

Fiscal Federalism and Comparative Analysis of Practices Regarding Political Dynasties

1

PROF. DR ANDREAS HEINEMANN-GRÜDER
UNIVERSITY OF BONN
SEMINAR „FEDERALISM IN FOCUS“
CAGAYAN DE ORO CITY, 09 OCT. 2018

Causes of centralism

2

- **Patronage & clientelism** as a result of monopolistic resource control
- Political parties & head of states & regions do not need federalism for acquisition of power
- Decentralization of functions w/o revenue raising powers (**unfunded mandates**) → **centre retains leverage**
- Collective action problem: **hard to build coalitions for decentralization & federalism from below**
- **Result:** Weak fiscal discipline & accountability, low economic growth rates, unequal access to opportunities & social security

Fiscal Federalism: Principles

3

1. Fiscal federalism should overcome disruptive effects of **uneven distribution of wealth** and / or lack of resources
2. States / regions and communes need substantial revenue raising powers (**balance of fiscal powers**)
3. **Fiscal gaps** should be remedied through transfers
4. **Stabilization** is primarily the **task of the central government**
5. Provision of regional and local public goods & services should be supported (equity and efficiency)

Guidelines for assignment of taxes



- Taxing powers should be related to responsibilities & borrowing powers
- Tax bases with high mobility should be federally taxed
- State or region should levy residence based taxes (i.e., property tax)
- Taxes for overall economic stabilization and redistribution should be reserved to the centre
- Tax in a way that desirable resource allocation is achieved (goal-oriented taxing, for example, road charges)
- Ask whether collection of taxes is „convenient“ (for payer and collector), accepted, efficient, effective, simple, and does it improve equity?

Guidelines (cont.)

5

- Equal standards for service provision, but not equal living conditions throughout the federation
- **Value Added Tax:** may vary in order to attract investors
- Fees may vary
- **Essential:** control over spending behavior (audit chambers, parliamentary, judicial control)

Potential Criteria for transfers

6

- Population (density, stratification)
- averaging p/c revenue yield
- Geography, distance to capital
- income & revenue raising power
- socio-demographic situation
- de-politicize transfers
- weigh factors
- award performance

Potential Criteria of Inter-state Allocation of Grants (case of India)

7

| Sl. No. | Criterion | Weight (Per cent) |
|---------|---|-------------------|
| 1. | Population | 40 |
| 2. | Geographical area | 10 |
| 3. | Distance from highest per capita income | 20 |
| 4. | Index of deprivation | 10 |
| 5. | Revenue effort of which | |
| | (a) with respect to own revenue of states | 10 |
| | (b) with respect to GSDP | 10 |

The inclusion of deprivation index in determining the interstate grants is commendable because it will ensure horizontal equity

Equalization schemes

8

- 1) **Co-financing of „joint competencies“** (regional infrastructure, agriculture, investment projects)
- 2) **Sharing of mass taxes** (for example, VAT)
- 3) **Unconditional revenue sharing aid** (no strings attached)
- 4) **Conditional matching aid** in targeted public services

Equalization schemes (cont.)

9

- 5) **Equalization of fiscal disparities** (grants consider personal income): Equalization of difference between the state p/c revenue yield and the national average p/c revenue yield. Guarantee of "reasonably comparable levels"
- 6) **Refunding** for implementing federal tasks
- 7) **Categorical aid:** to specific targeted services (for example, education, food and nutrition, Medical Aid)
- 8) **Capacity equalizing aid** (administration)

Models of federal taxation

10

- ❖ Shared taxation (Germany)
- ❖ Separate taxation (USA, Canada)
- ❖ Tax autonomy of regions and payments to the centre (Basque Country and Navarra in Spain or South Tyrol in Italy)
- ❖ Subsidies to the regions by the Centre (Scotland, Wales and Northern Ireland)

Federal income / tax distribution in Germany

11

| Federal tax | Länder tax | Communal tax | Shared tax |
|--|---------------------------------------|---------------------------|---|
| Customs & fiscal monopolies as tobacco | Wealth tax | Local business tax | Income tax (fed 42,4% / reg 42,5% / municipalities 15%) |
| Gasoline | Inheritance tax | Real estate tax | Corporate profit tax (50% : 50%) |
| Capital transaction tax | Lottery tax | Dog licences | Sales tax |
| Property tax | Motor vehicle tax, gambling, beer tax | | Business tax (12,5% : 12,5% : 75%) |

Federal legislation that accrues wholly or in part to the Länder and / or municipalities requires consent by the second chamber

Main Sources of Revenues in Canada

12

Federal Government:

- Incomes taxes
 - ✦ $\approx 65\%$
- Consumption taxes
 - ✦ $\approx 18\%$
- Payroll taxes (contributions to social security plans)
 - ✦ $\approx 7\%$
- Other
 - ✦ $\approx 10\%$

Provincial Governments:

- Percent share varies by provincial government
- Natural resource wealth
- In all provinces, income and corporate taxes take up largest share
- Equalization depends on whether province is non-renewable resource rich or not

Does Federalism Feed Corruption?

13

- **Uncertainty** whether decentralization leads to more or less corruption (some studies: increase of corruption ⇒ EITI provisions could make difference)
- **Market decentralization may increase corruption** in deeply rooted unitary state (espec. during transition from unitary to federal state)
- Transferring more money to local governments is insufficient, should be accompanied by **autonomy to levy taxes** and to collect revenues (otherwise more corruption)

„Political Dynasties“

Could federalism make a difference?

14

- **Notions:** political oligarchs, political “tribes”, machine politics, patronage & clientelism, traditional political clans, „trapos“, limited access orders
- **Present** in some socialist countries (notably in North-Korea, China), in authoritarian regimes (Azerbaijan, Syria), in South East Asia (Indonesia, Philippines, Myanmar, Pakistan), but in many democracies too: in the U.S. (Adams, Roosevelt, Kennedy, Bush families), in Argentina (Peron, Kirchner), in Japan, India
- **Virtues and pathologies of federalism not clear cut!**

Features of Political Dynasties

15

- personalistic politics
- patronage & clientelism
- Fusion of business and political power
- vote buying
- narrow set of elite interests dominates policy-making
- representation only of elite strata
- control of legislative agendas
- self-perpetuating political power (inheritable)

Root causes

16

- Extreme income equality
- monopolies (no market competition)
- legacy of old landed aristocracy
- weak institutional checks & balances
- no independent courts
- deficient rules on party and election financing
- distrust in equal provision of public goods
- weakness of civil society
- deeply entrenched culture
- key business sectors factor corruption costs in
- party lists not open, but „owned“
- control of subnational govt. by local „big men“
- catholicism (?)
- constrained social upward mobility, especially of rural population

Ways out...

17

- (1) Combine fiscal decentralization with revenue-raising competence and disciplined spending behavior
- (2) Allow for reforms on regional level if nation-wide reform not yet possible
- (3) Strengthen political parties, especially non-traditional parties on regional level
- (4) Regulate party finance
- (5) Prohibit switch of party allegiance after election (limit „free agents“)
- (6) Multi-member districts instead of single member electoral districts

Ways out...

18

- (9) Prohibit fusion of public duty with business (requirements for disclosure, enforcement of rules)
- (10) Educate and empower voters (voting on outcomes, not expectations)
- (11) Term limits
- (12) Reduce need for patronage (universal provision of public goods)
- (13) Open, transparent tenders for government contracts
- (14) Make data on „doing business“ („climate“), Corruption Perception Index part of electoral campaigns
- (15) Push companies to sign codes of conduct
- (16) E-government
- (17) Award corruption free zones and corruption free enterprises (award or ban on public contracts)

Logics of patron-client relations

19

- 1) Patron-client relations depend on bargaining power. Does the patron control scarce goods, does the client have an option to quit or to switch?
- 2) Only scarce goods make a patron strong – and a huge pool of substitutable clients
- 3) Patrons do not invest into all potential clients, only in those that are necessary for winning elections
- 4) A patron will invest in clients the more a challenger is capable to draw his clientele to his side
- 5) The social capital of patrons informs the loyalty of clients
- 6) Patrons are strong as long as they can punish the exit of clients

Sequencing of empowerment of subnational level

20



- (1) Control and audit systems at subnational level to ensure proper spending behavior
- (2) **Legal and regulatory frameworks:** intergovernmental roles & responsibilities have been clearly assigned
- (3) **Resolve local capacity weaknesses** (performance based): computerization, management training, competence certification, procurement procedures, e-governance
- (4) **Local support networks** (backing by associations, NGOs, community boards)

Empowerment of subnational level (cont.)

21

- 5) **Monitoring systems** to track progress
- 6) **Provide stable financing** (wage costs of decentralization or block grants for capacity building)
- 7) **Restructuring & streamlining of provincial & local offices** for new tasks (guidelines, handbooks)
- 8) **Results-oriented budgeting and reporting**