

# Fiscal Federalism and Comparative Analysis of Practices Regarding Political Dynasties

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# Causes of centralism

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- **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

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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.)

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- 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

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- 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)

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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

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- 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.)

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- 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

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- ❖ 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

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Federal tax	Länder tax	Communal tax	Shared tax
Customs & fiscal monopolies as tobacco	Wealth tax	<b>Local business tax</b>	Income tax (fed 42,4% / reg 42,5% / municipalities 15%)
Gasoline	Inheritance tax	<b>Real estate tax</b>	Corporate profit tax (50% : 50%)
Capital transaction tax	Lottery tax	<b>Dog licences</b>	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

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## 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?

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- **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?

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- **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

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- 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

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- 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...

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- (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...

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- (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

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- 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

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- (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.)

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- 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**