lower levels of government are then reduced.

While it is possible to debate the issue of whether to centralize or decentralize responsibility for stabilization policy from a theoretical perspective, in most federations that responsibility is shared. With shared expenditure responsibilities, shared revenue sources and the ability to issue debt, both higher and lower levels of government typically have the capacity to direct fiscal instruments to the conduct of stabilization policy. Thus, in most federations the issue of policy co-ordination is more important than that of policy assignment. The policy co-ordination problem arises most strongly in federations where there is a high degree of interdependence between the national and subnational levels of government. When there is not a clear delineation and exclusivity of responsibility, the policy initiatives of one government level will spill over onto the budget positions of other government levels. This spillover effect could potentially offset or undo the impact of the original policy initiative. For example, in Argentina, Brazil and Mexico there exists mandated revenue sharing from the national to lower levels of government. Should any of these countries' national governments decide that it is appropriate to increase tax rates on shared-revenue tax bases in order to dampen aggregate demand for stabilization purposes, lower levels of government will experience a revenue "windfall" through the revenue-sharing process. If the lower levels of government decide to simply spend these additional revenues, the restrictiveness of the national government's policy initiative will be reduced. Co-ordination of the policy between the national and lower levels of government may be required to ensure that it conveys the desired impact on the economy.

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PROCESSES FOR ADJUSTING FEDERAL FINANCIAL RELATIONS: EXAMPLES FROM AUSTRALIA AND CANADA

R. L. Watts

[From the book, *Fiscal Relations in Four Countries: Four Essays*, Paul Boothe, ed. Ottawa: Forum of Federations, 2003]

PART 1: THE CONTEXT AND ISSUES

a) The importance of processes for adjusting federal financial relations

The allocation of financial resources to each order of government within a federation is a fundamental feature for its effective operation. It is the allocation of these sources that enable or constrain governments in the exercise of their constitutionally assigned legislative and executive responsibilities. Furthermore, taxing powers and expenditure are themselves essential instruments affecting the ability of the various governments within a federation to influence and regulate the economy.

But the issue is not simply one of constitutionally defining taxing and expenditure powers and intergovernmental transfers. Because the values of different revenue sources and the costs of different expenditure responsibilities inevitably change over time, no constitutional financial allocations can be expected to remain permanent. Consequently, all federations have found it necessary to establish processes and institutions for adjusting from time to time the intergovernmental financial relations. Among the elements requiring regular adjustment have been the vertical imbalances arising from changes in the revenue and expenditure requirements of each order of government, horizontal imbalances in the revenue capacities and expenditure needs among the different constituent units arising from different paces of development, the consequent need to adjust intergovernmental transfers in order to respond to these changing imbalances, and the need to adjust arrangements for tax co-ordination in the light of changing conditions.

As a result, a major feature of intergovernmental financial arrangements in *all* federations has been the regular process of negotiation and bargaining between governments about these adjustments. In these continuing processes, federal-provincial (state) conflicts, conflicts between rich and poor provinces (states), conflicts between different interests in different provinces (states), and conflicts between political parties have all had to be accommodated.

b) The significance of context

While the need for processes facilitating regular adjustment to correct vertical imbalances in revenues and expenditures, horizontal imbalances, transfer arrangements and tax co-ordination is common to all federations, differing contexts affect the particular form that the processes of adjustment may take in a particular federation.

The adjustment of federal financial relations cannot, therefore, be considered purely analytically and technically in isolation from the particular social, political and constitutional context within which they occur. The processes and dynamics for adjusting federal financial relations are affected by the degree and kinds of social fragmentation and diversity and the particular form of the political institutions with which they interact: for instance, the degree and kinds of social diversity (linguistic, ethnic, religious, cultural and historical), how this diversity is territorially distributed, and whether this diversity is cumulatively reinforced or cross-cutting will have a significant influence.

The kinds of federal political and constitutional arrangements varies significantly among federations. The variables include the degree of legislative and administrative centralization and decentralization, the actual original constitutional allocation of taxing powers, expenditure responsibilities and provision for financial transfers, the extent to which there are areas of concurrent jurisdiction or constitutional requirements for administration of federal legislation by state governments, the extent to which financial arrangements for local government are embodied in the constitution or simply left to the discretion of provincial (state) governments, the extent of intergovernmental collaboration, interaction and autonomy, and the degree to which government of constituent units participate in or influence federal government policy-making. These factors affect intergovernmental financial arrangements and the processes for their adjustment.

The dynamics of the intergovernmental bargaining related to the adjustment of financial relations are also affected by the extent to which governments at each level are characterized by the separation of executive and legislative powers, such as in the presidential and congressional systems in the United States and the Latin American federations, and in the Swiss collegial executive systems, or by fused parliamentary executives as in many of the Commonwealth and European federations. In parliamentary federations, the common tendency to predominance of executives in their legislatures has meant that the primary arena for negotiating adjustments to the financial arrangements has been through the processes of "executive federalism," focusing upon the executives representing the federal and provincial (state) units of governments.

Different combinations of interacting factors tend to require their own distinctive processes for adjusting intergovernmental financial relations. Technical financial solutions that do not take account of how they interact with the social, economic, political and constitutional context have therefore, in practice, tended to be counter-productive.

c) Issues arising in processes of intergovernmental financial bargaining

In the processes for adjustment of intergovernmental financial relations a number of issues commonly arise. One is reconciling the need for flexibility to adapt to changing conditions with the need to provide stable arrangements enabling governments to plan ahead. Another is the impact that changing financial arrangements may have upon the degree of centralization and decentralization with the federation. Also, there is the issue of the impact of changes increasing or decreasing the autonomy or dependency of one level of government upon the other. Yet another issue is the extent to which adjustments are reached collaboratively by the different orders of government working together, or unilaterally by different governments.

One particular issue arising in federations has been the extent to which the spending power of each order of government has been limited to its constitutionally specified legislative and executive jurisdiction or has, in the interests of flexibility, been broadly unrestricted. In most federations, governments have been understood to possess a *general* spending power, either as a result of judicial review and convention in the older federations or explicitly in the constitutions of many of the new federations (Watts 1999b). This has enabled federal governments to use this general spending power to pursue their own objectives in the areas of state or local jurisdiction by providing conditional cash transfers or matching grants to induce state or local governments to provide services or meet standards they could not otherwise afford. While widely used in many federations to facilitate flexibility and intergovernmental collaboration, this practice has often been contentious, being viewed as a way of distorting state or local priorities and subverting their autonomy. Consequently, in a few federations the exercise of the federal spending power in areas of exclusive provincial (state) jurisdiction has required the consent of representatives of the constituent units, either through their representatives in the federal second legislative chamber or through intergovernmental negotiations.

Broadly speaking, there have been two conflicting models for the adjustment of federal financial arrangements. One has been a centralist approach based on assumptions of federal government superiority for steering the national economy, and therefore giving the federal government a predominant or even unilateral role in adjusting the financial arrangements. The other is a federalist approach that assumes that the states or provinces should have a say in changes affecting their fiscal independence and, therefore, requiring mutual agreement among governments within a federation in the processes for adjusting financial arrangements. In practice there have often been elements of both these approaches, with the latter counteracting the former.

d) Procedures for adjusting financial relations

In terms of actual procedures for adjusting intergovernmental financial relations, four typical patterns may be identified (Watts 1999a: 53-5 and Table 13). In Australia, India and South Africa, although in different forms, standing or periodic independent expert commissions established by the federal government have been given the primary task of determining changes to the distributive formula and recommending these to the federal parliament. A second pattern, found in Pakistan and Malaysia, is the constitutional provision for an intergovernmental council composed of federal and state representatives as the primary forum to reach agreement on modifications to the financial arrangements at periodic intervals. A third pattern is that found in Germany, Switzerland, Austria, the United States and Belgium, where grants to states are determined by the federal legislature with some effective formal participation by state governments, legislatures or interests within the federal institutions determining these transfers. A fourth pattern is that found in Canada, where the determination of financial transfers lies ultimately with the federal government whose legislature contains no effective representation of provincial governments or interests. While that is the formal situation in Canada, because of the importance of intergovernmental financial issues, in practice federal-provincial financial relations have been the subject of extended discussions in the extra-parliamentary arena of innumerable committees of federal and provincial ministers and officials, and the source of much political polemics between federal and provincial governments (Bird 1994: 304-305).

e) Canadian and Australian Experience

In considering processes for adjusting federal financial arrangements, this article focuses particularly on the Canadian and Australian experiences. These two have certain features in common (Bird 1994: 309-310). Each has a similar historical origin constituting an aggregation of former British colonies. Each has a British parliamentary system at both levels of government with the result that federal-provincial problems are resolved largely by the adversarial processes of "executive federalism." Each has a small number of provinces (states) but is dominated by two provinces or states that combined have a majority of the federal population. In each, formal constitutional amendment has been difficult to effect and, therefore, adaptation has had to be achieved through other evolutionary processes.

But there are significant differences, not the least in their federal financial arrangements. Taxing powers, as well as legislative and administrative authority, are far more centralized in Australia than in Canada. While both have equalization transfers, there is greater emphasis upon equity in Australia and more upon provincial autonomy within Canada. Regional differences are sharper in Canada, and in addition the linguistically and culturally distinct Quebec has no parallel in Australia. It is not surprising then that there are noteworthy differences in the processes for adjustment of federal financial relations in these two federations.

PART 2: THE CANADIAN EXPERIENCE

a) The context

Canada, when it was federated in 1867, became the first federation in the world to combine federal institutions and the Westminster form of parliamentary institutions. This has created political dynamics quite distinct from the earlier federations with non-parliamentary executives established in the United States and Switzerland. The Canadian model is of interest because a number of federations established since, both in the Commonwealth and in Europe, have combined federal and parliamentary institutions. These include Australia, India, Pakistan (at certain periods), Malaysia, Nigeria (for a period), Germany, Australia, Belgium and Spain.

In terms of constitutional allocations of revenues, in Canada both the federal and provincial governments have broad taxing powers in the fields of personal and corporate income tax and sales taxes. The result is overlapping tax jurisdictions that make the taxation and revenue system rather complex. Their access to income taxes (personal and corporate) and sales taxes has enabled the provincial governments to finance a large portion of their expenditures out of their own revenues. Nevertheless, since the federal government also has access to these tax sources, there has always been a discrepancy between the revenue capacity of the provinces and their extensive expenditure responsibilities, which have included such expansive and expensive areas as health, education and social services.

There are also considerable differences in the size, population and economic wealth of the provinces that have resulted in variations among them in revenue capacity and expenditure needs. As a result, there has developed an extensive and complex system of intergovernmental transfers. However, with one exception there is no constitutional provision governing these transfers. The exception is the inclusion in the Constitution (added in 1982) of the commitment to a set of principles (but not the detailed formula) that are the basis of the equalization system. Section 36(2) of the *Constitution Act, 1982*, commits the federal government to “the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Otherwise, in constitutional terms, the ultimate constitutional authority for determining financial transfers rests with the federal government and Parliament. The possible scope of such transfers is broadened by the fact that although there is no explicit constitutional provision for a "federal spending power" in areas of exclusive provincial jurisdiction, judicial interpretation of the Constitution has given the federal government a wide degree of discretion in how it chooses to use its spending power for purposes within areas of exclusive provincial jurisdiction (Watts 1999b: 3-6).

In examining the processes for adjusting financial relations within Canada, an important distinction that has to be recognized is that between constitutional provisions and actual practice. In strictly constitutional terms, the Canadian federal government is placed in a predominant position, both in terms of the scope of its legislative and executive jurisdiction and in terms of the allocation and adjustment of finances. In practice, however, because of the economic, linguistic and cultural diversity, political forces have over the years strengthened enormously the political leverage of the provincial governments. In the processes for adjusting the financial relations, although the constitutional authority ultimately lies with the federal government, the federal government has found it politically necessary to engage in extensive negotiations and bargaining with the provincial governments and to reach agreements with them regarding intergovernmental transfers and even some aspects of fiscal policy.

b) The processes for intergovernmental financial negotiations

Since major formal amendment of the Constitution in response to changing social and economic circumstances has proven to be extremely difficult in Canada, federal-provincial financial arrangements have evolved largely through the non-constitutional processes of intergovernmental relations. "Executive federalism," i.e., negotiations between the executives from each order of government, has produced adjustments to the arrangements for financial transfers from the federal government to the provinces. These have enabled the federal government to pursue general policy objectives in areas of exclusive provincial jurisdiction while at the same time leaving the provinces a major role in designing and financing the programs that meet the federal government's Canada-wide objectives.

These processes have been flexible enough to accommodate many of the particular needs of the provinces, although the concerns of Quebec for a greater degree of fiscal and policy autonomy and of the larger and wealthier provinces such as Ontario and Alberta to pursue their own economic strategies have placed some strain on the arrangements.

Broadly speaking, two sets of transfers to the provinces have been developed. One intended to deal with vertical imbalances has evolved over the last forty years from a set of shared-cost programs relating separately to health, post-secondary education and social assistance into a single, major block transfer – the Canada Health and Social Transfer, instituted in 1996-7. Shared-cost constitutional transfers, often using 50 per cent sharing formulas, were abandoned for health and post-secondary education in 1977 and for welfare in 1996. The CHST transfers are now basically equal per capita transfers intended to assist the provinces in financing health, post-secondary education and social welfare programs. The conditions attached are so general as to make these transfers basically unconditional in character (Watts 1999b: 58).

The second set of transfers that has been developed are the completely unconditional equalization transfers intended to assist low-income provinces. As a result of intergovernmental negotiations, these too have evolved since the early post-World War II period. The Canadian equalization system has always focused on equalizing tax capacity differences across provinces; there is no attempt to equalize for differing provincial expenditure capacities or needs. Over the years, the representative tax system, which calculates equalization transfers on the basis of a province's ability to raise revenues from a given set of tax bases, used by the provinces has been modified in the light of experience. It now takes account of over forty tax bases in order to define a common tax base against which to measure the tax capacity of a province. This common tax base is derived from a representative set of five provinces (excluding Alberta and the four Atlantic provinces because of their distorting special circumstances). Provinces above the standard receive nothing (e.g., Alberta, Ontario and, for most of the recent past, British Columbia) while provinces that fall below the standard qualify for these transfers.

While the CHST and equalization block transfers now represent the largest proportion of transfers (generally over 85 per cent), there do remain some much more specific and smaller shared-cost programs in areas like highway transportation, immigration and infrastructure (Vaillancourt 2000: 209.)

In terms of the processes that have produced these arrangements, the key point to note is that while they have been implemented by the federal government under its constitutional authority, the evolution of these arrangements has been the product of intense intergovernmental negotiation and bargaining. In terms of the adjustments of financial arrangements, much of these deliberations have occurred in the frequent meetings of finance ministers (of the federal and provincial governments), supplemented by the even more numerous meetings at the bureaucratic level between civil servants in the federal and provincial governments. A significant feature is that even when the negotiations have related to health, post-secondary education or social assistance programs, it has been the finance ministers and their bureaucrats in the federal and provincial governments that have dominated the process. Nevertheless, sectoral meetings of other ministers or bureaucrats have also on occasion been involved. Where negotiations have become particularly critical, financial issues have sometimes been considered at First Minister's Meetings involving the federal prime minister and the provincial premiers. Not infrequently, in order for the provinces to develop a concerted strategy in relation to the federal government, financial issues have been discussed in advance at the Annual Premiers' Conference or at the various regional conferences of premiers.

Two other features of the Canadian intergovernmental financial relations should be noted. One has been the practice of permitting specific provinces to "opt out" of a particular federal-provincial scheme without financial penalty. This has provided an added flexibility, particularly in accommodating Quebec's insistence upon its distinctiveness and autonomy. The other is the development of co-ordinated tax-collection agreements. For most provinces, the federal government has collected the income taxes autonomously levied at different rates by the provinces on condition that they use a common, federally established base (all provinces except Quebec participate in the personal income tax collection agreements and all provinces except Alberta, Ontario and Quebec participate in the corporate income tax collection agreements). Unlike income taxes, sales tax harmonization is much less well developed in Canada, although three Atlantic provinces (New Brunswick, Nova Scotia and Newfoundland) have fully harmonized their sales taxes, as a result of a financial incentive provided by the federal government. An agreement with Quebec has led to a harmonization in that province under which that province collects the GST (goods and services tax) for the federal government.

c) Summary and assessment

While the various intergovernmental meetings have been extensive and have been fundamental to the evolution of the system of financial transfers, and also to the arrangements for tax co-ordination, it has to be emphasized that these intergovernmental meetings have no constitutional status, nor are there formal rules such as voting requirements for decision-making. Their efficacy has rested simply upon the political leverage of the participants and upon reaching some sort of consensus that is then implemented by federal legislation. The federal government has played a leading role in the intergovernmental negotiations and bargaining, largely from the influence and inducements it can bring to bear from the use of its spending power and its ultimate constitutional ability to exercise this power unilaterally. However, the power and influence of the federal government is severely constrained by the fact that it lacks the constitutional jurisdiction to implement many policies. The federal government therefore has had to take care not to generate disagreements with the provinces that would then lead to resistance from the provinces to co-operating with the federal government on policy issues.

These intergovernmental negotiations have played a major role in enabling the adjustment of the federal financial relationships to respond over time to changing circumstances. Their informal character and the reliance upon intergovernmental consensus has meant, however, that a sense of trust between governments has been a crucial requirement. During the early 1990s the federal government’s gradual reduction in projected funding increases of existing jointly financed programs, and its unilateral decision (in order to reduce its own deficits) to do so, left the provinces with the burden of compensating for this reduction of transfers. This made it increasingly difficult for the provinces to predict and plan their budgetary revenues and expenditures. As a result of the unilateral federal reduction in support for existing programs in the early and mid-1990s, the provinces became extremely reluctant to enter any new joint agreements with the federal government, thus exerting a considerable constraint on the ability of intergovernmental processes to respond to changing economic and social circumstances. This illustrates how important the nurturing of a sense of intergovernmental trust is to effective processes for adjustment.

A recent effort to re-establish a sense of trust has been the Social Union Framework Agreement (SUFA) of 1999. As a result of provincial pressure, this agreement includes new limits on the federal use of its spending power, provides for advance consultations prior to renewal of or significant changes in social transfers to make federal funding more predictable for the provinces, and includes a dispute-resolution mechanism. Since this agreement was reached only recently, it remains to be seen what the long-term impact of the SUFA will be upon intergovernmental trust and consensus (Lazar 2000: 29-31).

PART 3: THE AUSTRALIAN EXPERIENCE

a) The context

Australia, when it became a federation in 1901, like Canada, combined federal and parliamentary institutions. But it added some unique adaptations, including a directly elected Senate in which the states are equally represented, together with a procedure that can in certain circumstances, when they fail to reach agreement, lead to the double dissolution of both houses of the federal Parliament. As in Canada, the combination of federal and parliamentary institutions has focused intergovernmental relations upon executive intergovernmental processes.

The major issues in the realm of federal finance have been: (1) correcting the relatively extreme fiscal imbalance arising from the considerably greater centralization of revenue raising in Australia by comparison with Canada; (2) fiscal equalization among the states taking account not only of differential revenue capacities but, unlike Canada, also of differential expenditure needs; and (3) co-ordination of public borrowing.

b) The processes for adjustment of federal financial relations

As in Canada, most of the institutions and processes for the adjustment of the Australian federal financial relations are not directly grounded in the Constitution but have evolved over the century of the federation's operation (Galligan 2000: 226). Exceptions were the formal constitutionalization by constitutional amendment in 1927 of the Loan Council, first established in 1923 to co-ordinate public borrowing; and the inclusion in the Constitution, from the beginning, of section 96 that explicitly extends the federal spending power to include possible payments to the states. While, as in Canada, many of the processes for adjusting financial-state financial relations and transfer were in Australia developed as a result of non-constitutional intergovernmental negotiation and agreement, in Australia there has been a much stronger tendency to establish formal institutions to facilitate these intergovernmental processes. Notable, for instance, have been the establishment of such formal bodies as the Loan Council (1923, and constitutionalized 1927), the Commonwealth Grants Commission (1933) and the Council of Australian Governments (1992).

The most contentious aspect of Australian federal financial relations has been the extreme vertical fiscal imbalance (1995: 226). This has been the result of two factors: first, as a result of judicial interpretation of the Constitution, the federal government has retained a monopoly over income taxation after the Second World War; second, the exaggerated judicial interpretation of "excise duties" has prevented the states from levying broad-based consumption or general sales taxes. As a result, the federal government levies the lion's share of revenue and the states are heavily reliant on federal transfers to meet their expenditure needs. Consequently, by comparison with Canada, in the mid-1990s intergovernmental transfers constituted 40.7 per cent of Australian state revenues, while in Canada the comparable figure was 19.8 per cent (Watts 1996a: 48). Although the proportion has varied over time, in recent years, virtually half of these in Australia took the form of unconditional general purpose assistance transfers (compared to over 90 per cent unconditional block transfers in Canada). These unconditional transfers have ensured some state autonomy in their application. Nevertheless, the states have no autonomous control over the size of these transfers. In an effort to address this vertical imbalance, when the federal government in 2000 instituted the new GST (goods and services tax, a form of VAT), it was agreed that the proceeds should be transferred to the states. While the revenue generated has assisted the states, accountability for its levy remains out of state hands since the GST is levied by the federal government.

For a long period these issues were considered regularly at meetings of the Premiers Conference (the meetings of federal and provincial premiers) and adjustments were as a result made in both the substantial general purpose assistance grants and the functional special purpose grants. In this respect, the process of executive intergovernmental deliberations influencing federal adjustments was not unlike that in Canada. Since the 1980s, however, the allocation of these general revenue grants has been combined with the allocation of equalization transfers, and the Commonwealth Grants Commission (see below) has been given the task of recommending the allocation of the entire pool of general revenue grants to the states, although the Premiers Conference is still involved in negotiations about the overall size of the pool.

The development of financial equalization in Australia has gone through a number of stages. The need for assistance to poorer states was foreseen in the original constitutional provision enabling federal financial assistance to any state on terms and conditions the federal government saw fit (Galligan 1995: 221). From 1910 to 1933, ad hoc federal assistance was granted to some needy states. In 1933 this was made more systematic when the Commonwealth Grants Commission (CGC) was established to make independent recommendations to the federal government on the special claims of states. Over the forty years up to 1973 the CGC developed an elaborate fiscal equalization methodology, and its annual reports during that period were a rich source of material on the issues, concepts and methodology for tackling equalization issues. The stature and independence of the CGC was enhanced by the consistency with which the federal government accepted and implemented its recommendations.

In 1973 the role of the CGC was changed radically from that of recommending separate supplementary equalization grants to the “claimant states,” to that of determining the “per capita” relativities for all states for establishing the allocation of the entire pool of general revenue grants to the states (including those dealing with the substantial vertical imbalances of revenue and expenditure). In this process, since 1981 the CGC has applied a comprehensive revenue and expenditure equalization methodology. Since 1989 the Territories have been included in its recommendations. When the new GST replaced the general revenue grants as the pool for the distribution of transfers to the states in 1999, it became the CGC's responsibility to recommend the relativities for distribution, subject to overview by a federal-state ministerial council.

The current definition of the equalization program, as pronounced by the CGC in 1999, is that "State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the same capacity to provide services at the same standard."

The CGC methodology involves five steps: (1) preparation of a standard state budget of revenues and expenditures (with an implied balance); (2) measurement of disability factors in each state; (3) application of disabilities as a ratio of the national average to standard revenues and expenditures for each state; (4) aggregation of relativities for each state; and (5) application of the relativities for each state to the available revenue pool. This methodology produced in 1998-1999 relativities of 0.90032, 0.86273 and 0.94035 in New South Wales, Victoria and Western Australia, and of 1.00775, 1.20764, 1.61001, 1.10358 and 4.84095 in Queensland, South Australia, Tasmania, the Australian Capital Territory and the Northern Territory. The result was a variation in the per capita transfer from $1,010 in Victoria to $1,886 in Tasmania and $5,670 in the Northern Territory.

It should be noted that in contrast to Canada, the Australian process involves a representative tax *and* expenditure approach. The disability factors represent positive or negative deviations from the mean of state practices, reflecting both differing needs and costs that are measurable, significant and unrelated to policy preference (i.e., outside the control of a state government). In this assessment, considerable ongoing judgement is required on the part of the CGC. Not surprisingly, a continuing issue has been the scope of revenues and expenditures to be included in the calculations.

The CGC consists of four members appointed by the federal government. In the period since 1933, however, the CGC has established a reputation for independence. It has an official staff of about fifty, based in Canberra. It holds hearings, conducts site visits, has frequent meetings with state and territory Treasury Departments, and then exercises its discretion in making recommendations. The political context for its work is provided by the Financial Premiers Conference, which bargains over the terms of reference for the CGC reviews, advocates an overall pattern for intergovernmental transfers and debates the effects and future of equalization. Ultimately, the final say on the amount of the pool of general revenue grants and other funds to which equalization is applied lies with the Federal Treasurer. The 1999 Agreement, basing the distributable pool including equalization upon the new goods and services tax, has given the states greater revenue certainty. In practice, federal governments in Australia have made few changes to the relativities recommended by the CGC. What debate there has been, has been over what funds get put into the distributable pool and what gets included in the formula in the first place.

Another area where Australia has developed a formal intergovernmental financial institution has been public sector borrowing. First established in 1923 and then formally given constitutional authority by a constitutional amendment in 1927, the Loan Council was composed of federal and state representatives, with a formal voting rule, and able to make decisions binding on both levels of government. Under the decision-making rule, each state had one vote and the federal government had two votes plus a casting vote (i.e., to carry the day the federal government had to have the support of at least two of the six states). By the 1990s, however, with the increasing resort to privatization and contracting out, the call on public borrowing had declined and the role of the Loan Council diminished. Its role has now been modified to that of limited collective monitoring (Galligan 1995: 232-234).

Yet another example of the institutionalizing of intergovernmental relations in Australia was the establishment in 1992 of the Council of Australian Governments (COAG). Its task has been to oversee the intergovernmental collaborative processes and particularly to make the Australian economic reunion more effective. Including not only the heads of the federal and state governments but also a representative of local government, it has systematized the organization, terms of reference and decision-making rules of the various sectoral intergovernmental ministerial councils that come under its overview.

c) Summary and assessment

A number of authors have singled out the elaborate Australian system for intergovernmental financial adjustments and equalization as a particularly distinctive feature of the Australian federation (Gramlich 1984; Matthews 1994; Galligan 1995: 254). Like Canada, in Australia the processes for adjusting federal-state financial relations have been predominantly within the context of inter-executive negotiations and bargaining. What has distinguished the Australian approach from the Canadian, however, has been the much more extensive development of formal institutions for these processes. Although often not embodied in the Constitution, such bodies as the Financial Premiers Conference, the Commonwealth Grants Commission, the Loan Council and the Council of Australian Governments typify this approach.

Also contrasting with Canada has been the effort in the process of equalization to correct horizontal imbalances by taking account not only of variations in capacity to raise revenue but also of differences in expenditure needs (i.e., capacity to deliver services).

The Australian example is a particularly important one because it has been a pioneer among federations in developing formal procedures and institutions for the adjustment of federal-state financial arrangements, and because it has been the model that has most influenced many subsequent federations in Asia and Africa.

PART 4: CONCLUSION

The Canadian and Australian examples of processes for adjusting federal financial relations provide a number of common lessons:

(1) Intergovernmental interdependence is unavoidable in federations and collaboration between governments is essential. Because constitutional allocations of revenue sources and expenditure responsibilities can never be balanced precisely, intergovernmental adjustments in the form of transfers have proved necessary not only in Canada and Australia but in all federations.

(2) Federations require the establishment, either constitutionally or more often extra-constitutionally, of formal and informal processes and institutions for adjusting federal financial arrangements. These are needed both to correct inevitable vertical and

horizontal imbalances of revenues and expenditures and to adapt over time to changing values of revenue sources and costs of expenditure responsibilities.

(3) To preserve the principle that in a federation neither order of government should be subordinate to the other, the processes of adjusting financial relations should not be subject solely to unilateral determination by one or other order of government within the federation. In those cases where the constitution has assigned ultimate authority to the federal government to determine the level and scope of transfers, in both Canada and Australia federal political realities have generally forced the federal government to become involved in various processes of negotiation and bargaining with the provincial or state governments before applying adjustments to the financial arrangements.

(4) In parliamentary federations, of which both Canada and Australia are examples, intergovernmental financial negotiations and bargaining have typically taken the form of "executive federalism," i.e., negotiations between the executives and their representatives – first ministers, finance ministers and civil servants – of each of the governments within the federation. This has been because in parliamentary systems, although the executives are formally responsible to their legislatures, the executives through party discipline have in practice come to dominate this relationship.

While the Canadian and Australian models for adjusting federal financial relations share these fundamental features, there are also significant differences between them:

(1) Australia has relied much more on the establishment of formal processes and institutions to facilitate its processes of adjustment and co-ordination of financial arrangements, as exemplified by the Loan Council, the Financial Premiers Conference, the Commonwealth Grants Commission and the Council of Australian Governments. By contrast, Canada has relied almost totally on informal processes. The very recent Social Union Framework Agreement of 1999 marks a step towards more formal arrangements but it is too early yet to judge its effectiveness. The difference in approaches here would seem to stem both from the much more severe vertical imbalance of revenues and expenditures in Australia, imposing the need for substantial adjustments, and the extremely strong emphasis in Canada upon avoiding any arrangements that might undermine the autonomous activity

of either order of government. This contrast is illustrated by a notable ironic example. The 1991 proposals of the Government of Canada for constitutional reform included a proposal for an intergovernmental Council of the Federation as one new instrument for improving intergovernmental collaboration with a view to strengthening the economic union. In the subsequent intergovernmental deliberations, that proposal was abandoned because of the fears of some provinces that it might contribute to federal government dominance in the council, and because some provinces thought that a better alternative would be to strengthen the influence of the provinces in policy-making by establishing a Triple-E (elected, equal provincial representation, and effective) Senate. Ironically, just a year later in Australia (which since 1901 had had just such a Senate), the federal government and the states together agreed to adapt to their own uses the Canadian idea for a Council of the Federation by formally establishing their own intergovernmental Council of Australian Governments (COAG), its primary objective being to strengthen the economic union. Since its establishment, COAG has operated with varying levels of interest and influence.

(2) The differences between the Canadian and Australian processes for adjusting federal financial point to the significance of economic, social and political circumstances that influence these arrangements. For instance, among federations Canada clearly stands out in its emphasis upon provincial autonomy. The impact of Quebec’s insistence upon provincial autonomy and the sharpness of economic and social differences among the other provinces have been important factors. Furthermore, the emphasis in the Canadian Constitution upon the exclusive legislative powers of each order of government and the fact that Canada has fewer constitutionally concurrent areas of jurisdiction than any other contemporary federation have reinforced this trend. A further factor is that provisions for representation of provincial governments or interests within the Canadian institutions of federal policy-making have been less than in any other contemporary federation because of the centrally appointed character of its Senate. Thus, federal-provincial bargaining on financial matters has had to focus in Canada, more than in any other federation, upon the extra-parliamentary informal processes of intergovernmental inter-executive negotiation. In Australia, where the social and political differences among the states, while significant, have not been as sharp, where the Constitution recognizes much larger areas

of concurrent jurisdiction, and where there has been a directly elected Senate, there has been less resistance to establishing formal processes and institutions for intergovernmental financial and economic collaboration.

(3) It should be noted also that differences in patterns of intergovernmental financial relations have reflected not only the particular character of the economy, social diversity and political institutions, but also the values and political culture of the particular society. Thus, for instance, in Australia the prevailing emphasis upon equity has led to the stronger drive for full equalization of revenue and expenditure capacity, affecting the character of its intergovernmental financial relations. By contrast, the Canadian federal financial relations have reflected the character of the Canadian federation in which issues of equity have been counter-balanced by a strong emphasis upon ensuring the autonomy of each order of government.

The two examples, Canada and Australia, examined in this article point to the importance of the processes of financial adjustment in each federation and of the effectiveness of collaborative processes that sustain an appropriate balance between governments within the federation. At the same time, the differences in their experiences also point to the need for such processes to be adapted to the particular circumstances of each federation.

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