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Federation Account **COUNTRIES' EXPERIENCES**



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Outline



01

Introduction

02

Expenditure Responsibilities

- *Decentralization, Concurrent Responsibilities, and Central Government Influence*
- *Asymmetry in the Allocation of Responsibilities*

03

Taxation Powers and Revenue Decentralization

- *Tax Decentralization and Revenue-Raising Autonomy*
- *Shared Taxes and Formula-Based Revenue-Sharing*
- *Natural Resource Taxation*
- *Fiscal Gaps*

04

Fiscal Transfer Systems

- *Subnational Governments' Reliance on Transfers*
- *Decision-making Process for Transfer Systems and Advisory Fiscal Commissions*

05

Challenges to Fiscal Federalism Systems

06

Conclusion



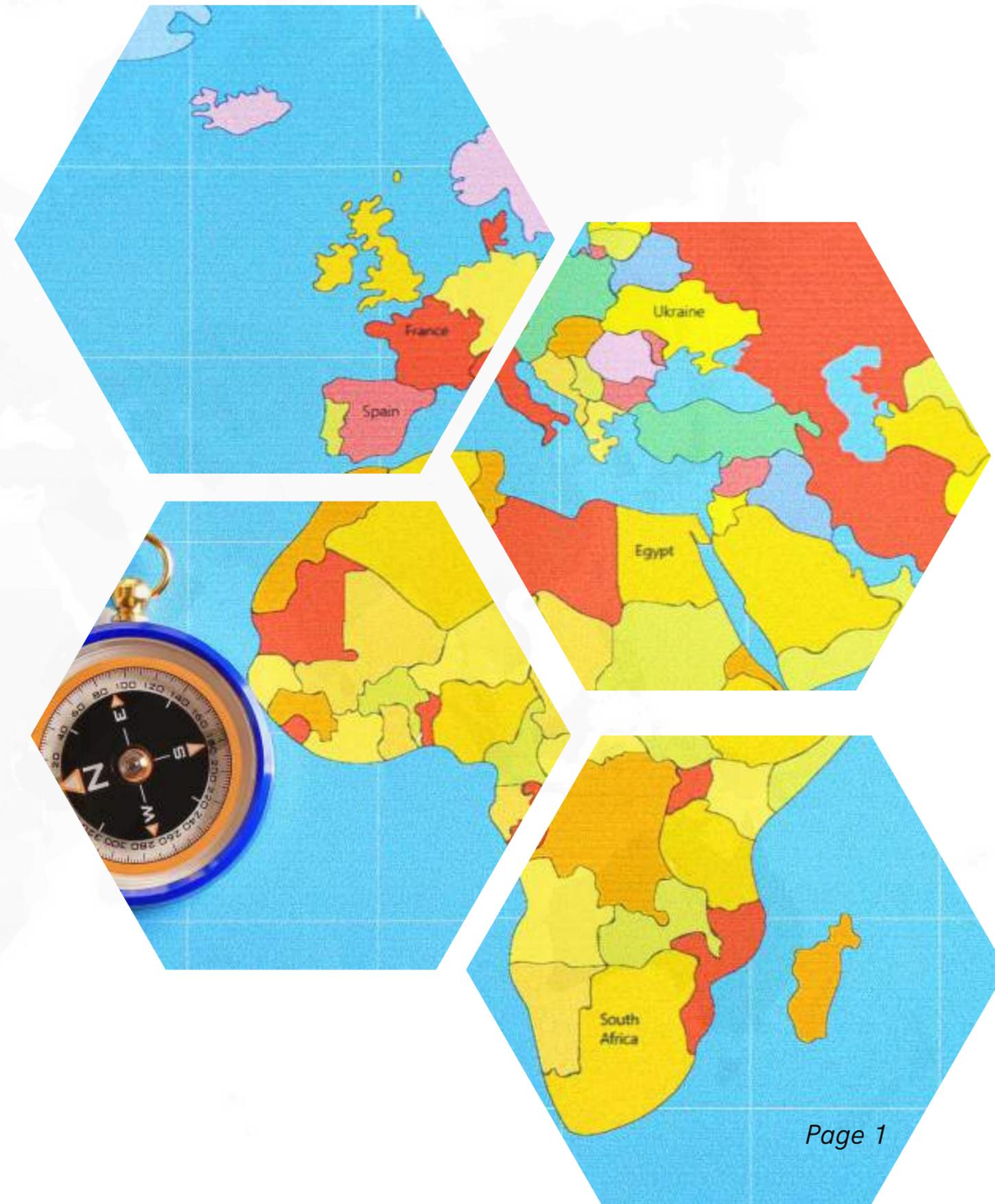
Main **Reference Text**



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Introduction

- There is great diversity across federal systems in how fiscal arrangements are designed.
- This applies to the allocation of spending responsibilities and taxation powers.
- Central elements of fiscal arrangements generally reflect the character and specificities of each federation.
- Fiscal arrangements are critically important for many defining features of federal countries, including:
 - effective autonomy of subnational governments
 - accountability and fiscal discipline,
 - economic efficiency,
 - fiscal disparities across subnational units, and so on.





Expenditure
RESPONSIBILITIES

Expenditure Responsibilities

There are many common features in the assignment of expenditure responsibilities.

01 Central Government

Central governments are typically responsible for functions that have an important national dimension, with interregional spillovers and for which policy harmonization across subnational units is important, including:

foreign affairs, international trade, national defense, monetary policy, the regulation of rail and air transportation and usually financial markets regulation, telecommunications, as well as competition and industrial policy.

02 State Government

State governments are generally involved, to varying degrees, in the areas of:

education, health care, social welfare services, natural resources, and environmental management, sometimes through exclusive responsibilities and sometimes through concurrent or shared responsibilities.

03 Local Government

Local governments are usually responsible for public services for which benefits are largely local in nature and for which delivery is more effectively managed at the local level. This includes

policing, water supply and sewer services, local roads and transit, housing, recreation and culture, fire protection, among others.

Decentralization, Concurrent Responsibilities, & Central Government Influence



In some countries, state governments hold most responsibilities and legislative authority with respect to education, health care, and social services

That is the case in Australia, Canada, Switzerland, and the United States.

they enjoy high autonomy in fulfilling these responsibilities.

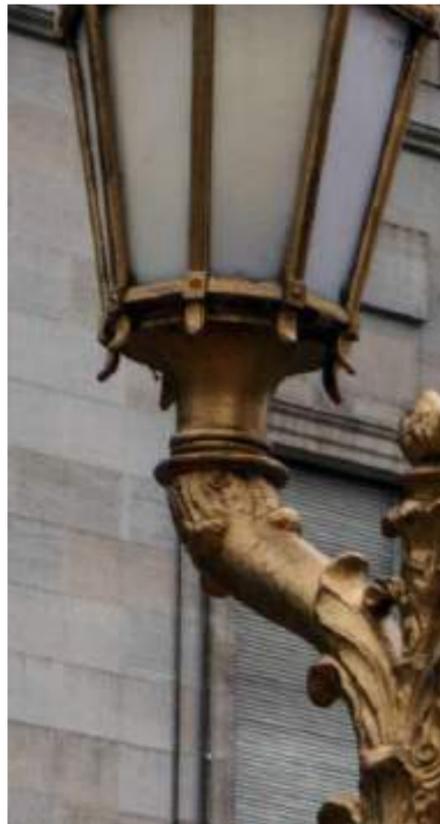


✓ In India, Union and state governments have concurrent responsibilities

✓ Germany has several areas of concurrent legislation of the federal government and the Laender, with federal paramountcy in general.

✓ In Spain, education and healthcare are, in effect, shared responsibilities of the Autonomous Communities and the central government.

Decentralization, Concurrent Responsibilities, & Central Government Influence Cont'd



✔ In Ethiopia, states are responsible, or share responsibilities with the federal government, for delivering many public services. *However, the federal government has considerable influence on how states fulfill their responsibilities.*



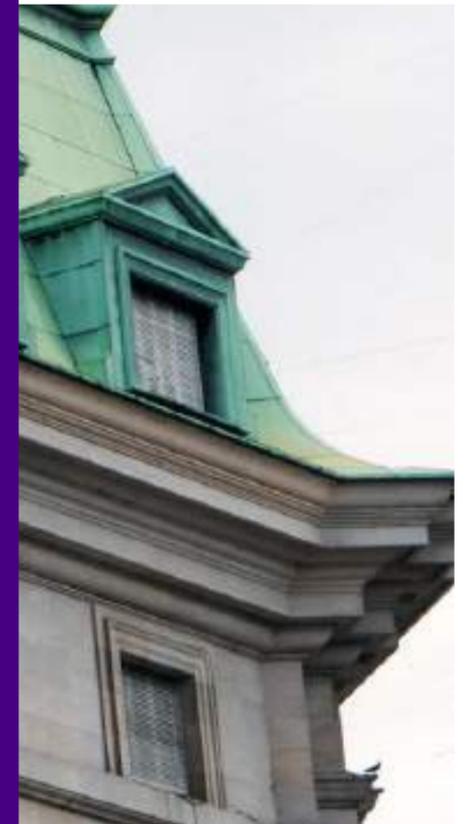
✔ In South Africa, provincial governments have considerable responsibilities but little effective autonomy.



✔ The Brazilian Constitution recognizes local governments and assigns them considerable spending and taxation responsibilities.



✔ Local governments also have constitutional recognition in Switzerland, India, and South Africa; *but do not enjoy as much autonomy as in Brazil, especially in the case of India.*



Decentralization, Concurrent Responsibilities, & Central Government Influence Cont'd



	Decentralization of Responsibilities to States	Decentralization of Responsibilities to Local Governments	Constitutional Status for Local Governments	Central Government Influence on State Programs and Policies	State Government Influence on Local Programs and Policies
Australia	Extensive	Limited	No	Moderate	Strong
Brazil	Limited	Extensive	Yes	Moderate	Weak
Canada	Extensive	Extensive	No	Weak	Moderate
Ethiopia	Moderate	Moderate	No	Strong	Strong
Germany	Extensive	Limited	No	Moderate	Strong
India	Extensive	Limited	Yes	Moderate	Strong
Italy	Moderate	Moderate	Yes	Strong	Weak
South Africa	Extensive	Moderate	Yes	Strong	Moderate
Spain	Extensive	Moderate	No	Moderate	Moderate
Switzerland	Extensive	Extensive	Yes	Weak	Moderate
United States	Extensive	Extensive	No	Weak	Moderate

Source: Tremblay (2023)



Asymmetry in the Allocation of Responsibilities



In some countries, there are asymmetries across subnational units in the allocation of responsibilities

Special regions have bilateral relations with the central government and hold a wider range of responsibilities and higher effective autonomy than ordinary regions.

In Italy, asymmetries exist between the fifteen ordinary regions and the five special regions.



This also exists in India where some states have special status
this provides some advantages such as exemptions from some Union taxes and more generous grants from the Union government, some intended to promote economic development.

In Canada, there are three northern and sparsely populated territories with fiscal arrangements with the federal government that are different than those applying to the ten provinces.

A different system of federal transfers applies to these territories and the federal government plays a more extensive role in the provision of some public services such as health care.



Taxation Powers
AND REVENUE DECENTRALIZATION



Taxation Powers and Revenue Decentralization



While subnational governments generally have more access to:

sales and value-added taxes, property taxes, and several narrow-based taxes and use fees such as: real estate transfer taxes, alcohol and fuel taxes, motor vehicle taxes, and parking fees



Generally, personal income taxes, corporate income taxes, and taxes on international trade tend to be more centralized.



Tax Decentralization & Revenue-Raising Autonomy

State-level governments have access to the personal and corporate income taxes in some of the more decentralized federations such as Canada, the United States, and Switzerland.

This is a key distinguishing feature of tax systems in these countries.



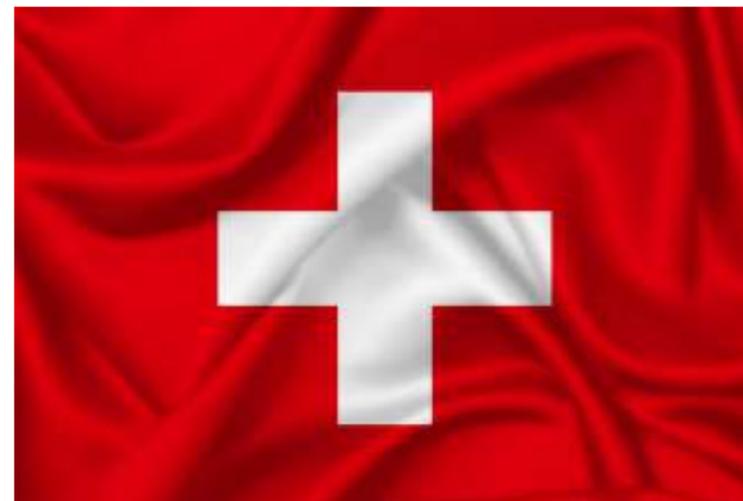
In Canada, the federal and provincial governments have unrestricted access to almost all main broad-based taxes

Exceptions are placed on taxes on natural resources which are reserved for provincial governments and taxes on international trade which are available only to the federal government.



The United States Constitution gives full access to most major tax bases to the federal and state governments.

States have high revenue-raising autonomy, which has led to considerable diversity in relative reliance on different taxes across states.



In Switzerland, the autonomy of cantons over tax policy is also guaranteed by the constitution. Cantons have access to personal income taxes, corporate income taxes, wealth, and inheritance taxes, among others, and the constitution provides them freedom to set tax rates, as well as define the tax bases and special provisions.

Tax Decentralization & Revenue-Raising Autonomy



Generally, State level governments in most federations have less access to broad-based taxes and enjoy less revenue-raising autonomy

Table 2: Taxation Powers and Revenue Decentralization

	Taxation Powers/Autonomy of States	Taxation Powers/Autonomy of Local Governments	Shared Taxes and Formula-based Revenue-Sharing	Size of Vertical Fiscal Gap	Size of Horizontal Fiscal Imbalances (before equalization)
Australia	Low	Low	No	Large	Moderate
Brazil	Low	Moderate	Yes	Moderate	Large
Canada	High	High	No	Moderate	Small
Ethiopia	Moderate	Low	Yes	Large	Large
Germany	Low	Moderate	Yes	Moderate	Moderate
India	Moderate	Low	Yes	Large	Large
Italy	Low	Low	Yes	Large	Moderate
South Africa	Low	Low	Yes	Large	Large
Spain	Moderate	Moderate	Yes	Moderate	Moderate
Switzerland	High	High	No	Small	Small
United States	High	High	No	Small	Small

Source: Tremblay (2023)

Shared Taxes and Formula-Based Revenue-Sharing



In some federations, there are constitutionally based shared taxes and revenue-sharing systems.



✓ In Germany, main broad-based taxes are shared taxes.

- *The revenues from the personal income tax, the VAT, and the withholding tax are shared between all three levels of government in predetermined proportions;*
- *while revenues from the corporate income tax are shared equally between the federal government and the Laender.*

✓ In Brazil, revenues from the federal income tax and tax on manufactured goods are shared in fixed proportions among the three levels of government

while revenues from state value-added taxes, motor vehicle taxes, rural property, and other minor taxes are shared with local governments.

✓ In India, revenue-sharing with state governments applies for all Union government taxes which includes all the main broad-based taxes.

- *The sharing formula is determined by the Union government based on recommendations from an independent expert commission.*
- *The formular takes into account criteria intended to act as an equalization mechanism based on interstate disparities in both fiscal capacities and expenditure needs.*

Natural Resource Taxation

In Canada, subnational ownership of resources is established by the constitution

- *This gives jurisdiction over natural resource management to provincial governments*
- *as well as the exclusive right to impose taxes on renewable and non-renewable resources.*
- *This is an important source of horizontal disparities and tensions.*



In the United States, the federal government can impose royalties on resources extracted offshore or from federal lands.

- *States have the power to levy taxes on fossil fuels and the majority of them do so.*



In Australia, state governments own natural resources and impose various resource royalties.



In Brazil, royalties on natural resources are shared between all three levels of government, on a derivation basis, with local governments being the main beneficiaries.



Fiscal Gaps



In all federations, there is greater decentralization in terms of expenditures than in terms of taxation.

This implies that subnational governments' own-source revenues fall short of their expenditures.

This gives rise to vertical fiscal gaps that are filled by intergovernmental transfers.



The size of vertical fiscal gaps varies widely across countries

Vertical fiscal gaps at the state level are largest in South Africa, where the own-source revenues of provincial governments represent less than two percent of total public sector revenues.

Vertical fiscal gaps are also sizeable in Ethiopia, India, Australia, and Spain.



In some countries, vertical fiscal gaps are larger at the local government level than at the state level.

That is the case when local governments rely more heavily on transfers to finance their expenditures.

This holds in Brazil, Canada, Germany, and the United States.

Based on vertical fiscal gaps, the relative fiscal autonomy of local governments is greater than that of state-level governments in Australia, South Africa, Spain, and Switzerland.

Fiscal

TRANSFER SYSTEMS

Fiscal Transfer Systems



The intergovernmental transfer system is a critical pillar of any fiscal federalism system.

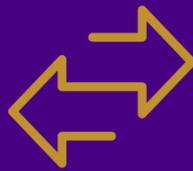


In addition to filling the vertical fiscal gap, it contributes to horizontal equity by equalizing fiscal capacities across subnational units.



Intergovernmental grants are also used to pursue various national objectives

- *such as achieving standards in the provision of public services, inducing policy harmonization across subnational units, and promoting economic efficiency and development.*



Transfers also play a risk-sharing function among subnational governments.

Subnational Governments' Reliance on Transfers



✓ State level governments finance most of their expenditures with their own revenues in some countries while they are heavily dependent on transfers in others,

✓ Figure shows Transfers received by states represent less than 20% of state governments' expenditures in Germany and Canada,

and less than 30% in Switzerland, Brazil, and the United States.

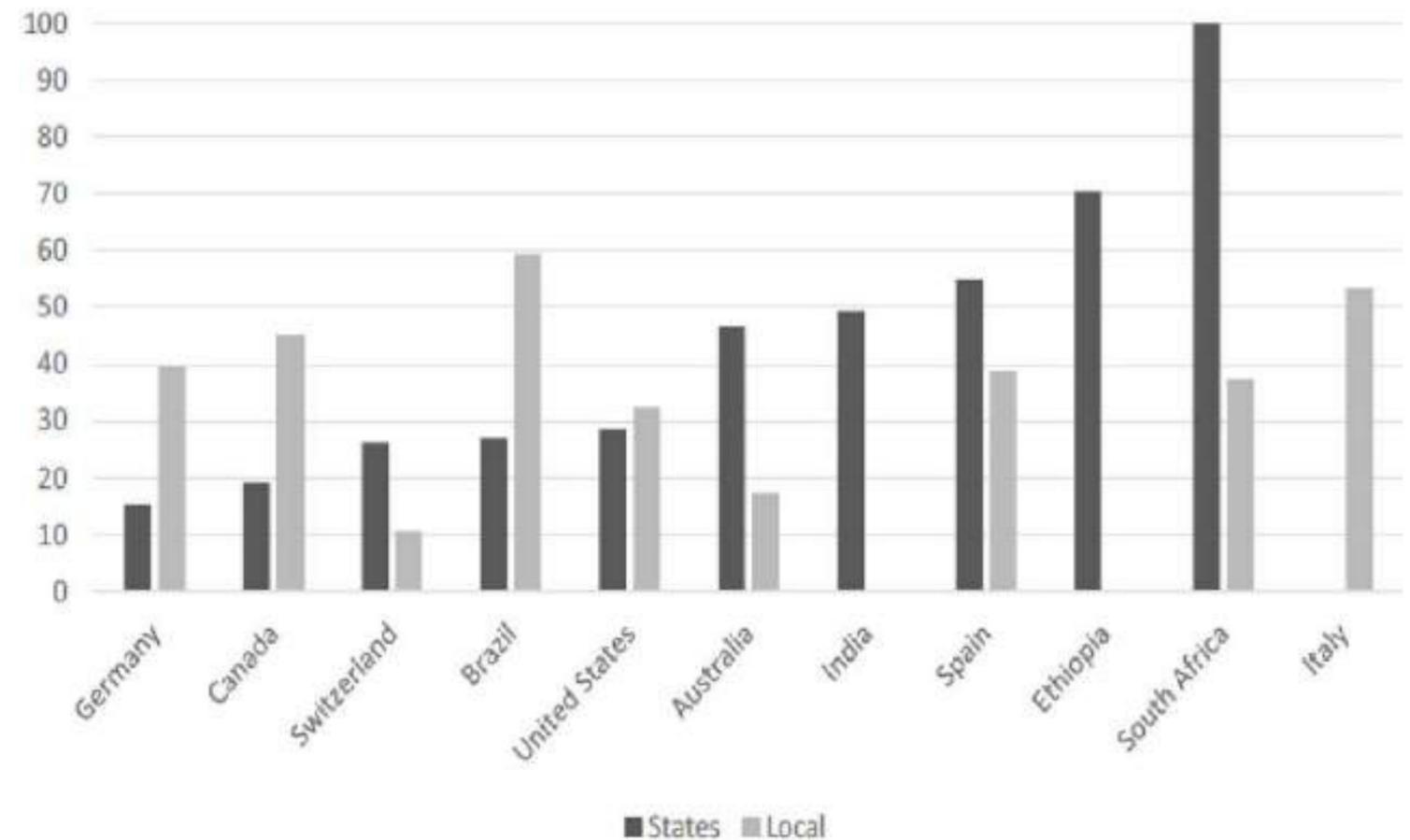
✓ In contrast, that proportion is around 70% in Ethiopia and close to 100% in South Africa.

✓ In some countries, local governments rely much more heavily on transfers than state-level governments.

That is the case in Germany, Canada, and Brazil.

The opposite holds in Switzerland, Australia, and South Africa.

Source: Tremblay (2023)



Transfers received by state and local governments as a percentage of their expenditures (%)

Decision-making Process for Transfer Systems and Advisory Fiscal Commissions



In some countries, the size and allocation of transfers are largely determined by the central government.

This is essentially the case in Switzerland

In other countries, subnational influence on the transfer system is achieved through subnational representation in national institutions.



Canada

In Canada, federal-provincial meetings sometimes lead to negotiated changes to the transfer system.

This provides opportunities for provinces to participate in the decision-making process, although achieving consensus is always difficult given competing provincial interests.



Germany

In Germany, Laender has some impact through representation in the Bundersrat, the upper house of parliament.

Decision-making Process for Transfer Systems and Advisory Fiscal Commissions

The House of Federation in Ethiopia has the power to review and approve budgetary measures of the national governments that impact states including intergovernmental transfers.

For instance, in South Africa, the Financial and Fiscal Commission, established by the Constitution, is responsible for making recommendations about the size and allocation of federal transfers to provincial and local governments.

- ***However, there is no obligation for the government to adopt them, and in practice, recommendations are not always adopted.***
- ***The Financial and Fiscal Commission is also consulted on matters of government borrowing and debt.***



But in contrast to the cases of India and Australia, advisory commissions are not always as influential.

In India, the Finance Commission provides recommendations about the vertical and horizontal distribution of revenues and its recommendations are usually adopted by the government.

In Australia, the Commonwealth Grants Commission is responsible for assessing the fiscal capacities and spending needs of states and its recommendations are usually adopted by the government.

Decision-making Process for Transfer Systems and Advisory Fiscal Commissions



Fiscal commissions sometimes play various roles with respect to fiscal monitoring and dispute resolution



In Spain, implementation issues and disputes about the revenue assignment system are referred to the Fiscal and Financial Policy Council

It is responsible for assessing the revenue assignment system and submitting reform recommendations to the National Parliament.



In Italy, the Permanent Conference for the Coordination of Public Finance provides advice regarding the equalization system and budgetary objectives

It also monitors the public finances of subnational governments to ensure compliance with budgetary objectives.

Challenges to Fiscal Federalism Systems

There are many common challenges to fiscal federalism systems.

A

A major problem of fiscal federalism system is achieving and maintaining fiscal balance, both vertically and horizontally.

For many of them, the vertical fiscal balance is currently threatened by the fiscal implications of demographic trends.



Challenges

B

Government functions that are most heavily impacted by these demographics are often largely performed by subnational governments.

This imposes great fiscal stress on subnational governments and tends to produce vertical fiscal imbalances.

C

In Canada, for example, expenditures of provincial governments on health care are growing much more rapidly than other public spending and than public sector revenues.

This is also the case in the United States where, in addition to public spending, underfunded pension systems are imposing severe fiscal pressure



Challenges to Fiscal Federalism Systems



Several other countries are facing similar issues, to varying degrees.

- ☑ Most countries are calling for greater revenue decentralization and subnational revenue autonomy, some with more success than others.
- ☑ At the same time, revenue decentralization tends to exacerbate the potential for horizontal fiscal imbalances.
- ☑ Concerns about maintaining horizontal fiscal balance are challenged in several countries.
- ☑ This has been a concern in Brazil, Ethiopia, India, South Africa, Spain, and even Nigeria





Challenges to Fiscal Federalism Systems



- ☑ There are strong pressures for disentangling some of the functions and tasks of different orders of government to improve effectiveness in the delivery of public services and promote accountability.

In recent times, this has been the case in Germany, Spain, Switzerland, South Africa, and Italy, for example.

- ☑ The lack of effective harmonization mechanisms can lead to tax competition,

This has arguably been the case in Switzerland.

- ☑ Limited harmonization of tax policies can also impede interregional trade patterns, this has been an issue with respect to value-added taxes in Brazil.

- ☑ There are also concerns about variations in the structures and rates of income taxes in the United States, Spain, and Canada.

Conclusion

Maintaining fiscal discipline is a difficult challenge in all federal systems.

- ☑ Designing fiscal arrangements leads to tensions between
 - *on the one hand, sharing fiscal risks across subnational governments and promoting horizontal fiscal balance,*
 - *and on the one hand, maintaining strong incentives for fiscal discipline.*
- ☑ The dramatic impacts of the COVID-19 pandemic and current global challenges on budgetary balances will only make this challenge more difficult. Meanwhile, it is important that at the sub-national level, we:
 - *Intensify training of government personnel across MDAs on driving performance and public service that encourage revenue mobilization*
 - *Establish an incentive management system to attract the informal sector to pay taxes.*
 - *Develop a sub-national register of MSMEs for appropriate incentivization.*
 - *Develop and implement electronic system to streamline the collection of local levies and charges.*
 - *Be more efficient in our revenue collection and spending.*

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Thank You