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From Elections to Appointments of the Regional Governors: Major Challenges and Outcomes

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In 2005 Russian Federation moved from the elections of the regional governor to their appointment by the federal center. The study analyzes the possible changes in the regional governments fiscal policy due to the change of the preferences aggregation mechanism at the regional level. It includes an overview of the existing theoretical and empirical studies, as well as international experience of the regional governments formation. The study also contains a theoretical and empirical analysis of the possible changes in the fiscal policy in Russia at the regional level as a result of the implemented reform.

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Introduction

Starting 2005, a transition from the election of the Heads (Governors) of the subjects of the Russian Federation by their communities to actual appointment of the Governors by Russia's President subject to the approval of the nominees by the regional Parliaments. This change has obviously led to a higher degree of centralization of the executive power. In this study we shall consider the key approaches to the analysis of possible implications of such designation of the Governors in terms of the regional financial policies to compare this new situation with that of the elected Governors.

The first part of the review describes main theoretical and empirical approaches towards modeling of the mechanisms of public selection and formation of preferences of the regional governments given preferences of their communities and the bureaucracy, etc. While in the second part a review of the major specifics and challenges in the organization of centralized and de-centralized relations between the federal center and the regions from the international perspective will be given; the main outcomes of the reform of the regional governments in Russia are described.

The results of modeling of the financial behavior of the regional governments after the transition to the Governors appointment are described in the third part. The fourth part contains findings of the empirical testing of certain hypothetical changes of the system of the formation of the regional governments in Russia.

1. Theoretical and Empirical Models of the Public Choice Mechanisms and Preference Aggregation at the Regional Level

A traditional theory of the fiscal federalism is actually a common normative analysis based on which the functions are rationally distributed between the governments of various levels and a selection of a set of fiscal instruments is made to implement these functions (see, e.g. *R. Musgrave, 1959; Oates, 1972*¹).

At a very high level this theory suggests that the main functions of the central government are: macroeconomic stabilization and re-distribution of revenues. On the other hand, in modern times when the majority of the states have open economics with floating exchange rates, the central governments possess but limited possibilities for macroeconomic stabilization. Besides, the mobility of economic subjects may reduce chances for redistribution of revenues between them. Considerable progressiveness of wealth taxation may lead to re-location of most profitable entities or the rich to other countries². The functions of the central government also include such public benefits like national defense provided to all the communities. At the same time some of the authors (See *Wrobel, 1998*³) note that if regional and local governments deal with revenue distribution, the redistributed revenues in most cases will be less than the optimal amount. This is explained, in part, by the competition between regions to win over wealthy individuals.

The fiscal decentralization in the countries with a multi-level structure means that the governments at the lower levels are given the power to establish and collect for their budgets the taxes and make expenditures

¹ Musgrave, R.M., 1959, *The Theory of Public Finance*, NY: McGraw-Hill; Oates, W.A., 1972, *Fiscal Federalism*, NY: Harcourt Brace Jovanovich.

² If regional and local authorities deal with revenue distribution, the redistributed revenues in most cases will be less than the optimal amount. This is explained, in part, by the competition between regions to win over wealthy individuals (See, e.g. *Wrobel, 1998*).

³ *Wrobel, 1998*.

based on their own decisions. The existence of several levels of administration of the production of public wealth is justified by geographical regions of various sizes affected by the implications of such production. These regions (zones) may not necessarily overlap in covering the national territory (like communes in France that provide different public services). This approach to segregate regions that provide public benefits to their communities sometimes gets complicated when one accounts for economy in scale effect.

Oates, 1972 showed that the combination of the above considerations with a theory of heterogenic preferences of the communities in different geographic regions tends to lead to the decentralization theorem which is based on the assumption that different groups of population have varying preferences, and the central government therefore is unable to identify these preferences and deliver public benefits according to the latter. Lower levels of government can provide public benefits within their local limited areas (region or municipality) and possess much larger opportunities for taking into account the preferences of the people covered by their jurisdictions. The optimal scope of public benefits is reached where the sum of marginal norms of replacement of private benefits with public benefits of all the individuals residing in a given region or municipality is equal to the marginal norm of conversion of private benefits to the public ones. Since people differ by regions, the set of public benefits and the optimal level of their provision will vary from region to region. Therefore to maximize the public wealth, the set of the public benefits provided in each region should match the preferences of the individuals living in each such region.

Thus the advantages of the fiscal decentralization stem from the easiness of identification and coordination of preferences of the small communities. According to the decentralization theory, in the absence of externalities and economy of scale, decentralization of budget-related decisions has been always preferable or, at least, equivalent to centralization. The more different are the preferences of the communities, and the least capable is the center to identify communities' priorities in the area of financial policy, the larger may be the wins from the fiscal decentralization

and the least attractive will be the principle of appointing Governors that reflects the preferences of the central authorities.

With considerable external factors in place, the provision of public benefits in the regions and more specific advantages may lead to the situation where the central government finds expedient to set some of the mandatory levels of provision of public benefits in the areas of health-care, education, infrastructure, etc. This, however, presupposes certain limitations off the rights of the regions to sustain their own financial policy and remain decentralized. Simultaneously this speaks in favor of the need to build up the system of rendering financial assistance to the poor regions.

There is an important factor impeding obtaining benefits from decentralization the mobility of tax bases may lead to emergence of tax competition between the regions. As a result taxpayers become free riders paying taxes in one region while benefiting from public services in another. Unification (harmonization) of taxation in the regions together with provision of financial assistance by the central government may stop this practice.

Differentiation in the economic situations of the regions given fiscal decentralization may emerge not only as a result of unfair tax competition but also due to attracting of rich taxpayers by more wealthy regions. The economic inequality between the regions unacceptable according to the social considerations may be enhanced thus creating obstacles on the way of economic growth. This process may become self-supported.

Revenue decentralization due to complexities of financial interaction between the governments of various levels may adversely affect the government in performing the function of stabilization, moreover, in case of external shocks.

There is a possibility for the elected regional government not to reflect the regional preferences due to various reasons. The exposure of the regional and local governments to the influence of the groups with specific interests may be much higher vs the central government while the counter actions less developed (though one can assume that a small community can exercise more effective control over red-tape). Regional governments

may also consist of less qualified officers than the central one. These factors in general speak against a high degree of decentralization.

However, if a country has a high mobility of its citizens, financial decentralization will trigger the mechanism of “voting by feet”, thus allowing individuals to implement their rights to have their preferences considered in making financial decisions (Tiebout, 1956⁴). Interregional migration helps the citizens to choose a region with a maximum level of provision of private and public benefits to the best of their preferences. This creates competition among the regions to win taxpayers over; and the regional governments are faced with the need to make their financial policies compliant with the regional preferences.

The Governor appointed by the central government may not reflect the preferences of a specific community; therefore in the absence of electivity principle the Tiebout idea of the possible achievement of effective equilibrium in the public benefits delivery where there is a sufficient number of communities and the opportunity for the customers to elect the best suitable community for living may not be realized. In addition to the known factors that run contrary to the distribution of resources in the Tiebout scheme (see below: market inefficiencies, inequality, externalities, mandatory goods), if all the regions had equal preferences this would interfere with the selection by the individuals of the communities best suited for them in terms of public benefits.

Decentralization of finance as a result of emerging competition among the center and the regions adds up to the slow down of the public sector growth (Brennan, Buchanan, 1980). Horizontal and vertical competition between various governments may work against the “Leviathan” hypothesis. In a number of works it is stated that such competition counteracts confiscation trends in the economic policy (Veingast, 1995; Oates, Schwab, 1998; Sinelnikov, 1997).

The briefly enumerated aspects to be taken into consideration in studying the rational degree of fiscal decentralization create a link between such degree and the level of development of the respective public institutions: it is recommended to decentralize finances as much as one

⁴ Tiebout, C.M., 1956, A Pure Theory of Local Government Expenditures. *Journal of Political Economy* 64: 416–424.

can given the ability of the local and regional governments (as a limitation) to effectively perform their functions including that of matching their policies with the preferences of the local/regional communities (Oates, 1972⁵).

In the section below the relations will be analyzed between common problems of decentralization of the authorities that establish closer links between the decisions regarding production and control over the production of public welfare for separate communities and appointment of the Governors who reflect the preferences of the central government. By comparing the regional administration systems based on electivity principle we assume that the elected Governors reflect the regional preferences while the appointed Governors reflect the preferences of the central government. We will also consider possible options where the Governors deviate from their policies designated to maximize welfare of the population in their regions towards the interests of the bureaucracy, as well as the options where the Governors' behavior after they have been elected (in case of the election system) becomes different from the pre-election declared preferences. In the section below we consider possible approaches to the analysis of pluses and minuses of the centralized provision of public benefits from the viewpoint of several basic directions of modeling: decentralization theorem, Tiebout hypothesis and also classic theoretical models of the public sector.

1.1. Specific Features of Provision of Public Goods at the Regional and Local Levels

The majority of analysts engaged in studies of the public sector (see *Inman Review*, 1987) establish that the minimal functions of the government are: protection of property rights and redistribution of resources in the economy. Speaking of the protection of property rights, these authors generally understand this protection as national protection from external attacks and legislation compliance assurance. A forced distribution of resources occurs where the market fails to ensure the required level of public services. Distribution also means redistribution of revenues to en-

⁵ Oates, W.A., 1972, *Fiscal Federalism*, NY: Harcourt Brace Jovanovich.

sure social security and giving support to low-income groups of population, to relieve social tension created due to a high differentiation of individual incomes, etc.

In addition to the minimal functions required for the state sustainable performance, the government is assigned some other functions such as: provision of public goods, minimization of the negative effects of externalities, incomplete information and unemployment. It was shown (*Samuelson, 1954*) that there is a class of goods and services (public benefits/goods) that can not be effectively provided by private channels. To reach the public best, these benefits should be provided at the level where the total of marginal benefits from their consumption for all the consumers is equal to marginal costs of their provision. If all these benefits were privately consumed, their consumption would be at the level below the optimum since if a consumer needs to buy additional quantity of public goods at the fixed volume paid for by other consumers, our consumer will elect to consume public good at the level where its marginal value equals marginal costs for provision of this good, in other words, it will be lower compared to the optimal amount of public benefits.

This statement, as we will demonstrate later, was questioned by Tiebout (*Tiebout, 1954*) who showed that if there is a competition between the governments offering various sets of different public benefits at various prices (e.g. several regions or municipalities) the consumer elects to take the set of public benefits (and the respective region) that will maximize his/her wellbeing; this is how the public best satisfaction is ensured. This model, however, works only where the number of communities is quite large to assure selection of various sets of public goods; the number of individuals in each such community should be relatively small compared to the entire population of the given country.

Demsetz (*Demsetz, 1970*) proposed another option of effective provision of public benefits. If there is a certain number (N) of equal individuals in the economy, then knowing how much of the benefit each individual will consume if he/she is allowed to choose the amount of this benefit, this benefit could be provided by N times more and sold at $1/N$ price of the production costs. In practice the situation becomes more compli-

cated since individuals have different preferences, and this mechanism ensures reaching the public optimum.

As with pure public goods, the existence of externalities makes private provision of public goods ineffective since the private decision of one individual on the consumption of a public good having externalities affects other individuals while this impact is not accounted for in the decision-making process. Thus it seems logical to shift the provision of public goods that have considerable externalities to the central government that in taking decisions regarding the scope of the provided public goods will account for the interests of all the consumers.

Since sellers and buyers at the market do not have access to comprehensive information, various effects may occur related to opportunistic behavior and unfavorable choices. Thus, e.g., where the consumers lack information about the quality of purchased goods, the risk to buy substandard goods pushes the buyer's price down, and therefore the sellers of quality goods have to leave the market while the sellers of bad goods remain.

This problem may be resolved within the market framework, by the formation and protection of the sellers' reputation and application of qualification requirements (membership in professional associations, voluntary or mandatory certification, etc.). On the other hand, provision of additional information on the quality of goods or services always brings in extra costs for either the seller or the buyer. These costs upset the Pareto-optimal balance. To minimize these costs, the majority of the national governments establish mandatory certification procedures of all goods and services which is in essence a pure public welfare. As we see, market mechanisms fail to assure the Pareto-optimal balance in certain cases. It is the state that in case of a market failure ensures the protection of property rights, effective distribution of resources and provision of public goods.

In the section below we are going to address in more detail the problems arising in the context of the centralized and decentralized provision of public goods in a country with a multi-layer structure of administration.

1.1.1. Effectiveness of Differentiation of Public Benefits by Regions; Decentralization Theorem

The theorem of decentralization is one of the most significant outcomes of the fiscal federalism theory and the analysis of public goods provision by various governments (Oates, 1972⁶). According to this theorem, any public benefit provided to a geographical subpopulation of individuals will be more effective (or at least not less effective) if supplied locally vs the federal level provided the costs of provision do not depend on the level of government that offers this benefit to the public.

To prove the theorem (see also Oates, 1998⁷), one should stem from the assumption that the individual preferences of those living in different regions may vary. If the regional or local governments are going to provide these public benefits according to the individual preferences, it will promote the growth of wellbeing of the people as compared to the provision of a unified set of benefits supplied by the federal government.

The main concept is that the federal government may provide only the equal set of public goods for all the regions. In the context of perfect public awareness, we can assume that there may be such a national leader who by knowing and accounting for the preferences of each and all the citizens is capable of providing the best amount and set of public goods in each region and municipality of his realm. If this possibility were implemented, there would be no need for decentralization at all. In reality, however, with incomplete and skewed information across the country, the regional and local governments happen to have much greater degree of awareness about the preferences of their communities, the costs of provision and, therefore, the best composition of the public goods.

There are also political constraints of the public goods differentiation. The point is that the centralized provision of public goods at different levels of government and in various regions runs contrary to the constitutional guarantees of the uniform nation-wide level of life. With the centralized power, this helps to equalize the level of public goods provided by regions. In other words, if the Governors are appointed from the cen-

⁶ Oates, W.A., 1972, *Fiscal Federalism*, NY: Harcourt Brace Jovanovich.

⁷ Oates, W.A., 1998, *On the Welfare Gains from Fiscal Decentralization*, U. Maryland Econ. Dept. WP 98-05.

ter, they are likely to provide a more or less uniform set of public benefits, thus reducing the general level of wellbeing. Unlike this situation, with the electivity principle in play, the Governors will take much more efforts to win their electorates over and try to supply them the set of public goods that would maximize the value/usefulness of the regional residents (a regional median elector).

The gains from fiscal decentralization depend on how wide is the range of consumers' preferences and also on the extent the costs of the provision of public goods vary among the regions⁸. Empirical estimates of such welfare gains from decentralization (see *Rubinfeld, 1987*⁹; *Oates, 1996*¹⁰) demonstrate that a potential gain may be quite large (*Bradford, Oates, 1974*¹¹), in other words, bringing closer the levels of provision of public goods regionally may potentially reduce welfare of the population if the regional Governors are appointed.

The decentralization concept was established under assumption that the regions enjoy large authorities in choosing their fiscal policies. If this is not so, the gains from decentralization may not be fully assured. In particular, the above mentioned Samuelson's requirement of the optimal volume of public goods will not be met (it is met when the marginal gains from consumption of the public goods equal marginal costs of their provision).

Similar situations are analyzed by Krellove (*Krellove, 1990*) who considers problems of regional governments that have constraints to apply certain fiscal instruments; e.g. they are not entitled to set various tax rates

⁸ In particular, Oates (*Oates, 1998*) showed that the potential gain from decentralization due to inter-regional differences in public goods demand is in inverse proportion to the demand elasticity in terms of price.

⁹ Rubinfeld, D.R., 1987, The Economics of the Local Public Sector, in *Handbook of Public Economics*, Vol. II Alan Auerbach and Martin Feldstein, eds. Amsterdam: North-Holland.

¹⁰ Oates, W.A., 1996, Estimating the Demand for Public Goods: The Collective Choice and Contingent Valuation Approaches, in *The Contingent Valuation of Environmental Resources*. D. Bjornstad and J. Kahn, eds. Aldershot: Edward Elgar.

¹¹ Bradford, D.F., Oates W.A., 1974, Suburban Exploration of Central Cities and Governmental Structure, in *Redistribution Trough Public Choice*. Harold Hochman and George Peterson, eds. NY: Columbia U. Press.

for various tax bases. In this paper we consider the economy consisting of several regions. This model assumes that labor (of absolute mobility) is the major production factor while land generates rental income. The regional governments by setting a single tax rate on rental and labor income and ensuring value of the individuals at a certain level tend to maximize rental generated by landowners. Due to limitations of using financial instruments the sum of marginal replacement rates is lower than the marginal transformation rates (the Samuelson's requirement is not met). The local governments are unable to realize their intent of encouraging the inflow of labor hands at the expense of reduced rates on labor income.

Thus the executive governments at the regional and local levels are more aware of the local preferences than the federal government. Where these governments are elected by their communities and not appointed, they have more incentives to reflect the preferences of their electorates. With the appointment of the executive authorities at the sub-national level a situation may develop where these authorities in building up their policies would tend to adhere to the federal preferences ignoring the local ones. Therefore sustainable decentralization may facilitate the increase of public welfare provided the sub-national governments are allowed to keep certain flexibility of their fiscal policy instruments.

1.1.2. Limited Provision of Public Benefits Sub-Nationally; Optimum Size of the Region

Unlike public goods provided to all individuals of a federal state (e.g. national defense), in case of public goods provided within the areas of sub-national units an effect of the impact of the optimum size of the region on public wellbeing may occur. The implications of this effect can be demonstrated in that the changes in regional configurations will affect public wellbeing, this, in turn, can serve as a pretext for the central government to interfere into the regional affairs.

Some public goods regionally provided may have considerable externalities. Thus the unification of the regions that are affected by externalities of a certain public good will increase wellbeing. A situation may be created when such associations of sub-national formations established for supplying different public goods are remarkably different from each other.

The specifics of public goods provision in such situations are considered by club models (the base model is described in (Buchanan, 1965¹²). In analyzing such models for simulation of public goods provision, a number of simplifying assumptions is used such as the reduction of per capita expenditures for providing public goods as a function of growth of the number of consumers, the absence of mobility of population, lack of funds for public governance, etc.

Oates, 1972¹³ looks into the law enforcing activity that may be organized by the regional governments as a public benefit or by the people themselves. The law enforcement as a public benefit brings about the economy of scale, in other words, the more people reside in the given region, the lower are per capita expenditures. On Fig. 1.1 these per capita expenditures are shown by *OC* curve.

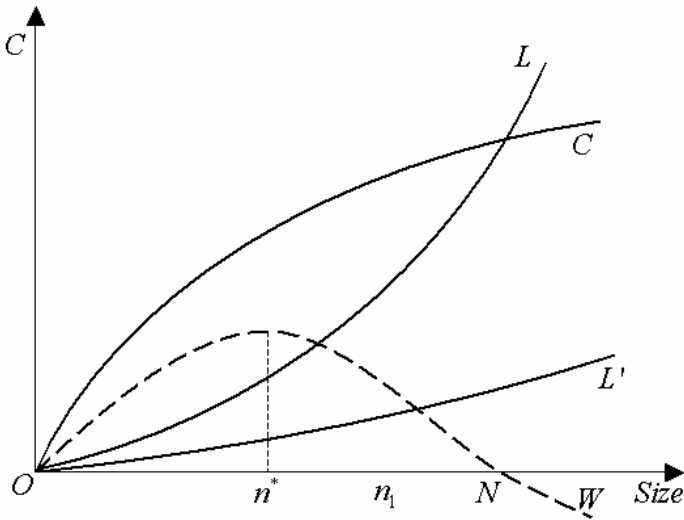


Fig. 1.1

¹² Buchanan, J., 1965, An Economic Theory of Clubs, *Economica* 32, 1–14.

¹³ Oates, W.A., 1972, *Fiscal Federalism*, NY: Harcourt Brace Jovanovich.

This *OC* curve demonstrates a conventional increase of wellbeing of each next individual who comes to live in the region thus reflecting the overall increase of the wellbeing every time this particular individual buys some additional public good he/she needs at lower price. In reality each person is hardly able to choose the amount of public goods he/she needs therefore the actual growth of wellbeing is lower. The increasing loss of wellbeing due to ever larger discrepancy between the desired and actual volume of the provided public goods following the growth of the population in the given community is described by *OL* curve. Thus the optimum size of the region with the growing population is defined by the growth of wellbeing as a result of public goods provision, on the one hand, while on the other hand, by the decreasing wellbeing due to the growing gap between the desired and actual provision of public goods according to the local preferences.

Another factor of the optimum size of the region (see, e.g. *Stiglitz, 1977*¹⁴) may be the falling labor productivity resulting from the population growth in the region:

$$Y = f(N), \text{ где } f'(N) > 0, f''(N) < 0, \quad (1)$$

where Y is overall production volume that may be used for private consumption, (X – per capita consumption) and as a public good G

$$Y = XN + G = f(N). \quad (2)$$

The solution of the task to maximize public welfare is the condition of the first order (equal to that of Samuelson):

$$\sum MRS = MRT, \quad (3)$$

which can be written down for this task as follows:

¹⁴ Stiglitz, J.E., 1977, The Theory of Local Public Goods, in *The Economics of Public services*. M. Feldstein and R. Inman, eds., NY: MacMillan.

$$G = f(N) - N \cdot f'(N) \quad (4)$$

Since $f'(N)$ is a marginal product of labor, $f(N) - N \cdot f'(N)$ is the volume of production less wage expenses if the workers are paid marginal product of their labor. Thus, if the level of government expenditures is fixed and the population number is a variable, then the number of population maximizing per capita consumption will be such as to keep rental (profit) generated in this region matching the costs of the public goods¹⁵. This assertion is known as Henry George theorem¹⁶.

There are various extensions of the club models, in particular, for the case of optimum club size with congestion. For the model to reflect the possibility of consumption exceeding the optimum level or competitiveness of consumption, Henderson (*Henderson, 1979*)¹⁷ considers a function of costs of public goods provision $C(N)$, where $C'(N) = 0$ (net public goods), $C'(N) > 0$ (public goods with some features of private goods such as competitive consumption).

Rubinfeld (*Rubinfeld, 1987*)¹⁸ while studying the club task with competition in consumption assumes that the consumer buys services of the utility sector in the amount of H at the exogenous price p . Individuals resolve the following task of optimization where Y is exogenous income:

$$\max U(X, H, G) \quad (5)$$

¹⁵ In his work *Rubinfeld, 1981* shows that in the above relatively simple model at certain ratios of production function and the function of usefulness of consumers some border solutions are possible: $X = 0$ and $G = 0$.

¹⁶ "Optimum quantity of public goods will be the quantity that maximizes rental value of land and is paid for from this rental". Henry George in 1879 came up with a theory that the land rent is a most efficient source of public goods. George, Henry. 1879 [1975]. *Progress and Poverty*. New York: Robert Schalkenbach.

¹⁷ Henderson, J.V., 1979, Theories of Group, Jurisdiction, and City Size, in: P. Mieszkowski and M. Straszheim, eds., *Current Issues in Urban Economics*. The John Hopkins University Press, Baltimore.

¹⁸ Rubinfeld, D.R., 1987, The Economics of the Local Public Sector, in *Handbook of Public Economics*, Vol. II Alan Auerbach and Martin Feldstein, eds. Amsterdam: North-Holland.

$$\text{with constraint: } X = Y - pH - [C(N)/N]G. \quad (6)$$

First-order conditions for this task may be presented as follows:

$$N[(\partial U / \partial G) / (\partial U / \partial X)] = C'(N) \quad (7)$$

$$[(\partial U / \partial H) / (\partial U / \partial X)] = p. \quad (8)$$

The first condition of the first order (7) is an equality of sums of the marginal rates of replacement of private consumption by public goods and the marginal rate of conversion of private to public good. The second condition of the first-order (8) reflects Samuelson equation for the supplied public good.

As a result of the solution of the individual task with the number of people and fixed amount of public goods we get the following condition of the optimum:

$$C'(N) = C(N) / N, \quad (9)$$

where the optimum size of the region is determined by a point where the average value of the public good equals the marginal cost of the public good provision. Under standard assumptions of the U -curve of costs this point shows minimal average costs of the public good provision.

As shown by such models, the regional governments regulating the population of their communities and the amounts of public goods in order to cut down costs may increase the “entry” price of migration to their regions for new comers. If to assume that all the people in the country have equal incomes and similar preferences, then the country would be divided into identical regions of one size with a minimal cost of the public goods

provision; and, as shown by Henderson¹⁹, this equilibrium will be stable and effective.

The size of the region affects the standards of life of the local population. According to the above approach, one should find the optimum size of the region to ensure maximum value of public goods. In addition, the size of the region, among other factors, affects distribution of production among several regions.

Thus Nicoud in his work (*Nicoud, Sbergami, 2002*) investigates the problem of an industrial agglomeration in the region pursuant to a certain policy of the regional government. There are two regions in the model: one is rural with scarce population, while the other is urban and more densely populated. The production function consists of two factors (mobile capital and immobile labor resources) and there are two goods manufactured: the first non-homogenous good is manufactured by a monopoly bearing huge transportation costs; the second good is homogenous, and produced in the context of perfect competition. The government can subsidize both productions by leveling rate of return, and as the transportation of the first good is costly the regional governments try to attract into the region as many companies as possible to bring down the price of the good for the locals.

The model demonstrates that in case of no subsidies and with a demand for sizable investments to concentrate production in the underpopulated region, all the producing facilities will be focused in the densely populated region. This “population effect” may be explained by the fact that labor is one of the production factors, and the companies are competing for it. To make production equal in both regions, it is necessary that the government provide positive subsidies to the rural region. The “population effect” is pretty strong in the sense that the concentration of production is elastic depending on population, and this elasticity grows following the growth of the population in the urban region. Within this model one can show how the production concentration changes as a function of change of trade liberalization (costs borne in relation to transporta-

¹⁹ Henderson, J.V., 1979, Theories of Group, Jurisdiction, and City Size, in: P. Mieszkowski and M. Straszheim, eds., *Current Issues in Urban Economics*. The John Hopkins University Press, Baltimore.

tion of goods from one region to the other). Let $\tau^{1-\delta}$ represent the free trade, τ – transportation costs for the first good $\delta > 1$ – replacement elasticity inside the set of the first good; then we can show that in the absence of subsidies and with restricted freedom of trade ($\tau^{1-\delta} < 0.5$) the concentration of companies will increase in the urban region provided trade is liberal. In case of the regional policy open for subsidies from the central government, the results will be somewhat different.

Let $\bar{\theta}$ be such level of subsidies where all companies are located in the rural region, $\underline{\theta}$ is such level of subsidies where all the production facilities will be moved to the urban region. Then, in order to concentrate all production in the rural region the companies of this region should receive positive subsidies. Subsidizing of the urban region companies is not obligatory; moreover, certain negative subsidies (or taxes) may be allowed due to the “population effect”. This effect, as mentioned above, is related to the labor offer which is greater in the urban region, therefore the companies striving to receive higher rate of return on their investments will re-locate their facilities into the urban region. The government in its desire to level the size of rental income will allocate subsidies to the rural region to de-centralize production in the city.

Secondly, for any positive subsidies allocated to the rural area we can show that if the level of trade liberalization changes, the production facilities will be moved to another region. With a relatively low level of trade liberalization the production facilities will be centered in both regions. However, if the trade liberalization goes up to a certain level – $\tau^{1-\delta} < 0.5$, all the production facilities will migrate to the urban region. With any further liberalization the “population effect” will tend to become weaker vs the subsidies effect, and time will come when the production facilities will escape the urban region; moreover, when liberalization comes to a higher level, all the production will be centered in the rural area. With growing share of population in the urban region the “population effect” becomes stronger, and in order to keep the production in the rural region large subsidies to the rural area will be required.

Now let us consider the superposition of such factor as electivity of the regional Governor on the model of production distribution by regions.

Let us assume that the regional policy is determined as a result of elections of one of the candidates to the Parliament, and each of the candidates offers some subsidies for the companies. The local residents in electing the candidate take into account the political mottos of the parties of those candidates; the political preferences in each region are dispersed.

The key factors affecting the concentration of production in the regions are: the urban/rural population ratio (λ) and the ratio of dispersion of political preferences of the urban population (relative political power)/dispersion of the political preferences of the rural population (m). Also we can show that the share of urban production is decreasing with the increasing dispersion ratio; all other things being equal, the region with more homogenous political views will find itself in a more favorable position.

The author points out that this effect is often seen in real life since politics does not reflect the preferences of a median elector; the real politics is biased in favor of certain groups of population (group of interests) that are powerful in lobbying and tend to have more or less homogenous preferences. In the course of the study we found out that it is the ratio of population sizes and relative political power of the regions – λ/m that is the key driver of the production concentration. This ratio shows the correlation between the number of electors who are indifferent to both candidates, therefore one can expect that the region for which $\lambda/m > 1$ will be more beneficial. This means that the urban region in order to become more attractive for producers should compensate for the bigger political weight of the rural region.

The model suggests that under our assumptions the equal subsidies to the rural region tend to increase with the growing political power of the rural region since the candidates strive to attract more “indifferent” electors to their side, and these indifferent electors are greater in number where the preferences are less dispersed. Regardless of the political and economic strength of the regions, if trade becomes more liberal, then eventually the production will be focused in one region only, and this region will not be necessarily the most populated; it looks like the political and economic strength of the regions is a decisive factor.

Thus we may conclude that in our models the size of a region or a municipality should be determined, primarily, by the optimal provision of the regional and municipal public goods. As a result there may be a general gain of higher efficiency due to the economy of scale factor (in this case the cooperation between the regions is profitable for all of them) but also a loss of efficiency due to irrational distribution of production facilities between the regions (in this case to increase welfare the federal government should interfere).

*1.1.3. Local Public Goods Provided
by Sub-National Governments*

One of the key problems in the public sector theory is how to identify preferences. Each individual tends to reduce the value of consumption of public goods by believing that if due to the reduced value he/she will reduce his/her input in financing the public goods the amount of the provided public good is not going to change much. Under this assumption the level of taxation and provision of public goods may be lower than the public optimum. Tiebout (1956)²⁰ showed that this problem in certain circumstances may become very “hot” for the central government only but not for the regional and local governments. He analyzed the model of economy made of a number of regions offering various sets of public goods and the respective levels of taxation required for their funding.

In the Tiebout model the consumer-electtor chooses a region for living so that he/she could maximize his/her own value based on the preferences regarding public goods at the set tax prices. By moving to the chosen region the consumer-electtor is “feet-voting” as was shown by Tiebout in his work; eventually this process results in the effective distribution of resources.

At the first glance this Tiebout model is extremely attractive: it does not contain highly restrictive assumptions and resolves the challenge of identification of preferences. However, Oates (Oates, 1972)²¹ demon-

²⁰ Tiebout, C.M., 1956, A Pure Theory of Local Government Expenditures. *Journal of Political Economy* 64: 416–424.

²¹ Oates, W.A., 1972, *Fiscal Federalism*, NY: Harcourt Brace Jovanovich.

strated that the model assumptions are hardly met in the real life. The discussion of this model is given also in the work of *Pestiaeu, 1977*²².

Now let us review the Tiebout model in more detail. We assume that the economy consists of J non-crossing regions, $j = 1, \dots, J$, each of which offers its own set of public goods and taxes. The economy has a total set of S public goods, $s = 1, \dots, S$. The amount of a public good s offered in region j is shown as b_s^j . The tax amount in region j is a_0^j . The public goods do not affect other regions, i.e. no externalities are found (A1)²³.

There is an I number of consumers in the model, $i = 1, \dots, I$. Each consumer has an income of \bar{x}_0^i to be spent on paying taxes or private consumption; the consumer's income does not depend on the region where he/she resides (A2). The consumers' preferences can be described by the following quasi-concave function:

$$u^i(\bar{x}_0^i - x_0^i, x_1^i, \dots, x_s^i, \dots, x_S^i), \text{ где } i = 1, \dots, I \quad (10)$$

where x_0^i is total amount of taxes paid by the consumer; x_s^i is the volume of consumption of the public good s .

Each consumer can freely migrate from one region to another (A3). The time spent in the region j is represented by θ_{ij} , where $\sum_j \theta_{ij} = 1$.

The consumer is aware of the public good sets offered by all the regions (A4). Thus the consumer selects the place of residence in each moment of time so as to maximize his/her value from the consumption of the public goods.

$$x_0^i = \sum_j \theta_{ij} a_0^j, \quad i = 1, \dots, I \quad (11)$$

²² *Pestiaeu, 1977*.

²³ Capital letters «A» with the respective numbers denominate key assumptions used in the model building.

$$x_s^i = \sum_j \theta_{ij} b_s^j, \quad i = 1, \dots, I \quad (12)$$

The model suggests that the public goods offered by the regions are not net public goods, i.e. the cost of provision of each such public good increases in proportion to the number of residents in the region (A5). Besides, it is assumed that the structure of the public goods remains constant, in other words, with the growth of tax revenues in a region the amount of each public good in this region also increases in proportion to the revenue growth (A6):

$$(b_1^j, \dots, b_s^j) = a_0^j (\bar{b}_1^j, \dots, \bar{b}_s^j), \quad j = 1, \dots, J. \quad (13)$$

The consumer task is to maximize the following Lagrangian:

$$\sum_i \lambda^i u^i (\bar{x}_0^i - x_0^i, \sum_j \theta_{ij} \bar{b}_1^j a_0^j, \dots, \sum_j \theta_{ij} \bar{b}_s^j a_0^j) + \beta \sum_i (x_0^i - \sum_j \theta_{ij} a_0^j). \quad (14)$$

In an economy where the consumers are allowed to migrate freely between the regions and select the best set of the public goods, a pareto-optimal equilibrium is reached with the maximum welfare of the consumers ever possible under the established set of the public goods offered by the regions.

In building a simplified Tiebout model the assumptions were used similar to those in the classical Tiebout work (*Tiebout, 1956*²⁴) except the assumption A5 which was absent in the classical work. Besides, the initial model proposed that the consumer chooses only once the region that fits best his/her demand for the public goods from a large number of regions. The number of regions where sets of the public goods considerably vary may be more than the number of the consumers. *Pestiaeu, 1977*²⁵ in his work assumed that the number of regions is limited, and the consumer is able to move from one region to another several times using compara-

²⁴ Tiebout, C.M., 1956, A Pure Theory of Local Government Expenditures. *Journal of Political Economy* 64: 416–424.

²⁵ *Pestiaeu, 1977.*

ble benefits (like geographical location, set of the public goods, etc.) of each region and selecting the best set of the public goods.

Following the work by *Pestiaeu, 1977*, let us see how the conclusions of the Tiebout “feet-voting” model change if to delete each of the assumptions used in the model building.

A1: No externalities

Let us assume that a certain public good has considerable externalities. Then the consumer can live in a region adjacent to the region that provides the public good with considerable positive externalities and receive value from that good, not paying any taxes. Therefore no effective distribution of resources is achieved in this case. This problem may be resolved by using centralized distribution of public goods with greater externalities or by using inter-regional grants that would be a payment for the consumption of the public good in question offered by the neighboring region.

A2: No geographic limits of consumers' incomes

Tiebout in his model assumed that all the consumers live on the dividend income; this helped him to go away from the income dependency on the consumer location. If to weaken this assumption, the model would have to consider not only the tasks of the optimal selection of a set of the public goods but also the task of income maximization. Income maximization would deprive the model from its key advantage which is the identification of preferences. This problem was resolved by *Buchanan and Goetz, 1972*²⁶, who considered the Tiebout model not as a choice among the regions but rather a choice among the clubs. In other words, the consumer selects not a region but a club which offers the consumer the respective set of the public goods regardless of the consumer location. Such development of the model is an extremely strong extension of the basic model and, as a rule, it is not discussed further.

A3: Complete mobility of the population

The introduction into the model of costs and other different restrictions regarding moves from one region to another (this often happens in reality) leads to a stable equilibrium with ineffective distribution of re-

²⁶ Buchanan, J.M., Goetz, C.J., 1972, Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model. *Journal of Public Economics* 1: 25–43.

sources. Tiebout in his model assumes that there is an infinite number of regions with varying sets of the public goods and the consumer, therefore, can choose a region for himself/herself to maximize his/her welfare. The probability of coming to this beneficial region initially is being reduced, however, with respect to the growing number of regions, while the consumer may not have a possibility to move to another region due to the absence of mobility. Some authors suggest the regions should change independently the sets of public goods; however, this does not fully correspond to the basic Tiebout model where the consumers are entitled to make their choices.

A4: Complete information

The model assumes the availability of complete information about all the sets of the public goods and taxes in all the regions; where such information is not available, the “feet voting” does not bring about the pareto-optimal equilibrium.

A5: Equal revenues and expenditures in the regional budgets

According to this model the growth of provision of public goods in a region must go side by side with the increase of taxes, and the growing taxes increase the aggregate provision of public goods for the same amount; therefore if a new consumer moves into this region this does not change the tax price of the public goods.

This assumption allows us not to review two additional aspects of the theory of the local public goods (see *Buchanan, Wagner, 1970*²⁷). On the one hand, in case of a net public good the cost of its provision is flat and does not depend on the consumption volume. Therefore, with every new consumer arriving to the region the tax price of the public goods offered in the given region will go down for all the regional residents; on the contrary, when a consumer leaves the region, the tax price for all the consumers residing in this region will go up. On the other hand, if we start analyzing the expulsion in the process of consumption of public goods (competition in consumption) it will result in that the relocation of each new individual into the region would increase the tax price for all the consumers living in this region by more than on a pro rata basis. To ad-

²⁷ Buchanan, J.M., Wagner, R.E., 1970, An Efficiency Basis for Federal Fiscal Equalization. In *The Analysis of Public Output*, Margolis, ed. New York: NBER.

dress this problem, *Buchanan and Goetz, 1972*²⁸) proposed to create such a system of taxation for the coming migrants and subsidies for the permanent residents that will neutralize these effects. A similar solution was proposed by Flatters (*Flatters et al., 1974*²⁹), who suggested that a system of inter-regional grants be used for this purpose.

A6: Fixed structure of the provided public goods

In the model the set of the offered public goods is fixed in each region; this means that whenever a new person moves to the given region the set does not change. The weakening of this assumption would have led to two complications. First, the solution of the task in this case would require additional assumptions about the change of the set of public goods by regions. Second, if to assume heterogeneity of preferences in the given region, then the rule of the public choice such as the rule of the simple majority would not necessarily lead to the optimal balance.

The analysis of the specific features of the provision of public goods sub-nationally in the context of comparison of the election and appointment of the Governors has shown the following. Within the framework of the given model and the optimal equilibrium in various regions different sets of public goods will be provided among which a citizen will be able to select the best one. In case of electivity, this may be manifested in the form of support by the community to the Governor who elects to keep the preferable set of public goods unchanged. Where the federal government appoints Governors, it is the center that elects the set of public goods for all the regions, and then every person decided in which region he/she is going to live.

If to assume, however, that in the transition from the election to the appointment of the Governors the levels of provision of regional public goods will start being brought closer, then the chances to select the optimal set of the public goods by moving to another region will be strongly diminished. In other words, within the framework of our task the unification of the set and amount of the regional public goods at the phase of

²⁸ Buchanan, J.M., Goetz, C.J., 1972, Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model. *Journal of Public Economics* 1: 25–43.

²⁹ Flatters, F., Henderson, V., Mieszkowski, P., 1974, Public Goods: Efficiency and Regional Fiscal Equalization. *Journal of Public Economics* 3: 99–113.

transition is going to deprive the people of the opportunity to improve their welfare by choosing the region where the set of the benefits meets their preferences most adequately.

1.1.4. The Problem of Interregional Externalities Emerging in Public Goods Provision at the Sub-National Level

In the models considered above it was assumed, implicitly or explicitly, that the gains and costs related to the provision of public goods did not cross the boundaries of a region or a club, or in other words, the absence of externalities was assumed (the condition A1 of the Tiebout model). In reality, however, this assumption is not complied with, and the individuals very often may receive education in one region and work in another.

In general, when building models and optimizing public welfare an assumption is used in assessment of benefits and costs from the provision of public goods that the residents of the given region bear all the costs associated with the provision of public goods in this region and they also receive all the gains thereof (see *Oates, 1972*³⁰). Otherwise in order to avoid ineffective distribution of resources that arise in connection with externalities, public goods with high externalities should be reasonably provided by the central government.

Positive externalities give birth to the effect of free use of the public goods: the more public goods with externalities are provided by a region, the more gains individuals of a neighboring region will receive from those goods, and they do not fund them. Besides, a situation may arise where positive externalities from public goods provided in the neighboring region appear to be substitutes of the public goods in the region where these externalities have no effect.

The presence of externalities may lead to a situation where certain groups, clubs or regions would be willing to pay for positive externalities or demand compensation for negative externalities caused by the production in the neighboring region. Such trade-off can close gaps and smooth distortions in the resource distribution as a result of externalities and, eventually, lead to a pareto-effective equilibrium. As mentioned before,

³⁰ Oates, W.A., 1972, *Fiscal Federalism*, NY: Harcourt Brace Jovanovich.

to reduce the effect of negative externalities, the provision of public goods can be centralized (in many cases it may be enough to take a centralized decision concerning the level of provision of public goods rather than to centralize the production of such goods).

Fig. 1.2 demonstrates the gains of the public goods provision (*OC-curve*), the loss of welfare related to the growth of the population (*OL-curve*), and also the growth of welfare related to the acquisition of gains from positive externalities and from the public goods produced by the neighboring regions (*OE-curve*).

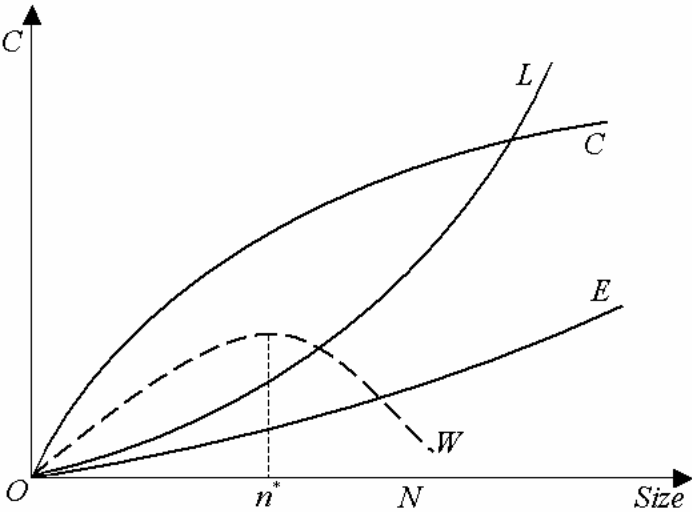


Fig. 1.2

The welfare (*OW-curve*) is the sum of the gains from the public goods provided in the given region and those from externalities from the public goods produced in the neighboring regions less the loss of welfare due to the growth of the population N . In this task the account of positive externalities leads to the optimum size of the region.

Besides economic externalities, the research papers also discuss fiscal externalities³¹, when the input of regional taxes into the price of a good is funded partially by the consumers of other regions. Like economic externalities, such fiscal externalities can lead ineffective distribution of resources, and therefore to equilibriums that are not pareto-optimal. This effect may be weakened by the centralization of tax revenues generated by taxation of a highly mobile tax base and de-centralization of revenues from a low-mobile tax base. This reduction, however, is only partial as a result of inter-regional trade flows and placement of taxes on the producers or consumers of the neighboring regions.

There is a lot of articles where the authors discuss theoretically and empirically economic and fiscal externalities (e.g. *Gordon, 1984*³²; *Bird, Slack, 1983*³³ and others).

Oates, in particular (*Oates (1972)*³⁴) discusses two regions *A* and *B*, with *N* individuals residing in each of them. The value function of the residents in *A*-region is $U^A(X_A, G_A + aG_B)$, in *B*-region – $U^B(X_B, G_B + aG_A)$, where *X* is a private good, *G* – public good, *a*-parameter is limited $[0;1]$ and describes the level of externalities. The public good is provided according to the production function $F(X, G) = 0$ and funded from the revenues generated by a local tax; out of this $(k - 1) * 100\%$ are exported.

An ineffective equilibrium when the decisions are made in one region can be demonstrated by the following task:

$$\max NU^A(X_A / N, G_A + aG_B) + NU^B(X_B / N, G_B + aG_A). \quad (15)$$

$$\text{Restrictions are } F(X_A + X_B, G_A + G_B) = 0. \quad (16)$$

³¹ *Baxter, King, 2005.*

³² *Gordon, 1984.*

³³ *Bird, Slack, 1983.*

³⁴ *Oates, 1972.*

The first order optimum conditions are:

$$N(aMRS_A + MRS_B) = MRT, \quad (17)$$

$$N(MRS_A + aMRS_B) = MRT. \quad (18)$$

With no externalities, i.e. where $a = 0$, the standard conditions of Samuelson are met $\sum MRS_A = N \cdot MRS_A = MRT = N \cdot MRS_B = \sum MRS_B$ in each region. In case of $a = 1$, there is only one common condition for two regions $\sum MRS_A + \sum MRS_B = MRT$. In all other interim cases from the first order optimum it follows that public goods should be provided at such a level where the sum of marginal values from the consumption of the public good produced in an adjacent region and the externalities from such public good equal marginal costs associated with the provision of the public good in the given region.

If decisions of decentralization are made in those regions, we have the following task:

$$\max NU^A(X_A/N, G_A + aG_B), \quad (19)$$

$$\text{Restrictions are } F(kX_A, G_A) = 0. \quad (20)$$

The first order condition (the sum of marginal values equals the sum of marginal costs of the provision of the public good given export of taxes) is as follows:

$$kN \cdot MRS_A = MRT. \quad (21)$$

If $k = 1$, i.e. the tax is not exported, then the region produces the public good at the level of $MRS_A = MRT/N$. However, in case of externalities the region will produce the public good below the optimal level

since the optimality condition with externalities is $MRS_A = MRT / N - aMRS_B$.

In case k is more than 1 (the tax surplus of k exceeding 1 is exported), and there are no externalities, i.e. $a = 0$, the deviation from the optimal production will be reverse: the region will produce public goods in the amount exceeding the optimal one. In general the total effect is defined as an impact of both factors; however it is unlikely that this solution coincides with the optimal solution which is $MRT / N - aMRS_B = MRT / kN$. To level these effects, the central government should introduce a system of inter-regional grants.

Thus the problem of economic externalities may be partially resolved in two ways. The first, easiest method is to centralize the provision of public goods with high externalities or to reduce the degree of differentiation of provision of those goods by regions. In this case all pros and cons are borne by the entire nation unlike the case of decentralized provision where the costs of public goods are paid by one region while the gains from its consumption are received by all the regions including those that derive benefits from externalities.

The other way of reducing the impact of externalities is less feasible and provides for taxation of subsidies and inter-regional grants that would be treated as payments by neighboring regions for getting benefits from externalities associated with the provision of public goods in the region.

1.2. Regional Governments Preferences: Aggregation

Given quite a high share of the public sector in a developed and/or developing country and/or a country with economy in transition, the examination of how the mechanisms of identification of individual preferences are built and integrated in the public preferences remains acute. According to Arrow (*Arrow, 1963*), “there is no ideal mechanism of the public choice”. In this section we are going to discuss the classical mechanisms of the public choice in one-dimensional case (e.g. in electing a certain volume of the public good provision).

1.2.1. Restrictions in Building a Tool for Aggregation of Individual Preferences

One of the first scholars who studied an effective establishment of government financing was Wicksell (*Wicksell, 1896*, see his review in *Inman, 1987*), who proposed that since each individual benefits from tax collection and provision of public goods, a cooperative equilibrium which is pareto-optimal comes to existence. Lindahl (*Lindahl, 1919*) showed that this equilibrium exists; moreover there exists a set of prices of the public goods (individualized taxes) that ensure the achievement of such balance at the highest point of the public welfare. If, however, the people refuse to honestly report the obtained value of the consumption of public goods, no voluntary financing of the public goods will be possible. Thus some enforcement tools for tax collection should be used to fund the public goods.

The need to enforce creates a problem of correction and adequacy of decision-making regarding the amount of tax withdrawals and budget spending. Arrow demonstrates (*Arrow, 1963*) that if some natural conditions are introduced (the requirements to the public selection procedure) no other mechanism than the dictatorship (when the preferences of only one person are taken into consideration) can be used that would not give rise to the problem of non-existence of the only transitive solution with no limitations of the preferences of the voters and their choices. The conditions are as follows:

(P) Pareto-optimum: if one individual prefers the first alternative to the second then the whole society should also prefer the first option.

(ND) No dictatorship. No person (a dictator) must exist whose preferences would be domineering regardless of the preferences of other community members.

(U) Completeness. This is an opportunity to compare all possible alternative options.

® Reasonable ranking. All the alternatives for each individual can be ranked, and between any alternatives the condition of transitivity is fulfilled.

(I) Independence from other alternatives. The choice of an individual regarding a certain set of alternatives should be defined only on the basis

of his/her preferences for these alternatives but not for any other alternative.

According to Arrow, there is no mechanism of decision making that will meet all these conditions, however, if one or several such conditions are weakened, such mechanism may be created. In other words, we elect what is more important for us: an effective decision-making process (including identification of preferences) or an effective distribution of resources, or democracy.

A benevolent dictator and different types of voting are the best studied phenomena in the theoretical models of decision making process.

1.2.2. Establishment of Preferences as those of the Benevolent Dictator

The preferences of a benevolent dictator aggregate individual preferences by weighting the functions of value (usefulness) of the population³⁵, therefore, maximization of the benevolent dictator preferences accounts for individual preferences in this or other way. The challenge in the formation of the regional governments' preferences is the above discussed problem of the community having no stimuli to voice out their true preferences; and this problem impedes the work of the market mechanisms for making decisions.

For the dictator to provide the public goods at the optimal level, the dictator should know the value (*MRS*) of each consumer. To collect taxes at the optimal level, the dictator should know incomes of each person and his/her reaction to taxes. The dictator has a definite advantage in taking public decisions in the theoretical models which is definitively in the welfare function. However, the question is how to build this function in practice, and we will look into the works of the following authors: *Malinvaud, 1971; Dreze, de la Valle Poussin, 1971* (hereinafter – *MDP*); *Vickrey, 1961; Groves, 1973* and *Clark, 1971*.

The main idea of *MDP* is that each person is placed in such a context where he/she elects not to cheat, i.e. by reporting his/her true preferences he/she is going to keep his/her wellbeing, at least, at the same level, while

³⁵ Medina Luis Fernando, 2003, Is Fiscal Federalism Distributively Neutral? University of Chicago, August 4, 2003.

if he/she chooses to reduce the value of consumption of the public goods, it may cut down his/her wellbeing. Where each individual reports his/her true preferences, the *MDP* process leads to Pareto-effective equilibrium.

Let us consider the *MDP* process by using a simple model with two consumers (A and B) and one public good (the unit cost is \$1). Now, the individuals report the values of consumption of a supplementary unit of the public goods π_a and π_b , that may equal or vary from their real marginal substitution standards. The dictator increases the volume of the provided public goods in case where $\pi_a + \pi_b$ is lower than the marginal costs of such provision, and reduces the provision of the public goods where $\pi_a + \pi_b$ exceeds the marginal costs. The change in the volume of public goods X follows the rule: $\Delta X = \psi(\pi_a + \pi_b - 1)$, where ψ – is a positive constant value. Any increase or decrease of taxes which revenues are used to fund the public good will be distributed among the individuals on an equal basis:

$$\Delta Y_a = (1/2)\psi(\pi_a + \pi_b - 1) \quad \text{и}$$

$\Delta Y_b = (1/2)\psi(\pi_a + \pi_b - 1)$. A major advantage of such mechanism is that we are going to receive a balanced budget eventually. A disadvantage however is that to report true preferences may not be always a domineering strategy, and the expected benefit may be higher in case of the strategy of underestimated value of the consumption of public goods when the gain from lower costs to finance public goods is actually higher than the actual reduction of value from the reduced volume of their provision.

Unlike *MDP*, the *Vickrey-Groves-Clark* mechanism allows for complete revelation of preferences, and the domineering strategy here is to report true value of the public goods consumption. Let *i*-individual inform that the consumption value of the public good X equals $P_i(X)$, which may reflect or not reflect the real usefulness (value) of an individual. The planner maximizes public welfare $(\sum_{i=1} P_i(X) - C(X))$. From the condition which is similar to that of Samuelson $\sum_{i=1} \pi_i(\hat{X}) = MC(\hat{X})$ follows that \hat{X} is a public optimal level of provi-

sion of the public good provided that none of the individuals has reduced the consumption taxed in the amount of:

$$T_i = C(\hat{X})/N + \left\{ S_i - \sum_{j \neq i} \left[P_j(\hat{X}) - C(\hat{X})/N \right] \right\},$$

Where $S_i = \sum_{j \neq i} \left[P_j(\tilde{X}) - C(\tilde{X})/N \right]$, \tilde{X} is a solution of the task without *i-individual*. Thus the second part of the tax is a difference between the public surplus of all the consumers except for *i-individual* in the tasks where this *i-th* individual does not report of his/her preferences and where he/she reports thereof.

Now what makes each individual to tell the truth about his/her preferences. The planner maximizes:

$$\sum_i P_i(X) - C(X) = P_i(X) - C(X)/N + \sum_{j \neq i} \left[P_j(X) - C(X)/N \right].$$

I-st individual maximizes:

$$U_i(X) - T_i = U_i(X) - C(X)/N + \sum_{j \neq i} \left[P_j(\hat{X}) - C(\hat{X})/N \right] - S_i.$$

Since for each individual S_i is exogenous, to make the task of the *i-th individual* coincide with the planner's task which unlike the task of the individual will be realistically resolved, the solution of this task will be the volume of the public goods, it is necessary to report truly that: $P_i(X) = U_i(X)$.

Vickrey-Groves-Clark mechanism has a number of specifics. First of all, the individual value function should depend on the volume of public goods only which is a strong statement since in reality the value of consumption of the public good depends on the individual consumption of private goods. Secondly, this mechanism is open for manipulations by coalitions. Thirdly, the tax in the Vickrey-Groves-Clark mechanism may not correlate with the actual revenues of some individuals. Finally this mechanism brings in budget surplus that needs to be spend in addition to

the existing optimal volume of expenditures for the provision of the public goods³⁶.

Thus theoretically a benevolent dictator may exist who will have all the mechanisms to identify preferences of the public good consumers and, therefore, the possibility to provide the public-optimal quantity of public good; however, with such a system of “public choice” in place, it will hardly be possible to guarantee the dictators’ benevolence.

1.2.3. Aggregating Individual Preferences Based on Democratic Electoral Procedures

To date, a great number of democratic decision making mechanisms have been offered and are being in use, but each of these mechanisms fails to satisfy one of the conditions of Arrow’s theorem. The most well-known democratic decision making mechanisms are majority voting as well as the mechanisms which account for preference intensity processes (preference intensity processes (hereinafter referred to as the PIP), *Inman, 1987*).

Voting satisfies the *I*-condition (independence of irrelevant alternatives) of Arrow’s theorem, i.e. an individual’s choice between a set of alternatives is determined only by preferences towards these alternatives rather than other alternatives. However, it fails to satisfy either the *U*-condition of Arrow’s theorem which states that it should be possible for the mechanism to compare any alternative options, or the *R*-condition (rationality) which states that all alternatives for each individual can be ranked, while the transitivity condition is satisfied between any alternatives. The *U*-condition (completeness), and the *R*-condition (rationality), are satisfied rather than the *I*-condition (independence of irrelevant alternatives condition) in the mechanisms accounting for preference intensity processes (PIP). The most well-known illustration of restricted rationality during the majority voting is a cycle occurring now with three individuals and three alternatives (the Condorcet’s paradox).

To avoid voting cycles, Sen (*Sen, 1966*) suggested that voters should have ‘alike preferences’, which means that all voters agree that each al-

³⁶ *Vickrey (1961); Groves (1973); Clark (1971)* in Atkinson, A.B. and Stiglitz, J.E. Lectures in Public Economics. London: McGraw-Hill, 1980.

ternative is always good (i.e. not the worst one) or bad (i.e. not the best one) enough, or not an acceptable compromise (i.e. not an average one). This argument means that preferences are single-peak for the preferences which can be ranked by a single axis. The transitivity condition is satisfied in this case, but other conditions may not be as such.

It is often assumed that public authorities seek to maximize practicality of median voters for the purpose of being reelected. It is very simple to see logic in using the median voter's preferences – in case of single-peak preferences the median voter's choice towards the level of taxation and social utility becomes preferable by more than a half of voters in conducting a pair wise comparison, which means that during majority voting it is the median voter's choice that will yield majority of votes against any other choice.

The requirement of single-peak preferences is a very strong assumption which rarely can be found practicable. Gans and Smart (*Gans, Smart, 1996*) defined a more general condition which is sufficient for existence of the Condorcet winner. Voters' preferences satisfy the single-crossing condition, provided that the following conditions are met:

If $q > q'$ and $\alpha^{i'} > \alpha^i$, or if $q < q'$ and $\alpha^{i'} < \alpha^i$, then

$$W(q; \alpha^i) \geq W(q'; \alpha^i) \Rightarrow W(q; \alpha^{i'}) \geq W(q'; \alpha^{i'}),$$

where q and q' are policy alternatives, a α^i and $\alpha^{i'}$ are parameters of the indirect utility function $W(q; \alpha^i)$ reflecting voters' preferences i and i' , respectively. In other words, in our task it implies that if a single citizen prefers a certain level of expenses to a lower level, then a higher-income citizen will prefer this level as well. Likewise, if a citizen prefers a certain level of expenses to a higher level, a lower-income citizen will prefer this level of expenses as well.

A wider, than single-peak preferences, class of functions possesses the single-crossing condition, but this condition is sufficient for the Condorcet winner to exist and match the median voter.

In addition, Persson and Tabellini (*Persson, Tabellini, 2000*³⁷) showed that the Condorcet winner exists and matches the median voter in case of selection of different lines of policy (for example, in voting by the volume of federal and regional utilities), provided that voters have intermediate preferences³⁸.

Voters of the V set have intermediate preferences if their indirect utility function $W(\hat{q}; \alpha^i)$ can be denoted as $W(\hat{q}; \alpha^i) = J(\hat{q}) + K(\alpha^i)H(\hat{q})$, where $K(\alpha^i)$ is a certain monotonous function α^i , while $J(\hat{q})$ and $H(\hat{q})$ are any functions which are common for all voters. With all other functions the Condorcet winner will not exist for sure.

Plott, 1967 showed in his study that in case of various alternatives of policy through several lines the transitivity condition can be satisfied with finiteness in the number of voters whose preferences are described by quasi-concave, continuously differentiable utility functions. In addition, there is a point at which a voter receives maximum utility, while for any other voter who would prefer other equilibrium there would be found a voter which would prefer a similar but contrariwise deviation from equilibrium.

Open voting or voting by ballot concerning the volume of non-federal educational costs are often referred to as classical illustration of the mechanism of choice through voting (see, for example, *Inman, 1987*). During open voting the level of costs is offered by voters themselves, in which case the median voter's preferences are realized.

In case of closed questionnaire, selection is made of the proposed alternatives, in which case the issues related to incentives of the bureaucracy which proposes these alternatives are normally considered. Romer and Rosenthal (*Romer, Rosenthal, 1979, 1982*) used a modified Niskanen's model of bureaucracy (*Niskanen, 1971, 1975*) to simulate such effect. The model was estimated by using empirical data and in doing so it was demonstrated that if bureaucrats seek budget expansion, then ma-

³⁷ Persson, Tabellini, 2000, Political economics: explaining economic policy. MIT Press.

³⁸ In particular, it follows from this condition that all voters can be ranked by a certain variable on which all other preferences depend monotonously.

nipulations with the proposed alternatives may have an effect on final equilibrium outcomes.

If we discard the *I*-condition (independence of irrelevant alternatives) of Arrow's theorem, it would be possible to build up such a social choice mechanism which would satisfy the *R*-condition (rationality) and the *U*-condition (completeness of preferences). If any individual may determine a particular price of his vote on any issue, then traffic of votes may lead to satisfaction of rationality and completeness conditions (as evidenced by *Wilson, 1969*). In this case, however, traffic in votes provides no guarantee of public optimal equilibrium. In addition, traffic in votes often results in surplus production of social utilities (see *Mueller, 1979*).

In practice, cases may occur when state power authorities may deviate from their economic goals for the purpose of taking into account political preferences of the general public. This may occur if (see, for example, *Rogoff, Sibert, 1988*) information on the bureaucrat's competence (as ability to provide high personal income level as well as social utilities) is closed, and voters only may estimate the bureaucrat's competence by his choice of a monetary and fiscal policy.

Some authors like, for example, *Alesina, Cukierman, 1990*, argue that voters are unaware of the bureaucrat's preferences towards economic policy and it is only his performance results that can reflect such preference. However, the authors implicitly believe that voters make their inferences based on economic efficiency outcomes of the selected policy, and it is this policy that in fact determines voters' opinion about the bureaucrat. In other words, if economic policy instruments were observable, then economic performance results would play a minor role for voters.

Harrington (*Harrington, 1993*) studied an issue of bureaucrat's attempts to influence the economic policy driven by a desire to be re-elected. It is assumed that possible outcome of the selected process depends on specific performance results exhibited by the bureaucrat as well as the policy he is going to choose. This is related to the fact that the general public has its own preferences towards economic policies available for the bureaucrat (for example, it may assume that a single policy would yield higher results on average). Therefore, a situation may be realized when the bureaucrat may retain his office in spite of his poor perform-

ance results, because he has chosen the policy which is popular among the general public, while at the same time the general public believes that the poor performance results were caused by a negative economic shock rather than the bureaucrat's incompetence.

At the same time, the bureaucrat may not retain his office if he has shown good performance results but has chosen unpopular policy, because voters will think that his performance results are caused by positive economic situation. The author also argues that the higher the dispersion in the general public's preferences towards economic policies and the higher the dependence of results on the selected economic policy on average, the stronger the general public is guided by specific economic outcomes. Conversely, if the general public is positive as to which policy is most effective, it will support bureaucrats based on its chosen policy rather than economic performance.

It may be inferred from this model that in order to retain their offices state power authorities may be guided by not only the general public's preferences towards the volume of social utilities, taxation system parameters, etc., but also some subjective preferences of the general public towards possible economic policies. In other words, to be reelected, executive authorities may often deviate from economically reasonable policy in favor of a policy which is more favored by voters at large or a policy which is more advantageous for groups with specific interests which can play a decisive role during elections. Therefore, appointment of the head of a region or municipality who is independent on his voters may help avoid political cycles, provided that the appointed person will pursue an adequate economic policy. This issue will be discussed in details in the next chapter.

1.2.4. Democratic Electoral Preferences Aggregation Mechanisms and Political Business Cycles³⁹

Relationship between political life of the society and economic policy were studied intensively in the 1970x (see *Kramer, 1971*⁴⁰; *Tufte, 1975*⁴¹;

³⁹ This section was prepared by S. Shulgin.

⁴⁰ G. Kramer. "Short-Term Fluctuations in U.S. Voting Behavior". *American Political Science Review* 1971 Vol. 65: 131–143.

*Nordhaus, 1975*⁴² at al.) with a focus on the issue of economic cycles build-up caused by political processes. The models which are based on the assumption that current policy is resulted from policy makers' attempts to win elections are called opportunistic political business cycle models.

Opportunistic political business cycle (Nordhaus – McRae). W. Nordhaus (*Nordhaus, 1975*⁴³) offered a model of political business cycle build-up caused by opportunistic behavior of the incumbent policy maker. The policy maker tends to stimulate the economy prior to elections with a view to reducing unemployment, according to the Philips curve, which subsequently is going to result in high inflation as a payoff. The opportunistic policy maker has no personal preferences towards inflation and unemployment, while voters prefer both low unemployment and low inflation. At the same time they estimate policy maker's consistency on the basis of current performance results.

If voters are "shortsighted", have short memory, and take vote based on the current levels of unemployment and inflation (adaptive expectations), the elections will result in cyclic movement of inflation and unemployment, in which case unemployment will be reduced prior to elections due to a positive monetary shock to be followed by conducting a policy aimed at reducing inflation (for the next elections).

Most of criticism of this type of model boils down to the fact that in most countries the monetary policy is carried out by executive authorities which are formally independent on the Central Bank, as well as voters' inability to learn, as they know from previous elections that a period of low inflation and unemployment prior to elections will give way to a crisis after elections. Such criticism could be responded by the fact that extrinsically observed irrational behavior of voters should not yet be con-

⁴¹ Tufte, E. "Determinants of the Outcomes of Midterm Congressional Elections," *American Political Science Review* 1975 Vol. 69, 812–26.

⁴² W. Nordhaus. "The Political Business Cycle". *Review of Economic Studies* 1975 Vol. 42: 169–189.

⁴³ W. Nordhaus. "The Political Business Cycle". *Review of Economic Studies* 1975 Vol. 42: 169–189.

sidered as irrationality of voters themselves. It may just as well be based on information available for voters or other reasons.

Further development of this approach in modeling was focused on considering different models of voters with assumption of their rational behavior: K. Rogoff (*Rogoff, 1990*)⁴⁴; K. Rogoff, A. Sibert (*Rogoff, Sibert, 1988*)⁴⁵, T. Persson and G. Tabellini (*Persson, Tabellini, 1990*)⁴⁶; A. Cucierman and A. Meltzer (*Cucierman, Meltzer (1986)*)⁴⁷.

Partisan political business cycle (Hibbs – Alesina). A model in which the policy maker has his own preferences in the economy aside from the desire to retain his office is an alternative to the Nordhaus approach. In particular, such assumptions may be made when the policy maker is representing the interests of a particular political party. This is why models built up on the assumption of existing preferences of policy makers are called partisan political cycles. In 1976, Douglas Hibbs (*Hibbs, 1977*)⁴⁸ suggested the political business cycle model accounting for political preferences of incumbent policy makers, in which, unlike identical voters in the Nordhaus political business cycle model, it is assumed that each voter has his own preferences.

D. Hibbs studied a two-party model in which the parties have different preferences towards the level of unemployment and inflation, as well as different costs they are ready to sustain during inflation in order to change the unemployment level. The targeted unemployment level of a conventional left-wing party is lower than that of the right-wing party, while the latter has a lower level of target inflation. In this case changes in inflation and unemployment reflect changes in incumbent parties. A

⁴⁴ Rogoff, K. Equilibrium Political Budget Cycles, *American Economic Review* 1990 Vol. 80: 21–37.

⁴⁵ Rogoff, K. and A. Sibert, 1988, Elections and Macroeconomic Policy Cycles, *Review of Economic Studies* 55, 1–16.

⁴⁶ Persson, T. and G. Tabellini, 1990, *Macroeconomic Policy, Credibility and Politics*. London: Harwood.

⁴⁷ Cucierman A., Meltzer A. A Positive Theory of Discretionary Policy, The Cost of Democratic Government and the Benefits of Constitution. *Economic Inquiry* 1986. Vol. 24. 367–388.

⁴⁸ Hibbs, D. Political Parties and Macroeconomic Policy, *American Political Science Review*, 1977, Vol. 71, 1467–87.

qualitatively new approach towards the model of partisan political business cycles was introduced by Alesina A. (*Alesina, 1988*)⁴⁹, which assumed a model of rational expectations of voters. Like in the Hibbs political business cycle model, competing political parties have different targeted values towards unemployment and inflation levels. The inflation level is governed by expectations towards future periods.

The key aspect for cycling is uncertainty of outcomes of elections in the future. If the society is positive about that the incumbent party will remain as such after elections, neither inflation nor unemployment will fluctuate (because expectations will be equal to the existing values). At the same time, if the probability for the incumbent party to remain in the office equals less than one, the expected values of inflation will be different.

Political business cycle phases. Both the opportunistic and partisan approaches to analysis of business cycles will result in cycling of economic activity associated with cycling of the electoral process. Let us consider phases of these cycles as applied to different models.

1. “Recession” (government’s policy after elections). Opportunistic cycle models are based on that the policy maker, being concerned with retaining his office, in selecting among various development strategies will try to use policies which produce a positive effect prior to elections, while any possible adverse affects are not supposed to become evident until after elections. Leaving aside the issues related to rationality and expectations of voters, let us focus on possible effects from such strategies.

Expansive monetary policy, i.e. positive cash flow, stimulating a short-term economic growth and reduction in unemployment tends to lead to higher inflation, in which case the government has to impose restrictive measures with a view to reducing inflation by the coming up elections. Expansive fiscal policy tends to entail growing budget deficit with all that implies. Deficit financing through debt schemes further leads to the need to reduce budget expenditures related to service and repay-

⁴⁹ *Alesina A. Macroeconomic policy in a two-party system as a repeated game // Quarterly Journal of Economics. 1987. V. 102. P. 641–678; Alesina A. Macroeconomics and Politics // NBER Working Annual. Cambridge: MIT Press. 1988.*

ment of debts. Financing through creation of money tends to increase inflation.

As noted above, the opportunistic behavior is only one of the possible reasons for economic and business cycles. Let us consider the phases that will occur in the two-party model of the political business cycle. The beginning of incumbency of the right-wing party will see an effect similar to the behavior of the economy in the opportunistic business cycle, i.e. the government will pursue a restrictive policy aimed at reducing inflation. However, the reasons for this differ largely from those in the opportunistic cycle. If the left-wing government is replaced by the right-wing one, the latter tends to establish the selected target inflation though restrictive policy thereby increasing unemployment.

Even though the right-wing government is elected again, it will have to pursue a restrictive policy at the beginning of its incumbency, which may be more or less strict depending the pre-election likelihood of its victory. The better the likelihood, the higher inflation expectations and the harder inflation should be restricted (increasing unemployment) to return to the target level.

Should the left-wing government come to power, the situation is going to be precisely the opposite: the economy will be booming, i.e. unemployment will be below its natural level and inflation will be high. Like in the case with the right-wing government, the size of the boom will depend on whether the victory of the left-wing party was expected or not. If the society expected its victory and consequently had certain expectations with respect to inflation, such victory would sharply increase inflation.

2. The “tranquility phases” (government’s policy between elections). Of course, the division of the political cycle into periods is conventional to a certain extent. In model with political preferences the beginning of the tranquility phase is associated with the economy reaching the target figures. In the Alesina model, for example, the level of unemployment is natural for both the right-wing and left-wing governments, while inflation is higher for the left-wing government against the right-wing one. The tranquility phase ends conventionally when expectations of the coming elections begin to influence current inflation.

In case of an opportunistic policy maker whose unique goal is to retain his office, the tranquility phase begins after adverse affects of stabilizations have been eliminated and the target of the policy maker at this stage is to build up persistent expectations with respect to future periods to be able to effectively take advantage of various shocks in the next period preceding the elections.

3. “Increase” (government’s policy prior to elections). There is such term as the election year in the terminology of political economy which implies understanding of the pre-elections period for the opportunistic policy maker.

Policy makers may have incentives to use policies producing a short-term positive effect, whether it be expansive fiscal policy increasing the current welfare of voters, or expansive monetary policy as a positive monetary shock. However, an increase in budget payments tends to increase budget deficit, and with debt financing such policy may be launched relatively early thereby making its effect stronger. Since adverse affects of budget deficit monetization will become evident somewhat earlier, it is reasonable to use it prior to elections (with less positive effect).

Of course, by considering expansive policies we describe not all but just a few of the possibilities to influence elections by way of manipulation with economic status of voters. For example, F. Veiga (*Veiga, 2002*)⁵⁰ puts forward and tests an idea of forming a political business cycle based on the policy maker’s selection of macroeconomic stabilization (inflation reduction) programs.

The author makes analysis of strategies which policy makers chose: foreign exchange rate stabilization (exchange rate-based: ERBS) or money supply stabilization (money-based stabilizations (MBS)). Veiga shows that prior to elections the policy maker is more likely to choose ERBS, because it helps reduce inflation and increase industrial output in a short-term period. ERBS helps the policy maker to create a good image of a competent manager prior to elections, while MBS results in a short-term recession and produces positive results after a while. The author hy-

⁵⁰ Political Business Cycles and Inflation Stabilization Veiga Francisco NIPE Working Papers . (September 2002).

prothesizes that MBS will likely to be used after elections so that the policy maker have time to “harvest fruits” from MBS by next elections. The author provides arguments in support for his hypothesis through analysis of econometric models of 35 stabilization programs at high inflation countries.

With regard to political preferences of policy makers, even though there is no reason for opportunistic behavior, the period prior to elections is characterized by uncertainty with respect to the future period.

As noted above, if the society is positive that the incumbent government will stay at the office, expectations will not misrepresent the current situation. However, it is not true as a rule. There is always a positive probability of that the government may be changed. Such uncertainty leads changes in the expected inflation figures and consequently inflation itself. In this case inflation tends to increase with the right-wing government at the office, and decrease with the left-wing one.

Of course, interaction between politics, elections and economics is not limited by political business cycles. To perform thoroughgoing reforms under the circumstances of economic transformation, the government often needs support of voters, and the policy under such circumstances may come within the scope of the definition of political business cycle, but the nature of interaction (incentives, reasons) will take other forms.

In general, analysis of the existing approaches towards the effect of political cycles on economic policy shows that to be re-elected, it is advantageous under certain conditions to pursue a softer policy providing short-term positive effects, with possible adverse mid-term and long-term effects though, to gain support from voters. In this case it is possible to expect relationship between political cycle and the performance of economic policy, primarily in the field of budget expenditures.

There is no unique estimate as to advantages for voters. In the mid-term and long-term perspective political business cycles may lead to reduction in welfare due to unstable behavior of economic policy and ineffective utilization of budget funds. At the same time stable democracies are able to trace such variations and form negative reputation expectations to be taken into account at next elections, which will lead to reduction in the amplitude of political business cycles. In developing countries,

with short planning horizon and high discount, political business cycles may be strong enough and lead to significant distortions and losses in efficiency. Consequently, as applied to our problem, it is possible to expect that regional governments' switch from taking into account voters' opinion to that of the central federal government in case of transition from the election principle to the appointment principle may lead to elimination of such cycles and enhancement of effectiveness in mid-term and long-term perspectives.

At the same time, in the Russian Federation one can observe not only the transition nature of the economy, but also a relatively poorly developed democratic procedures allowing individuals to express their preferences towards economic policy. Accordingly, the influence of political business cycles may be weakened as a result of weak effect of individuals on the financial policy of regional governments due to poorly developed institutions of representative democracy when policy makers are guided rather by support of the central federal government or bureaucracy than interests of individuals.

With such an interpretation emergence of political business cycles early in the 2000s (see section 4 herein) may be construed an improvement in the development of democratic institutions, the prevailing economic policy became to be influenced by individuals. Consequently, regardless of the costs incidental to political business cycles, their emergence under the described circumstances can be considered as a positive sign.

1.3. Preferences of Regional Governments in Models of Bureaucracy

As noted above, simple models of social choice theory (*Downs, 1957*⁵¹; *Black, 1958*⁵²) suggest that costs of financing of social utilities are governed by preferences of the median voter, otherwise if government's costs of provision of social utilities deviated considerably from prefer-

⁵¹ Downs, Anthony, 1957, *An Economic Theory of Democracy*. New York: Harper.

⁵² Black, Duncan, 1958, *The Theory of Committees and Elections*. Cambridge, UK: Cambridge University Press.

ences of the median voter, such government would be displaced by the opposition which would proposed costs closer to preferences of the median voter's.

However, institutes of distribution of political power may operate against the median voter (see, for example, *Romer, Rosenthal, 1979*⁵³). Niskanen (*Niskanen, 1971*⁵⁴, *1975*⁵⁵) suggested an alternative, non-competitive model of bureaucracy. The model suggests that bureaucracy finances production of social utilities based not only on the preferences of legislative bodies or voters, but also the monopoly power it is wielding. Consequently, even though the incumbent authority has been elected by the median voter, there might be deviations in real life.

1.3.1. Bureaucrats' Preferences and Budget Increase

An important postulate of the traditional economic theory is that provision of private goods and services is a result of incentives for and restrictions on consumers, manufacturers and employees⁵⁶. In other words, provision of private goods and services is an effect rather than an immediate goal of any participant in the private economy. Likewise, the central postulate of studies, which are currently attributed to the social choice theory, is that provision of public services is a result of incentives for and restrictions on voters, policy makers and bureaucrats. Any agency (public agency engaged in provision of social utilities) is defined as an organization with two characteristics as follows. First, employers and employees have no share whatsoever in the difference between earnings and costs as personal income. Second, a certain share of current earnings of the organization is generated from sources other than output selling as per unit of output.

⁵³ Romer, T. and Rosenthal, H., 1979, Bureaucrats versus voters: On the political economy of resource allocation by direct democracy. *Quarterly Journal of Economics* 93: 563–587.

⁵⁴ Niskanen, William, 1971, *Bureaucracy and Representative Government*. Chicago: Aldine-Atherton Press.

⁵⁵ Niskanen, William, 1975, Bureaucrats and Politicians, *Journal of Law and Economics* vol. 18 (December), 617–43.

⁵⁶ Niskanen, William, 1971, *Bureaucracy and Representative Government*. Chicago: Aldine-Atherton Press.

The formal model of Niskanen is based on the assumption that it is only the government bureaucrats that know how much resources should be spent to achieve the social outcome in question. It is assumed that these public servants are interested in growing bureaucratic entities, because public servants' power, career opportunities as well as other emerging opportunities are increasing function with respect to the budget they are entitled to dispose of.

Niskanen (*Niskanen, 1971*⁵⁷) introduced the following variables into the bureaucrat's utility function: wage, service-related perquisite, social reputation, power, patronage, agency's performance, freedom to make changes and freedom to administer the agency. One may assume that all these variables (exclusive of the two last ones) are positive monotonous function of the agency's aggregate budget. A bureaucratic organization is facing a restriction: the electorate will stand against a proposal on public programs allowing aggregate costs to be in excess of the value of provided utilities. Optimization strategy performed by bureaucrats, leads to expansion of bureaucratic structures beyond the efficient one as defined by Pareto. As a result, bureaucracy assumes the entire "consumption surplus" which is pictorially equivalent to the area underneath the social demand curve for the given utilities provided by the government (*Olson, 1986*)⁵⁸).

Atkinson and Stiglitz (*Atkinson, Stiglitz, 1980*⁵⁹) adduce some examples of how pursuance of goals by independent agencies (departments, bureaus) along with restricted control can affect government's behavior. First, the agency may strive to expand such government program though systematic overestimation of its benefits or underestimation of its costs. If the executive authorities in their turn is striving to control budget calls, it would add costs of such control to the costs of allotments. Second, if the agency has its aggregate budget as a tool of control, it can act without restraints within the limits of such budget, then the fund utilization

⁵⁷ Niskanen, William, 1971, *Bureaucracy and Representative Government*. Chicago: Aldine-Atherton Press.

⁵⁸ Olson, 1986, *Toward a More General Theory of Government Structure*, *American Economic Review*, Papers and Proceedings, May 1986, vol. 79, p 120–125.

⁵⁹ Atkinson, A.B., Stiglitz, J.E., 1980, *Lectures on Public Economics*.

scheme would more likely to reflect agency's preferences rather than law-makers' preferences. As a result, if a full control was established, it might be necessary to increase the budget so that it exceed the minimum requirement in order to achieve a certain level of costs of a specific type of social utility. Finally, if agencies are able to control the course of developments by offering only a single funds utilization program as an alternative to the current level of costs in case of non-approval of the plan, then such behavior may result in deviations from the optimal level of costs.

In 1996 Niskanen (*Niskanen, 1996*⁶⁰) revised the nucleus of his model based on his work experience gained with the government as well as observation of his colleagues. As a result, the bureau behavior theory became to rely upon the following basic principles.

1. Bureaucrats and officials at other organizations are basically alike. The former have some differences, if any, in behavior which are based on bureau-specific incentives and restrictions rather than other personal features.

2. Most of the bureaus have a monopoly buyer of their service which is often represented by a group political officials. Effective demand for the bureau's output is influenced by such political sponsor rather than end consumers of services.

3. Most of the bureaus are monopoly providers of their services. To be more specific, most of the bureaus are encountered with a descending function of the effective demand even though an alternative of current and potential providers of the same or similar service is available.

4. The bilateral monopoly relationship between the bureau and its sponsor is exchange of the promised products for budget rather than selling of the product to the bureau at the per-unit price.

5. Like in any bilateral monopoly, there is no unique budget-output equilibrium between preferences of the sponsor and the bureau. The basic advantages for the sponsor in this bargain are its right to control the bureau and approve a management team, while the basic advantage of the

⁶⁰ Niskanen W.A. *Bureaucracy and Public Economics* – 2nd ed. Cheltenham: Edward Eldar, 1996, pp.269–283.

bureau is that it is better aware of the cost of service provision over the sponsor.

6. The sponsor's role in this bilateral bargain inasmuch as it concerns the budget-output combination is getting weaker or changes under the influence of other condition. The sponsor has no enough incentives to control the bureau, because it participates only in a small share of any advantages from more efficient operation of the bureau (*Niskanen, 1975*⁶¹); in other words, effectiveness control is a social utility for law makers and voters whereby the sponsor exercises its power mostly for taking over the bureau's surplus in such a manner that is favorable for specific interests of the sponsoring group rather than the interests of a wider group of law makers and voters.

7. Neither the members of the sponsoring group, nor top-ranking bureaucrats participate in cash sharing with relation to any surpluses generated by the bureau. As a result, surpluses will be spent so that both the sponsors and the bureau have their interests met without receiving no direct compensation.

As a result, it may be inferred that bureaucrats (regional executive authorities) have the ultimate goal of overestimating the bureaus' budget (regional budget as a whole) or discretionary budget. In transition to the principle of governors appointment by the central federal government, the possibility of budget maximization may be reduced for executive authorities, because such practice allows for performance control of the appointed governor. However, this inference would be correct provided the central federal government have sufficient information, which is uncommon in practice, on the situation in a given region.

⁶¹ Niskanen, William, 1975, Bureaucrats and Politicians. *Journal of Law and Economics* vol. 18 (December), 617–43.

1.3.2. Realization of Bureaucrats' Preferences by Manipulating Alternative Options at Elections

Romer T. and Rosenthal H. (*Romer and Rosenthal, 1979*⁶²) in their study expanded the monopoly bureaucracy model of Niskanena (*Niskanen, 1971*⁶³) in order to explain referendum results (direct democracy) on social expenditures. The expanded model suggests that bureaucracy, like in the Niskanen's model, maximizes budget expenditures, but, unlike in the original model, it is done indirectly by offering a certain set of social costs at the referendum. The idea of the model is that bureaucracy, being aware of the preferences of the median voter, may offer at the referendum such a set of social expenditures that the level of expenditures selected by voters maximize the bureaucrats' utility. It is assumed that voters have an opportunity to choose only among the level of expenditures proposed by bureaucrats and a certain reserved level of expenditures which is provided for by the constitution in case the budget fails to be approved at elections (i.e. the level which depends on tax system pattern for a given region).

In case of full awareness, when bureaucrats are aware of voters' preferences and the percentage of voting to be casted by every layer of the society, it is assumed that secondary elections either will not take place or an interval between elections is going to be quite long (for example, one year).

Preferences of voters are assumed quasilinear and monotonous. Suppose $U^i(C, G^i)$ is voter's utility function, where:

C stands for consumption of private utility,

G^i stands for consumption of collectively financed utility,

Production function is viewed as a monotonous function of government expenditures $G^i = f^i(E)$ with $E = \tau Y$, i.e. government expenditures are equal to budget tax revenues.

⁶² Romer, T. and Rosenthal, H., 1979, Bureaucrats versus voters: On the political economy of resource allocation by direct democracy. *Quarterly Journal of Economics* 93: 563–587.

⁶³ Niskanen, William, 1971, *Bureaucracy and Representative Government*. Chicago: Aldine-Atherton Press.

Therefore, taking into account voter's budget restriction, his indirect utility function may be described as follows:

$$V^i(E) \equiv U^i[Y_0^i - EY^i / Y, f^i(E)]$$

The single-peak property of preferences, which is the key to the analysis, derives from quasiconvexity of preferences and convexity of the multitude of available choice for voters.

Figure 3 shows a choice problem for the median voter among private and social utilities. The level of social expenditures \bar{E}^i maximizes the median voter's utility. However, bureaucracy proposes a set of two levels of social utilities for the referendum: E_0 and E^* . Points E_0 and $\tilde{E}^i(E_0)$ are on the same budget multitude. Consequently, at elections (assuming that the voter is indifferent to the fact the he is voting for what the bureaucrat wants him to vote for) maximum level of expenditures to be accepted by the given voter with the predetermined reserved level of expenditures is determined as $\tilde{E}^i(E_0) = \sup\{E : V^i(E) \geq V(E_0)\}$.

It follows from *Fig. 1.3* that equal level of utility is achieved with the level of expenditures E_0 and $\tilde{E}^i(E_0)$, however E_0 is too low level of social expenditures, whereas $\tilde{E}^i(E_0)$ is too high against social optimum. Bureaucracy offers a sufficiently high level of expenditures E^* at the referendum, which would satisfy its desire to maximize expenditures as well as be chosen by the referendum, because the median voter's utility of the level of social expenditures E^* is higher than its utility of E_0 .

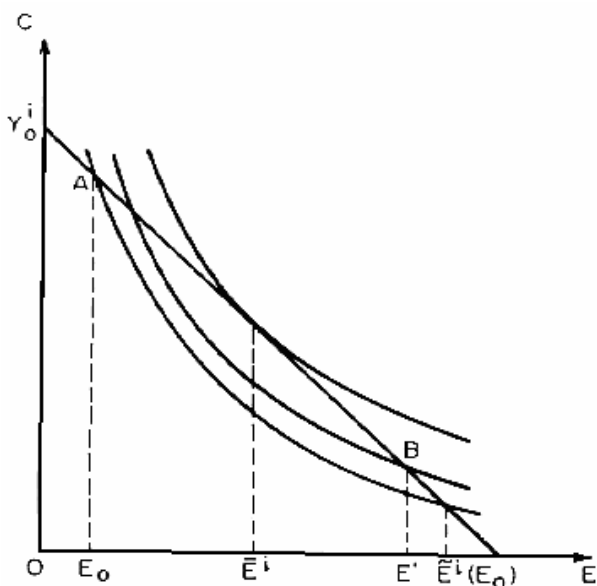


Fig. 1.3

The bureaucrat's problem is as follows:

$$\begin{cases} \mathbf{max} E \\ \sum_i b_i(E) > \frac{m}{2} \end{cases}$$

where m stands for the number of voters, and $b_i(E) = 1$ in case of the “for” vote and 0 in case of the “against” vote.

Let us denote $\tilde{E}'' \equiv \mathbf{sup}\{E : \mathfrak{S}(E) < 0.5\}$, median level of expenditures, where $\mathfrak{S}(E)$ stands for the function of voters distribution against the most preferable level of expenditures. Therefore, if the reserved level of expenditures is higher than the median level, the bureaucrat may not poll more than E_0 at elections based on the majority of direct voting.

If the reserved level of expenditures is less than the median one, then $E^*(E_0) = \text{median } \tilde{E}^i(E_0)$. In addition, it may be noted that the lower the reserved level of expenditures, the higher the level at which the bureaucrat achieves his maximum. Therefore, at any level of reserved expenditures which is different from the median one, the bureaucrat reaches higher budget expenditures than the level preferred by the median voter.

In case of partial uncertainty, when the bureaucrat is aware of voters' preferences but do not know whether they are going or not to go to the polls, the authors suggest that there is a possibility r of the voter going to the polls. The case that bureaucrats do know voters' preferences is quite common in practice, especially during elections at small municipalities (regions) at which state power authorities are very close to their electorate or in cases of a long-lasting election history allowing voters' preferences to be clearly seen.

The bureaucrat's problem can be resolved depending on the level of alternative expenditures. For example, if alternative expenditures equal to 0, then for any limited symmetrical distribution the budget under uncertainty will be less than the budget which the bureaucrat can achieve in case of full voting turnout. In case that legally provided alternative expenditures are higher than the level preferred by the median voter, the situation under uncertainty will be quite opposite. In case of full voting turnout, the best thing the bureaucrat could do is to determine the level of expenditures equal to the alternative level. Under uncertainty, with at least one voter for whom the best level of expenditures should exceed the reserved level, the bureaucrat may alternatively offer higher budget than that provided for by the law, because of nonzero probability of the budget being approved at elections. Therefore, in this case the expected budget, with incomplete information available, will be higher than that during full voting turnout.

It may be noted that the effect of changes in the probability of the voter not going to the polls is differential in this model for different values of x^* , level of expenditures which provides maximum in the bureaucrat's uncertainty problem. For example, if x^* is less than the budget under full voting turnout, the bureaucrat gains from higher voting turnout,

otherwise he wishes low voting turnout. It should be noted that the case in hand is an exclusively uniform voting turnout for the entire electorate. In general, the bureaucrat has incentives to increase voting turnout in the social layers which prefer a high budget level.

Monopoly power of the bureaucrat with this types of elections may be strengthened by repeating elections. It may occur that the bureaucrat be entitled to submit the budget for voting more than once if the budget fails to pass at first attempt. If it is granted that the number of elections cannot be bigger than a previously predetermined number T , and that voting is not strategic for the residents, i.e. each time they consider these elections as the last ones, then the bureaucrat's problem boils down to the following:

$$\max B(x_1, \dots, x_T) = \sum_{t=1}^T p(x_t) \times \prod_{k=0}^{t-1} (1 - p(x_k)), \text{ where } p(x_t) \text{ is a}$$

possibility of budget approval. This problem can be resolved by sequence $x_1 > x_2 > \dots > x_T = x^*$, where x^* stands for the best budget for the bureaucrat if no secondary elections are possible. It means that under the circumstances it is reasonable for the bureaucrat to start with big values hoping for that voters will be comprised of those from social layers preferring a big budget.

From this it may be inferred that even though it is decided to increase expenses for any particular social utility at the referendum, the bureaucrat may just as well overestimate the budget against the socially optimal level. Within the framework of analysis of the effects of the policy aimed at appointing governors discussed in this paper it means that even though the central federal government had full information on preferences of individuals in the regions, the transition to the principle of governors appointment would hardly help to reduce monopoly power of the bureaucracy in taking financial decisions in the regions thereby bringing the level of regional expenditures closer to the socially optimal level.

In this case a stand-alone analysis, which is beyond the framework of this paper, should be made of the development of an optimal promotion contract to be entered with between the principal represented by the central federal government and the agent represented by the governor, which would help to create incentives for the governor in order to provide opti-

mal (in terms of criterion established by the central federal government) fiscal policy as well as, if possible, prevent the governor from choosing a fiscal policy deviating from the guidelines established by the central federal government .

1.3.3. Empirical Studies of Median Voter and Bureaucracy Models

Two basic points of view may be empathized in analyzing empirical studies of the effect of the politics on the economics: (1) future expenditures are determined based on past expenditures with a certain increase (adjustment) and (2) future expenditures are determined based on socio-economic performance indicators and preferences of voters (median voter/ medial income voter).

Most of empirical studies dedicated to the median voter⁶⁴ issue showed that there is a statistical dependence between median economic indicators (income, tax contributions) and budget expenditures. However, it may not allow one to infer whether actual expenditures reflect preferences of the median voter, or they are displaced towards any other quantile (for example, preferences of the median voter multiplied by a coefficient).

Another issue is that there are doubts upon that models which are based on the median voter hypothesis can be considered superior to alternative models which satisfy the common sense (for example, *Romer, Rosenthal, 1979*⁶⁵).

The outcome, in compliance with the median voter's stand, may be realized provided that there are two candidates competing at elections or the executive body looks over all budget options by using the majority voting rule. Consequently, if there are more than two candidates, or if

⁶⁴ Romer, T. and Rosenthal, H., 1979, Bureaucrats versus voters: On the political economy of resource allocation by direct democracy. *Quarterly Journal of Economics* 93: 563–587; Barr, J.L and Davis, O.A., 1996, An Elementary Political and Economic Theory of the Expenditures of Local Governments, *Southern Economic Journal*, Vol. 33(1), pp. 149–165.

⁶⁵ Romer, T. and Rosenthal, H., 1979, Bureaucrats versus voters: On the political economy of resource allocation by direct democracy. *Quarterly Journal of Economics* 93: 563–587.

their goal is not to only win, but also win legislative seats, or if the executive body can control options submitted for voting, then the outcome will not reflect preferences of the median voter.

It is often suggested in empirical models of the median voter that preferences of voters towards budget expenditures may differ due to differences in utility functions, income, tax price for specific voters and the system of distribution which associates the amount of budget expenses with the number of utilities received by specific voters.

For example, it is suggested in the model of Barr and Davis (*Barr and Davis, 1996*⁶⁶) that voters have equal preferences, while median voters for different regions differ only in perceived tax prices. A share of households in the total ownership is used as a tool for tax price in the model. Weaknesses of this model are that though it was confirmed that expenditures tend to increase with reduction in the tax price and, conversely, decrease with its increase, the amount of expenditures may not match the one which the median voter prefers. Such situation is possible if the executive body offers only two, not all, of the possible alternatives: the one that is favorable for him and a reserve one prescribed by the law in case the basic one fails to be approved at the referendum.

In this case the median voter is choosing between the proposed and reserved alternatives rather than between the preferred and the proposed ones. One should not argue that in this case the median voter will not be decisive, but the level of expenditures is very unlikely to reflect his preferences (it would rather reflect his most preferable point multiplied by a constant). The lack of such possibility may be coped with provided that the law allows for the median voter's most preferable alternatives to be included into the legislative bulletin. The price for the voter changes by 25% or 60% quantiles simultaneously with the median voter's tax price whereby there is no way to argue that empirical estimator of the expenditure choice model based on the median voter hypothesis speaks well for the fact that indeed the median voter's most preferable budgeting is in place.

⁶⁶ Barr, J.L and Davis, O.A., 1996, An Elementary Political and Economic Theory of the Expenditures of Local Governments, *Southern Economic Journal*, Vol. 33(1), pp. 149–165.

Bergstrom T. and Goodman R. (*Bergstrom and Goodman, 1973*⁶⁷) used the following linear and logarithmical model to associate expenditures with preferences of the median voter:

$$\ln E = c_0 + c_1 \ln \hat{Y} + c_2 \ln \hat{\tau} + c_3 \ln N + \sum \beta X + u, \text{ where}$$

E stands for an expenditure item in the budget,

n stands for the number of households in the region,

$\hat{\tau}$ stands for tax price per median income household,

\hat{Y} stands for median income in the urban/ rural settlement,

X stands for description of a set of most significant socio-economic characteristics of the urban/ rural settlement.

The authors rely on the basic assumption of that the demand elasticity is expected to be equal for all regional residents, consequently changes in the income has an effect on the demand not only directly but also through the tax price of residents. The amount of property (real estate) tax of the median income household is used as a tool for the tax price of the household.

The authors of the model tried to differentiate collectively financed utilities by degree of sociality. For example, it was suggested to consider the price per unit of provided utility as qN^γ , where q stands for a constant, N stands for the population, γ parameter specifies a value between zero and one. In case γ equals to zero, it doesn't correspond to pure social utility, if γ equals to one, it is equivalent to collectively financed private utility.

Assessment results of this model for regional aggregate budget expenditures as well as by specific cost items showed compliance with theory of demand for normal utilities to the extent that income elasticity was positive, while price elasticity was negative, with few exceptions.

The model has a weakness in that it fails to provide understanding of whether budget expenditures reflect preferences of the median voter or a

⁶⁷ Bergstrom, T. and Goodman, R., 1973, Private Demands for Public Goods. American Economic Review, 63, 280–296.

displaced level corresponding to preferences of other (non-median) voter whose income in the sample under review has a strong correlation with both the income of the median voter and per capita income in the region.

The issue of assessment of tax load on the median voter needs to be discussed. A possible error may happen to be found in wrongly selected data. Suppose that families with median income often rent rather than own the house, then the median value of tax load on real estate property fails to reflect the tax price of social utilities for the median voter.

Tests of this model revealed that the income value corresponding to the distribution median gives a better explanation of expenditure dispersion than, for example, 25% quantile does. Testing may be performed simply by replacing median values with other quantile with subsequent F-test for the difference between the sums of regression remainders. Such method was used by Inman (*Inman, 1978*). He tested the following model in his study:

$$\ln\left(\frac{E}{ADM}\right) = c_0 + c_1 \ln \hat{Y} + c_2 \ln \hat{\tau} + c_3 \ln[\{X\}] + u, \text{ where}$$

{X} stands for a function linear against coefficients including demographic variables for different quantiles. Variables accounting for the difference in voting turnout are included here as well.

Lovell (*Lovell, 1978*) studied education expenditures. The study is based on a suggestion that the demand of a representative household may follow from a utility function as follows:

$$U = [C^{-\beta} + \alpha n^{-\theta\delta} E^{-\theta}]^{-1/\beta}, \text{ where}$$

C stands for household's consumption of private utilities,

E stands for consumption of collectively financed utilities (in particular education expenditures),

n stands for the number of pre-school children in the family.

With $\beta = \theta$ this function with constant elasticity of substitution, and demand for collectively financed utility is reported in terms of:

$$\ln E / C = \sigma \ln \alpha - \sigma(1 + \beta\delta) \ln n - \sigma \ln p ,$$

where p stands for the price of the education “unit” per child.

In case $\beta = \theta = 0$ and $\delta = 1$ this is the Cobb-Dougllass production function. Then education expenditures per child, $E = \alpha Y / (1 + \alpha) np$, is a constant share in the family income.

Assumption on the demand based on the Cobb-Dougllass production function gives:

$$\ln(E / Y) = \ln \alpha / (1 - \alpha) - \ln SKEW - \Psi \ln HOO - \ln n + \beta X + \varepsilon ,$$

where

HOO stands for a share of housed in privet ownership (to take into account the situation when families rent their residential premises and, consequently, median displacement),

$SKEW = YMED / \bar{Y}$ stands for taking into account asymmetric distribution of income. This variable allows one to take into account the degree at which the median voter is decisive. If he was decisive, then the ratio of the medial income to the average income or the constant should be used.

X stands for some extra parameters.

If the demand is given by a function with constant elasticity of substitution, the expression is to be modified as follows:

$$[\ln E - \ln C] = \sigma \ln \alpha - \sigma \ln SKEW - \sigma \psi \ln HOO - \sigma(1 + \beta\delta) \ln n + cX + \varepsilon$$

One of the weaknesses of this model is that it lacks private costs of children maintenance. Another weakness is a possible nonmonotonicity with regard to income preferences of households against expenses. Without supposing monotonicity of preferences it would be impossible, even in theory, to argue that the median income voter is decisive. It should be noted that the use of average income values in models with variables characterizing socio-economic situation in the region may cause problems related to collinearity of repressors.

With empirical analysis of applicability of bureaucracy models even superficial consideration of the social sector’s performance gives certain evidence which comply with the two inferences arising from the Niskanen’s (*Niskanen, 1971*) theory of bureau behavior, namely growth in

real public expenses outstrips the consumer's demand for public services; a bigger share of growth in real public expenses is more likely squandered, i.e. represents such expenses that may serve interests of service providers and political officials but not increase cost effectiveness of such services.

Most common evidence in support of the excess expenditures hypothesis is the difference between the static (structural) model of public expenses and their model as time series. It was inferred in the best studies of statistical data, e.g. Borcharding T.E. and Deacon R.T. (*Borcharding and Deacon, 1972*⁶⁸), that income elasticity of demand for most of the services offered by the federal government and non-federal governments is less than one. In time, however, costs of these services grew against income.

Borcharding T. (*Borcharding, 1977*⁶⁹) inferred in his study that structural analysis of consumer's demand for public services explains more than a half of growth in public expenses in the United States. An assumption of that structural study of public expenses may result in underestimation of income elasticity of demand may serve as an explanation of this difference. This is unlikely, because structural studies of demand for consumer goods and normally produce demand elasticity values which are higher than those produced by studies of time series. Most acceptable explanation is that a combination of political and bureaucratic conditions results in higher growth in public expenses versus the growth caused by consumer demand for public services.

All in all, analysis of empirical results may lead to an inference that any efforts to explain budgeting singly based on the median voter model fail to correctly provide the real picture unless the structure of political institutions is taken in account. For example, the budget approved by the legislative assembly will not match the budget which may be approved at the referendum. Empirical estimates may lead to false inferences on the median voter's significance in budgeting. As noted above, budget expenditures along with preferences of the median voter may also be explained

⁶⁸ Borcharding, T.E., Deacon, R.T., 1972, Demand for services of non-federal governments. *American Economic Review* 62, 891–901.

⁶⁹ Borcharding, T., 1977, The sources of growth of public expenditures in the U.S., 1902–1970, in by T.E. Borcharding, Ed., Durham, N.C.: Duke University Press.

by preferences of voters from other distribution quantile. Consequently, correlation of preferences may lead to false inferences on that public authorities strive to maximize the median voter's utility. Comparison of models in which expenditures are explained by specific features of voters with different income levels commonly doesn't allow, due to the level of their explanatory ability, the best model with acceptable significance to be selected.

The bureaucracy models obtained during empirical analysis prove ineffectiveness inherent to public service production. Nevertheless, ineffectiveness related to overestimation of budget against the socially optimal level may be reduced by improving budget execution control which may be in place during transition from the election principle to the appointment principle of governors. On the other hand, costs of budget expenditures control may exceed benefits from efficiency upgrading. Consequently, the transition to the principle of governors appointment and growth in costs of budget expenditures control may fail to resolve the issues of effectiveness. In spite of the fact that the bureaucracy virtually tends to overestimate budget expenditures versus the level preferred by voters, in most cases the control over the appointed governors by the central federal government is unlikely to cost less and be more efficient than that the control of voters over democratically elected representatives of legislative and executive authorities.

1.3.4. Modeling Regions' Support to the Central Federal Government at Elections

A stand-alone issue of the analysis is to study relations between the central federal government and the regions with regard to the regional financial policy. Borck R. and S. Owings (*Borck and Owings, 2003*⁷⁰) set an objective in their study to prove that the regional government has real political reasons to receive federal support. To this end, it was suggested that financial aid to the regions is based on regions' support to the central federal government at federal elections. Importance of such aspect of interaction between the central federal government and the regions as ap-

⁷⁰ Borck, R. and S. Owings, 2003, The political economy of intergovernmental grants. *Regional Science and Urban Economics* 33, 139–156.

plied to the objectives of this paper is governed by a possible assumption of that the central federal government introduced the principle of governors appointment in an effort to strengthen support by residents of specific regions to the incumbent central federal authority at elections.

In their earlier studies Dixit and John Londregan (*Dixit and John Londregan, 1995*⁷¹), Romer and Rosenthal (*Romer and Rosenthal, 1979*⁷²) showed that political power of the regions has a direct impact on entitlement to grants, for example, states with a big share of rural population received more grants per capita than other states on average. It was demonstrated that the amount of federal aid depends, in particular how many potential votes the region can provide in support of the central federal authority. In addition, it was found out that entitlement to grants depends largely on the degree of deregulation related to decision making than interregional externalities.

The amount of grants, other factors being equal, increases with reduction of lobbying costs, non-federal authority's revenues per capita as well as increase in positive externalities from provision of social utilities within a given jurisdiction. The authors believe that there are direct costs of "influence purchase" and alternative costs. The study shows that costs of financial aid lobbying increase as the region is getting more remote politically, socially and geographically from the central federal authority. This can be related to the fact that lobbying policy makers may not be members of the incumbent party, the need to pay transportation costs to get to the capital, costs of lodging, meals, etc. The authors believe that the bigger the number of public servants in the region which make up an interest group maximizing the budget costs, the smaller the costs.

The model of Borck R. and S. Owings is presented in the form of a two-stage game. At the first stage regional policy makers decide on how much time they are willing to spend on lobbying (it is assumed that they value, among other things, leisure). Thereafter, the federal government

⁷¹ Avinash Dixit and John Londregan, 1995, Re-distributive Politics and Economic Efficiency, APSR, 1995, pp. 856–866.

⁷² Thomas Romer and Howard Rosenthal, 1979, Bureaucrats Versus Voters: On the Political Economy of Resource Allocation by Direct Democracy, QJE, Vol. 93, No. 4. (Nov., 1979), pp. 563–587.

selects an optimal amount of the grant for the jurisdiction under the given level of lobbying. The received aid is spent on the provision of social utilities. Further, the authors believe that there are interregional externalities.

It should be noted that in this model the term lobbying is construed as lobbying promoting reelection of the central federal authority, for example, providing access for the central federal government to local socio-political organizations or disclosure to the same the information of preferences of local voters, i.e. inadequate information is one of the main reasons that may lead to lobbying.

It is suggested that the central federal government maximizes the probability of reelection which is weighted sum of probability of that the central federal government will be supported by one of (two) jurisdictions:

$$\begin{cases} \max_{g_1, g_2} Nq(g_1, l_1) + (1 - N)q(g_2, l_2) \\ T = Ng_1 + (1 - N)g_2 \end{cases}$$

g stands for grants provided by the central federal authority,

l stands for the level of lobbying,

q stands for the probability of the region's support to the central federal government at elections,

T stands for the central federal authority's budget,

N stands for a share of the population of the first region.

First-order conditions for the central federal government is expressed as follows: $q_g^1 - q_g^2 = 0$. In other words, the central federal government keeps supporting one of the regions until the marginal benefit from the region's support at elections is compensated by diminishing probability of this region's support.

Regional public authorities' utility depends on the number of social utilities within the jurisdiction in question (through a possibility of being reelected) and leisure time of bureaucrats (leisure may be related to realization of personal objectives of bureaucrats). Bureaucrats choose the

level of lobbying and the level of provision of social utilities on the assumption that the level of lobbying and the level of provision of social utilities at other region is predetermined.

Therefore, the bureaucrat's problem looks as follows:

$$\begin{aligned}
 \max_{x_i, L_i, l_i} &= u(X_i) + v(L_i) \\
 \text{s.t.} \quad X_i &= x_i + a_i x_j \\
 x_i &= M_i + g_i(l_i, l_j, N) \\
 L_i &= 1 - (1 + s_i)l_i, i = 1, 2, i \neq j
 \end{aligned}$$

where X stands for the volume of social utility,

L stands for leisure volume,

a stands for intensity of externalities from the provision of social utilities outside the (in other regions),

M stands for the region's own revenues,

s stands for marginal costs of lobbying.

Regional governments enhance the level of lobbying until the marginal benefit from the possibility to obtain grants is compensated by marginal costs of giving up leisure.

The authors showed that there is an equilibrium when regional governments may give up lobbying the central federal government if externalities are big enough to have no concern for production of social utilities on its own territory.

Since increase in the level of lobbying by the first region reduces the value of obtaining grants by the second region, the marginal benefit from the provision of additional unit of social utility increases for the second region thereby optimal level of lobbying will increase in one region with an increase in the level of lobbying in the other.

Suppose that in a given region the possibility of obtaining grant depends exclusively on the level of lobbying in the same, the equilibrium in this model will be stable. One may say that under equilibrium per capita grants received the first region decrease with an increase in externalities from this region (for example, consumption of social utilities grows with

increased externalities thereby decreasing marginal benefits from lobbying), marginal costs of lobbying and revenues of the first region.

Information asymmetry between the central federal government and the regions may not merely encourage lobbying as defined above, but also lead to implementation of inefficient social projects (see *Bestfamilie*, 2003). If the regional government is going to launch a social project which is to be implemented by a private firm and financed by the central federal government which has no full information on benefits of the project and effectiveness of some or other firm, then in case that the central federal government has no full information on effectiveness of the firm and real benefits of the implemented project, this may result in distortion in decision making, i.e. some of the decisions may not be optimal at this juncture. Decisions will be optimal provided that either the central federal government has full information or has no information on the type of the firm, in which case it may simply prepare several projects for firms with different levels of effectiveness.

Where the central federal government has no full information on benefits of the project, there are different behavior strategies that central federal authority may pursue: the central federal government do not implement the project at any level of benefits or implements it subject to high level of benefits. Of most interest is the case when the central federal government implements the project subject to high level of benefits. Under the circumstances it has to make positive transfer in case that local governments report low level of benefits (so that they have no incentive for deception) and negative transfer in case that local governments report a high level of benefits (so that they have no incentive for overestimation of benefits). This results in distortions of optimal decisions on implementation of some or other projects. For example, if the absolute value of "high social advantages" of a project is low, transfer costs may exceed benefits of the project, therefore the central federal government decides not to implement projects as all. Likewise, the central federal government may refuse to make transfers and then decide to implement a project even though its benefits are insignificant for the project to be implemented with full information available.

Information asymmetry and consequently incentives for local governments' opportunistic behavior are inherent to the nation where local governments are elected through direct voting rather than appointed by the central federal authority. Appointed local governments are concerned about not being reelected for another term if their opportunism is disclosed, while elected local governments feel themselves safer as to their opportunism towards the central federal authority.

It may be inferred from the foregoing that with the principle of governors appointment being in place as well as the central federal government being in charge of redistribution functions, regional governments have incentives to allocate a share of resources for lobbying aimed at getting more financial aid. This leads to changes in the target function of executive authorities. In particular, we may no longer argue that local governments reflect preferences of the median voter. Suppose that the median voter has a possibility through lobbying to receive extra funds from the central federal authority, then a problem arises of it having no information on whether or not it is possible to obtain funds this way.

In case of governors appointment, the objective of supporting the central federal government at elections at the region of the appointed governor is quite natural and may be considered by using models of agent relations in which an important objective is to develop an stimulus contract stipulating the behavior of the appointed governor, rather than the model of strategic interaction between the central federal government and local governments as stand-alone participants. In this case it is possible to ensure more efficient allocation of resources through more flexible incentive tools and provision of the central federal government with more complete information on regional governments.

2. Elections and Appointment of Subnational Authorities: International Experience and Russian Reform

2.1. Assessing Contractual Relations between Federal (National) and Regional Governments: A Review of the International Experience and Possible Implications for Russian Federation

Federal countries combine “self rule” and “shared rule; that is, they afford constituent units substantial autonomy while at the same time also providing them with the benefits of unity. Fiscal federalism is mainly concerned with how federal states allocate revenue and expenditure responsibilities among the different orders of government. Since it is commonplace for revenues to be more centralized than expenditures in federal systems, fiscal federalism is also concerned with the intergovernmental transfers that are provided to offset the vertical fiscal ‘gaps’ that typically are found in federal states. Fiscal federalism is concerned as well with transfers that are designed to offset horizontal, that is, inter-constituent differences in fiscal capacity and/or need. The organizational and structural composition of intergovernmental fiscal systems varies between states, reflecting their unique historical, economic, political, social and geographical characteristics. According to R. Bird, however, it is the “workings of the myriad of intergovernmental relations that constitute the essence of the public sector in all countries” (*Bird, 1990, 281*).

The paper is organized as follows. The first section of this paper addresses some of the principal issues and concepts found in the literature on fiscal federalism and reviews current theoretical and conceptual works on intergovernmental transfer systems. It thus presents an overview of the key issues and central functions of fiscal federalism as well as the economic rationales for implementing intergovernmental transfer systems. The section then speaks to the criteria that an effective transfer system should seek to satisfy and highlights some of the “trade-offs” and ten-

sions inherent in attempting to satisfy these criteria. In short, it seeks to cast light on the nature of the ‘contractual’ relationship among orders of government that is found in the intergovernmental transfer arrangements in federal systems.

The second section describes and assesses different federal-regional contractual fiscal relationships for a cross-section of existing federations in order to glean insights into the design characteristics and effects of various intergovernmental transfer systems. The transfer systems described in the paper are classified based on conditionality and assessed with regard to their impact on accountability and power relationships as well as on policy goals linked to incentive and performance effects. A conceptual framework is utilized that enables the conditional transfers to be classified based on conditions linked to **inputs, outputs and outcomes**. This makes apparent the specific impacts and effects of each type of conditionality on policy goals, accountability relationships and constitutional stability. The framework is applied for the cross-section of federations referred to above.

2.1.1. Principal Issues and Concepts

Fiscal Federalism – Key Issues, Central Functions and Economic Rationales. As already noted, one of the central issues within the literature on intergovernmental fiscal relations has to do with the allocation of revenue and expenditure responsibilities to different levels of government. The economics literature generally refers to three principal functions of fiscal systems in federal states – also applicable more broadly to the fiscal systems of non-federal states. These are:

- macroeconomic stabilization,
- income (re) distribution, and
- resource allocation (*Fjeldstad, 2001; Oates, 1999*).

There is also, however, obviously a *fourth*, often ignored by economists, which is to preserve the political integrity of the state.

With respect to the first three listed functions, according to conventional theory, macroeconomic stabilization and income (re)distribution are mainly functions of the national government with the responsibility

for allocating resources falling principally to sub-national units of government (*World Bank Report, 2000, 115*).

Fiscal policy is a key mechanism for achieving and maintaining *macroeconomic stabilization*. This involves managing the budget, including control of the amount and structure of taxes and expenditure. The use of intergovernmental transfers, however, can create “risks for macroeconomic management and fiscal discipline” (*Fjeldstad, 2001, 11*). When expenditures are substantially more decentralized than revenues and intergovernmental transfers from national to sub-national governments correspondingly large, this can impose a considerable degree of rigidity on the federal (national) government’s budget and its allocation. According to the World Bank’s 2000 World Development Report, the destabilizing potential of shocks to macroeconomic stability is most significant when sub-national governments face no hard budget constraints (*World Bank, 2000, 111*). Fjeldstad adds that “expectations of bail-out in case of financial trouble weaken the incentives to economize on costs, and may generate resource waste and rigidity within local governments. These inefficiencies, in turn, may spill over into macro-economic imbalances,” (*Fjeldstad, 2001, 11*). Robin Boadway, however, suggests that there are ways that federations can protect against the potentially destabilizing nature of intergovernmental transfers, pointing to the existence of a common internal market as a means of absorbing and adjusting for shocks (*Boadway, 2001, 98*).

The literature on fiscal federalism also asserts that *income (re)distribution* is or at least should be primarily a function of the national (central) government. Fjeldstad writes that “it is sometimes argued that decentralized income-distribution is self-defeating. For instance, if a jurisdiction adopts policies to redistribute income by imposing high taxes on the rich and giving high benefits to the poor, the rich will tend to ‘vote with their feet’ and leave for more lightly taxed areas,” (*Fjeldstad, 2001, 4*). It is unclear, however, whether such fiscally induced migration within a federal system is statistically significant. Moreover Fjeldstad acknowledges that, whatever theory may declare, practically speaking redistributive measures are often carried out by sub-national levels of government in policy areas such as land use and rent controls as well as public health

care, education, water supply, housing, and public transportation, all of which have redistributive effects (Fjeldstad, 2001, 4).

Unlike macroeconomic stabilization and income (re)distribution, the responsibility for *resource allocation* is generally assigned to sub-national governments. Arguments supporting this assignment focus on the issue of “proximity to the people” in that it is asserted that local/regional governments are more likely to be in direct contact with “the people” and are, therefore, in a better position to identify the needs of “the people” and determine the appropriate supply of public services desired (Fjeldstad, 2001, 4; Boadway, 2001, 99).

Although not prevalent in the fiscal federal literature, a fourth rationale for implementing a system of intergovernmental transfers concerns the implicit and “necessary impulse” of the federal government to ensure that decentralization does not go so far as to jeopardize the political integrity of the state. This stems from state-level fears that too much decentralization of fiscal responsibilities may render the national state irrelevant fiscally and thus jeopardize its future politically. In this view, intergovernmental transfers can be seen as an instrument of nation building by the federal (national) government. This rationale appears to us to have particular relevance in both transition and developing countries, where the national government may wish to control the flow of fiscal resources, using them as carrots to win the loyalty and support of the different regions.

The literature on fiscal federalism also suggests several economic rationales for implementing a system of intergovernmental transfers: (1) to close the *vertical fiscal gap* (the vertical expenditure-revenue mismatch), (2) to address *horizontal* differences in fiscal capacity and fiscal need among regions and (3) to address *externalities* or “*spill-over*” effects (benefits or costs experienced by regions other than that which makes the initial expenditure).

The vertical fiscal gap (not to be confused with vertical fiscal imbalance) (Fjeldstad, 2001, 8; Boadway, 2001, 93) reflects a mismatch between the revenue-raising potential and expenditure responsibilities of sub-national governments (Ma, 1997, 2). Fjeldstad writes that “almost without exception countries assign more expenditure functions to sub-

national governments than can be financed from revenues belonging to those governments,” (Fjeldstad, 2001, 8). This results in the dependence of sub-national governments on intergovernmental transfers from national governments, which typically raise more in revenues than are needed for their own expenditures and thus are able to help regional (and sometimes local) governments meet their expenditure responsibilities.

Horizontal imbalances, on the other hand, arise due to the fact that regions differ with respect to their fiscal capacities (often linked to differences in their resource endowments) and needs (called capacity-needs imbalances). Jun Ma writes that “on the one hand, some jurisdictions may have better access to natural resources and other tax bases that are not available to others. They may also have higher income levels than those in other jurisdictions. [...] On the other hand, some jurisdictions may have extraordinary expenditure needs, because they have high proportions of poor, old, and young” (Ma, 1997, 2). Likewise, Fjeldstad and Shah suggest that designing intergovernmental transfer systems to deal with these *capacity-needs imbalances* can be further complicated by political measures that treat all sub-national regions as uniform, by historical conflicts and rivalries and by “spill-over” effects between regions (Fjeldstad, 2001, 12; Shah, 1994, 44).

2.1.2. Implementing Effective Transfer Systems: Criteria & “Trade-offs”

Before tackling issues associated with intergovernmental transfers, it must be noted that the relevance of the debate will vary from one country to another. In federations or other countries with small vertical fiscal gaps, the impact of intergovernmental transfers will be correspondingly small and the trade-offs discussed below will be similarly small. In federations with substantial or large vertical fiscal gaps, the opposite applies. This qualification must be kept in mind in the discussion below.

The literature on fiscal federalism outlines several criteria that an effective intergovernmental transfer system should seek to satisfy to help mitigate some of the “trade-offs” and challenges inherent in decentralized fiscal systems.

- The first is *revenue adequacy* and *autonomy*. In order to ease the expenditure-revenue mismatch sub-national governments should have sufficient funds after receiving grants to autonomously deliver the expenditure programs for which they are constitutionally responsible.
- Second, fiscal responsibility at sub-national levels should be promoted with the goal of promoting *transparency accountability*, and *stability*.
- Third, grant-giving formulas should be used with a view to encouraging *efficiency*.
- Fourth, transfers should be made with the principle of *equity* in mind, that is, transfers should consider both local fiscal needs and local fiscal capacity in determining the size of grants (*Fjeldstad, 2001; Boadway, 2001; Ma, 1997; Boadway, 1996; Shah, 1994*).

A central tension in the existing theoretical and empirical work on fiscal federalism, however, emerges out of the practice of fiscal decentralization itself between issues of *autonomy* on the one hand and *accountability* on the other. One of the key challenges to fiscal federal systems, thus, lies in finding ways to ensure that sub-national governments have access to an adequate amount of resources to meet expenditure responsibilities autonomously, while at the same time maintaining a sufficient level of transparency and accountability for how expenditures are allocated (*Prud'homme, 1995, 208*). The ability to balance political power between the national and regional governments and the degree of pressure that sub-national governments are able to exert on national government are two variables that factor into both *revenue adequacy* and *autonomy*. The 2000 World Bank World Development Report states that “the rules that govern relations between the central and subnational levels are almost always established at the national level [...] the balance of powers between national and subnational governments will therefore depend on the influence of regional interests on the national government” (*World Bank Report, 2000, 112*). The report continues that the ability of regional governments to influence the central polity depends on two factors: (1) a sub-national government’s ability to pressure the national government to change rules and (2) the strength of the central body to withstand such pressure (*World Bank Report, 2000, 112*).

The degree to which sub-national governments can be held accountable to their constituents and the national-level donors without jeopardizing the decentralized nature of fiscal federalism determines whether intergovernmental grant systems will likely yield beneficial results. Establishing an effective electoral rules-based system becomes important in factor in determining whether regional-level program expenditures reflect the interests of regional populations or are captured by the interests of regional elites (*World Bank Report, 2000, 121*). This consideration also raises questions of particular relevance for the current structure of regional governance in Russia inasmuch as the priorities there could also reflect the priorities of elites based in Moscow. Issues of *accountability* and *autonomy* have multiple layers of analysis, however, in the sense that in some instances lower levels of government may be better equipped to monitor the implementation and outputs of public service expenditures than national governments. For example, the literature states that in instances where programs are directed at specific sub-groups of the population (e.g. unemployment insurance) and their provision is dependent upon these sub-groups satisfying certain conditions, it may be difficult for national governments to closely monitor the effort that providers of these services are putting toward them. In practice, however, national governments may establish reporting mechanisms aimed at monitoring and enforcing the provision of these services, often through the implementation of output or outcome-based conditions. It may also be more challenging for national governments to determine whether they are targeting the services (or transfers) to the intended population and, therefore, also how effective such programs are at meeting the needs of program users (*Boadway, 2001, 101*).

In some ways arguments favouring sub-national *autonomy* are, thus, linked to those concerning *efficiency* in that it is asserted that placing fiscal decision-making power in the hands of sub-national governments is efficiency-enhancing. Support for this claim flows from the classic decentralization arguments first put forth by W. Oates in 1972 that suggest that different communities have different demands for public goods and services and, therefore, that efficiency can be improved if sub-national governments provide their own public goods and services (*Oates, 1972*).

This argument follows the “proximity to the people” position that asserts that sub-national governments are more likely to be aware of the needs and desires of their constituents than national-level governments. (Alternatively, sub-national governments may not have superior awareness but be more likely to act on their awareness because they have different trade-offs than national governments). The interdependency created between national and sub-national governments as a result of the decentralization of certain fiscal responsibilities, however, is at the centre of debates on the efficiency and equity of intergovernmental transfer systems.

Boadway writes that “much of the thinking is concerned with how best to reconcile national objectives with the decentralization of fiscal responsibilities to sub-national governments, given that many of those responsibilities impinge upon the fulfillment of national economic efficiency and equity objectives” (or outcomes) (*Boadway, 2001, 94*). He continues that the three principal causes of inefficiency are found in the three forms of fiscal externalities: (1) fiscal inefficiencies, (2) horizontal fiscal externalities and (3) vertical fiscal externalities (*Boadway, 2001, 102–103*). Standard *efficiency* concerns thus include: disruptions to internal common markets that distort cross-border transactions, including inefficient mobility of labor and businesses as well as misallocations of and “spill-overs” (from both program expenditures and tax revenues) that are both intentionally and unintentionally not taken into account by regional bodies (*Boadway, 1996, 678*). In recent years, a concern has been how to best balance the presumed efficiency gains associated with expenditure decentralization without corresponding revenue decentralization (there is more efficiency in expenditure decentralization than revenue decentralization) with the presumed efficiency losses associated with the absence of hard budget constraints in that same situation.

Regarding *equity* (the fourth item listed on page 5 above), the World Bank identifies two significant factors in determining whether intergovernmental transfer systems are likely to exacerbate existing regional disparities or become a positive force in alleviating them. The first factor, *fiscal* or *horizontal equity*, refers to the extent to which sub-national governments have the fiscal capacity to deliver generally equivalent levels of services to their populations. The second factor, *within-state equity*, has

to do with the level of will on the part of sub-national governments to improve resource and income disparities within their borders (*World Bank, 2000, 110*). Boadway writes that “fiscal decentralization leads to fiscal inequity simply because it gives rise to regions having different abilities to provide public services for their residents at given tax rates” (*Boadway, 2001, 109*).

This equity concern is, as noted earlier, a belief that people have “the right to be treated equally with others of like circumstances regardless of the region of their residence” (*Boadway, 2001, 99*). As Boadway notes, this is not a value that is equally held by people of all regions. This is because the people of wealthier regions will continually be net contributors for the programs that support horizontal equity while others are net receivers or beneficiaries of this principle (*Boadway, 2001, 99*). National equity issues, specifically those pertaining to *national interest*, are also an important consideration based upon the fact that by placing expenditure power in the hands of sub-national governments they may choose to design programs and adopt policies that are not in line with the overarching interests of the national state.

An effective transfer system must continually search for ways to mitigate the potentially negative effects and consequences associated with the concerns and dilemmas of efficiency and equity.

Ultimately, the assignment of various fiscal functions to the different orders of government is complex and there exists no clear, concise or concrete policies to adhere to in determining an appropriate intergovernmental fiscal arrangement. The literature does discuss several characteristics, however, that appear to be fundamental to the success and effectiveness of systems fiscal federalism. These include: continual intergovernmental consultation, negotiation within and outside of the formal institutions of government, including mechanisms for citizen participation and measures to ensure transparency in the fiscal system (*Kincaid, 2002*). In the end, there is an inevitable “trade-off” between the perceived benefits of intergovernmental transfers and their costs, in part mitigated by one’s views about the degree to which a national government can decentralize the process of determining fiscal policy without potentially sacrificing the ability to realize national objectives and maintain national unity.

2.1.3. Types of Intergovernmental Transfers & Mechanisms of Distribution/Provision

In the literature there are three principal categories of intergovernmental grants made from national to lower level governments. These are: (1) vertical *conditional grants*, (2) vertical *unconditional grants* (and *revenue sharing*) and (3) *equalization grants* (almost always horizontal).

- **Vertical Conditional Grants**

Vertical conditional grants, sometimes also called “special purpose” or “categorical” grants carry conditions with them regarding where and for what programs/projects funds must be allocated by the recipient government. Conditions are usually placed only on recurrent expenditures and costs and refer to “earmarking the financing of certain broad-based services, such as primary education, primary health, water supply, agricultural extension and roads. The grants are often based on minimum standards of service to be defined by the sector ministries in negotiation with representatives of sub-national governments” (*Fjeldstad, 2001, 10*). The provision of conditional grants may be tied or linked to conditions on:

- the inputs (expenditure or process);
- outputs (productivity or quantity-based); or
- outcomes (performance-based or quality-based) of the activity that is to be achieved (*Shah, 2003; Bird and Smart, 2002; Bird, 2000*).

A national government will often exercise some of its “spending power” (*Boadway, 2001, 96*), the granting of funds to a region with conditions attached, in order to influence the *manner* in which sub-national regions carry out expenditure responsibilities. This helps to ensure that programs that are highly important to national governments but possibly less so to regional levels are implemented by the regional governments accordingly (*Ma, 1997, 3; Shah, 1994, 6*). The imposition of “conditions” on inputs (i.e. *where* and *how* transfers are allocated) can also help to ensure a degree of fiscal and expenditure stability. Authors argue, however, that such input conditions may also limit the autonomy of sub-national governments and often impede the efficiency and effectiveness of fiscal federal systems, though they may be justified on the basis that they can

help to ensure specific outputs and outcomes, such as minimum nation-wide standards, fiscal responsibility and accountability (*Shah, 2003, 8; Fjeldstad, 2001, 10; Watts, 1999, 48–49*). There are several types or instruments for the delivery of conditional grants including: (1) *matching grants: open-ended and close-ended* and (2) *non-matching, “block” grants*.

Matching grants are traditionally used by federal/national governments to correct inter-jurisdictional “spill-over” effects. Boadway writes that “if regional expenditure programs cause spillover benefits to other regions, there will be no incentive to take account of those benefits when deciding levels of public expenditure” (*Boadway, 2001, 115*). Such “positive externalities,” where an increase in one region’s policy instrument has a beneficial effect on one or more other regions can lead to the specific instrument being set at too low a level (*Boadway, 2001, 96*). A classical example of a “positive” or “direct” spillover effect is pollution abatement by one state that benefits another state by lowering cross-border emissions (*Dahlby, 1996, 401*). Boadway continues “the spillover benefits can be internalized by a properly chosen matching grant formula, where the rate of matching reflects the share of spillover benefits in the total benefits of the project” (*Boadway, 2001, 115*)⁷³.

Choosing an appropriate matching grant rate is problematic, however, given that the share, or percentage, of external spillover benefits experienced in relation to total benefits is difficult to determine. *Matching open-ended grants* are such that for every dollar given by the donor to support an activity or service, the recipient must also expend a certain sum. For instance, an open-ended grant might stipulate that for every dollar spent by the local government on a particular service the national government will also provide a dollar. This often results in a matching rate of 100% of regional expenditures intended to stimulate regions to establish certain social and public programs.

Open-ended matching grants paid by national governments to regional or local governments often include conditions on inputs in order to com-

⁷³ For detailed examples of expenditure matching grant formulas refer to Dahlby, Bev. (1996). “Fiscal Externalities and the Design of Intergovernmental Grants”. *International Tax and Public Finance*. Vol. 3: 397–412.

pensate for benefit spillovers that create disincentives for the regional/local governments to increase expenditure investment on such programs. According to Shah, an open-ended matching grant system, “based on the expenditures giving rise to the spillovers will provide the incentive to increase expenditures” (*Shah, 2003, 4*). Similarly, Richard Bird and Michael Smart note “although matching (or conditional) transfers make local governments more susceptible to central influence and control, they also have the important political advantage of introducing an element of local involvement, commitment, accountability, and responsibility for the aided activities” (*Bird and Smart, 2002*).

Matching open-ended grants, however, also have significant disadvantages in that they may induce regional or local governments to expand or establish major social and public programs that they otherwise would not. Boadway thus argues that they introduce “adverse incentive effects into the transfer system” such that governments who have already-established programs to which matching grants are being provided might be inclined to expand the size of the programs substantially upon receiving grants. He writes that “generous shared-cost financing could potentially cause rational governments, which had already established the shared-cost programs, to expand them significantly” (*Boadway, 2001, 115–116*).

Matching close-ended grants are conditional grants in which a “ceiling” or “cap” is placed on the maximum “spill-over” amount that the national government is willing to “match” for the activity or service being provided by the regional government. This is often used by countries in order to help control the “adverse incentive effects” of open-ended matching grants and to maintain balanced budgets. Close-ended grants thus afford the grantee some control over the costs of transfer programs, predominantly pertaining to input or process-based aspects of such programs (*Shah, 2003, 4*).

In the case of *non-matching*, “*block*” grants central governments provide a fixed sum of money with the stipulation, which it may be difficult to effectively enforce, that it will be put toward a particular public service or good. The use of conditional “block” grants has become a prominent feature in the design and implementation of intergovernmental transfer systems, in many cases replacing the use of matching grants (*Boadway,*

2001, 116). Such conditions can in theory be linked to the inputs, outputs, or outcomes of various expenditure programs. For instance, “block” grants are often used as vehicles to induce regional spending programs to conform to norms of efficiency and equity as well as adopt policies/programs that are in the interests of the nation state, helping to ensure that national minimum standards of service are maintained across the nation (*Shah, 1994, 6*).

Setting conditions on outputs and/or outcomes, rather than on inputs, focuses not on how specific grants are allocated but, instead, on creating conditions that support the attainment of standards in the quality, access and level of delivery of public services in areas such as education, health care and social welfare (*Shah, 2003, 5*). In the case of such “specific purpose” grants Shah writes that “conditionality is best imposed on outputs or standards of access and quality of services rather than on inputs and processes. This allows the achievement of grantor’s objectives in achieving national/state objectives without undermining local choices on how best to deliver such services” (*Shah, 2003, 11*). Bird also asserts that the use of “performance” (output/outcome) “conditions” has “considerable merit” (*Bird, 2000, 16*). According to Bird, “it [performance “conditions”] focuses on what is presumably the real policy objective [...] It also, however, makes much greater demands on the federal/national government to interpret the inevitably incomplete (and perhaps biased) information it receives” (*Bird, 2000, 18–19*).

In this kind of analysis, the bottom line is that there are tensions or trade-offs in choosing between the different kinds of conditions. Input conditions assure the national government that the transfer is being unambiguously used by the recipient government for the designated purpose. But they generally interfere with local autonomy and also make accountability unclear. They may thus facilitate the immediate purpose of the national government but have an uncertain impact on the longer-term goal that the national government is attempting to pursue. Output or even better still outcome conditions do not detract nearly as much from local autonomy or accountability. But it may be difficult to prove a clear link between the expenditure of the transferred funds and the outputs or out-

comes that are being promoted. Indeed, the relationship between the transfer and its impact may be both ambiguous and uncertain.

- **Vertical Unconditional Grants (and Revenue Sharing)**

Unconditional grants are “general-purpose” grants intended to address vertical gaps. An unconditional grant is characterized by the fact that there are no restrictions on where and how grants must be spent (inputs), no “minimum standards of service” (outputs) defined and no “performance indicators” (outcomes) attached to the grants (*Fjeldstad, 2001, 11*). These funds can be allocated and used at the discretion of the sub-national governments to provide services that are in line with the objectives of the particular jurisdiction. They are generally justified based upon the argument that, like equalization grants, they “can be used to equalize fiscal capacities of different local governments to ensure the provision of a minimum (or reasonable) level of public services” (*Ma, 1997, 4*). Ronald L. Watts writes that “given an amount of available assistance, grant recipients prefer unconditional non-matching transfers, which provide maximum flexibility to pursue their own objectives. Because such grants augment resources without influencing spending patterns, a recipient can maximize his own welfare” (*Watts, 1999, 38*). Unconditional grants are delivered in the form of *unconditional “block” grants*.

According to the literature two factors are critical to the effectiveness of the unconditional “block” grant system. These are (1) accountability and (2) predictability (*Fjeldstad, 2001, 11*). Concerning accountability, an absence of internal audit mechanisms, poor reporting systems and non-compliance with established financial regulations can negatively impact the effectiveness of unconditional “block” grants. In terms of predictability, the “block” grant system can be negatively affected if delays occur regularly in the receipt of grants by sub-national governments. This suggests that in practice it may be difficult to enforce and monitor the implementation of both conditional and unconditional “block” grants if the appropriate financial management and monitoring mechanisms are not in place or if sufficient capacity to monitor such programs does not exist (*Fjeldstad, 2001, 11*).

It bears noting that unconditional block grants are less usual and unconditional revenue sharing, which has similar effects, more usual. The advantages and disadvantages of unconditional revenue sharing relative to unconditional intergovernmental transfers are straightforward. Revenue sharing provides more certainty that anticipated funds will flow to recipient governments because such arrangements are usually constitutionally based and thus revenue sharing is likely to be more attractive to regional governments than intergovernmental transfers. But revenue sharing may be less attractive to national governments because they reduce the flexibility of the national government in the management of its finances.

- **Equalization (Horizontal) Grants**

The provision of equalization grants is tied to the issue of horizontal equity among sub-national regions of government. The purpose of equalization grants is to redistribute funds from relatively richer sub-national jurisdictions to relatively poorer ones. They exist to offset net fiscal benefit (the level of benefits received less the level of taxes paid) differentials and fiscal inefficiencies and inequities that exist as a result of capacity-needs imbalances among regions. Often, these transfers are based on an equalization formula or system that measures the fiscal need of a regional government against its fiscal capacity and attempts to equalize regional capacities nationwide (*Fjeldstad, 2001, 13; Boadway, 2001, 112*). According to Watts, there are a range of formulas for basing the transfer of equalization grants on, from an agreed formula system to the recommendations of standing or periodic independent commissions (*Watts, 1999, 51*).

Watts also notes that “the extent of the equalization transfers varies considerably” (among federations). However, in most countries, whether federations or not (e.g., Canada, Australia, the United Kingdom, Japan, Korea etc.), equalization grants are provided by national governments to sub-national governments in order to achieve redistribution (*Watts, 1999, 51*). Germany, however, is unique in that equalization transfers are made in the traditional national government-to-region format as well as between sub-national governments, based upon fiscal capacity imbalances

(Watts, 1999, 51; Ma, 1997, 4). The use of equalization grants does have disadvantages, however, as “sub-national governments may differ in their willingness to raise taxes.

The first section of this paper has provided an overview of some of the central issues, concepts and economic rationales found in the literature on fiscal federalism and, specifically, on intergovernmental transfer systems and revenue sharing. The second section will now turn toward a comparative description and assessment of the experience of different federations with fiscal federalism and will explore the nature of the contractual fiscal relationships between national and sub-national governments. In this regard, it is worth reminding the reader that the significance of all these above considerations is linked to the magnitude of the vertical fiscal gap: the larger the gap the more these theoretical considerations need to be weighed and vice-versa.

2.1.4. Conceptual Framework

Regarding intergovernmental transfers, R. Bird and Michael Smart write that “what matters are their effects on such policy outcomes as allocative efficiency, distributional equity and macroeconomic stability [...] The most critical aspect of intergovernmental transfers is thus not who gives them or who gets them but their *effects* on policy objectives” (Bird and Smart, 2001, 2). Following this proposition, the paper embraces a conceptual framework that enables the federal transfer systems explored to be assessed with regard to their *effects* on the achievement of national policy objectives with particular reference to the impact of different types of conditionality on the kinds of policy objectives realized. These objectives include: (1) policy goals and incentives (efficiency and equity trade-offs), (2) transparency, accountability, and autonomy considerations and (3) macroeconomic and constitutional stability (the economic and political integrity of the state).

Conditional transfers are classified based upon *input* (expenditure or process), *output* (productivity or quantity) and *outcome* (performance or quality)-based conditions, which provides insights into the impact that different types of conditionality have on the nature of the institutional arrangements of various federations. Such a classification system also makes visible which conditions are appropriate for the realization of cer-

tain policy objectives and the specific “trade-offs” inherent in different types of intergovernmental transfer systems (See *Shah, 2003*). In states where unconditional transfers or revenue sharing arrangements are a central component of the federal-regional contractual relationship, such transfers and arrangements are evaluated based on actual accountability (including power) relationships and incentive effects.

2.1.5. Country Assessments

Australia

Australia has a population of 20 million people living in six States and two Territories. As will be seen below, the Australian system of fiscal federalism is highly centralized. However, this appears not to have been the aim of the constitutional founders as in its early years (Australia was created from the British colonies at the beginning of the 20th century) as it was initially heavily decentralized fiscally. But through judicial interpretations, the national (Commonwealth) government has become dominant. (As will be seen below, the situation in Canada is more or less the opposite of that in Australia.)

Among the countries analyzed here, Australia is the most centralized fiscally with federal government collecting close to 70% of total government revenues and states raising around 30%. But states expend close to half of total government outlays. In short, the vertical fiscal gap is large in Australia, at least as compared to other developed countries, with the result that state governments are heavily reliant on cash transfers from the federal (Commonwealth) government to finance their expenditures.

And there is indeed an extensive system of cash transfers from the Commonwealth to the state governments fiscal transfers to finance specific programs, such as health and education, and to deal with vertical and horizontal fiscal imbalances (HFI). Bird and Tarasov write that “among the established federations, Australia is the clearest case in which long-standing vertical imbalance has been dealt with almost exclusively by intergovernmental transfer systems” (*Bird and Tarasov, 2002, 18*)⁷⁴. Under Sections 94 and 96 of the Constitution Australia’s central govern-

⁷⁴ We use the term “vertical fiscal gap” for what Bird and Tarasov refer to as “vertical imbalance”.

ment, the Commonwealth, transfers “surplus” funds to the States and sets out the terms by which “the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit” (*The Australia Constitution, Section 94 and 96*)⁷⁵. Although not originally designed for this purpose, Section 96 has become a major avenue through which the Commonwealth is able to exert influence over state spending on public services through the imposition of conditions on transfers.

Two principal types of transfers are used: conditional (specific-purpose payments [SPPs]) and unconditional (general purpose or revenue grants [GRGs]), which fulfills both a general revenue and equalization purpose. In 2005–06, close to 60% of all transfers were provided in the form of unconditional GRGs with the remaining 40% taking the form of conditional SPPs (*Australia Budget, 2005–06*).

Specific-Purpose Payments (SPP)

As already noted, Australia has one of the largest vertical fiscal gaps of any developed federation (the gap being a measure of state reliance on transfers from the Commonwealth government). The result is that the states rely heavily on grants and revenue sharing from the Commonwealth in order to meet expenditure responsibilities (*Searle, 2002, 7*). The Commonwealth controls major sources of revenue generation, including personal income tax, customs and excise duties, corporate taxes and the sales tax, while the states are responsible for the majority of expenditures. The Commonwealth relies on Section 96 of the Constitution to justify not only the transfer of “surplus” funds to the states but also the right to tie grants to specific expenditures through the imposition of conditions, thus, influencing the standard or level at which services under state jurisdiction are provided. For example, even though the Commonwealth has no legislative power in education and health, almost 60% of expenditures in these areas originate from the Commonwealth’s budget (*Searle, 2002, 7*). The significant use of transfers from the federal government to the states to fund state expenditures enables the Commonwealth to exert strategic influence over *performance effects*, in terms of equalizing performance

⁷⁵ The Australia Constitution can be found online at: <http://www.australianpolitics.com/constitution/text/>.

across the states, as well as setting expenditure priorities to satisfy the national objectives of the Commonwealth.

SPP grants are distributed to the states for use within their budgets to fund the “normal” activities of the state. SPPs generally have **input-based conditions** placed on the expenditures that they are intended to fund, in areas such as the activities of municipal governments and the provision of primary, secondary, and tertiary education at religious or non-governmental institutions. Input-based conditions are used to influence the provision of public services for which states have constitutional authority but for which they might not devote sufficient funds to meet particular nationally desired standards in the absence of the use of conditions. In financial year 2002–2003 SPPs constituted AUD \$22 bn of the total AUD \$54 bn (or 40%) of the volume of Commonwealth grants (*McLean, 2002, 9*) and as of 2004 an estimated 120 SPPs existed (*Hull and Searle, 2004, 3*).

One example of an input-based conditional SPP is the transfer of federal funds to the states to be transferred on to local (municipal) governments. In 1999–2000 this funding made up approximately 11% of municipal revenue that was transferred from the federal government through the states to local governments based on the recommendations of each state’s Local Government Grants Commission⁷⁶ (*Searle, 2002, 11*). SPP funding to the states from the Commonwealth is also provided in the area of vocational education training and for services directed toward indigenous Australians. There are no detailed reports, however, outlining either the specific conditions for the transfer of each SPP or the basis on which the distribution has been determined (*Searle, 2002, 14*). The process by which SPP conditions and the basis for their distribution are determined is the result of negotiations between relevant Ministers and senior bureaucrats, and raises questions regarding the *accountability* mechanisms that can be used to determine whether funds have in fact been used for their intended purpose and if so, how *effective* the transfers have been in achieving their desired purpose. The system of SPP distribution also

⁷⁶ Local Government Grant Commissions have been established in each state under Local Government Grants Commission Acts to make recommendations concerning the distribution of financial assistance to local government bodies and for related purposes.

highlights potential *transparency* limitations in intergovernmental transfer process in Australia.

There have, however, been some attempts to implement more **output** and **outcome-based** conditions on SPPs. Regarding Health Care Grants for hospitals, for example, both input and output-based conditions have been implemented but no move towards uniformity in service standards has been achieved. Within the Health Care Grants program conditions have been placed on funds going toward the provision of (1) “free public hospital treatment”, (2) reporting requirements and (3) requirements to reduce waiting lists with no clear agreement on national **outcomes** in terms of *accountability* and enforcing the conditions attached to SPPs (Hull and Seale, 2004; Institute on Governance, 1998). One notable **outcome-based condition** in the area of government school services should also be acknowledged as observed convergences in literacy and numeracy can partly be attributed to Commonwealth conditions placed on states adopting the same starting age, reporting standards and testing procedures to evaluate programs designed to achieve higher standards outcomes in these areas (Hull and Searle, 2004, 18–19). While the continued use of input conditions through the use of SPPs has been a source of contention between the Commonwealth and the states, these conditions do tend to take the form of “relaxed” conditions, with states maintaining a “relatively high degree of discretion over the allocations of specific purpose grants” (Institute on Governance, 1998, 49). Decision-making control over the *amount* of SPPs provided by the Commonwealth, however, remains firmly in the hands of the federal government.

General Revenue Grants and Equalization: Intergovernmental Agreement on Principles for the Reform of Commonwealth-State Financial Relations (IGA)

As a result of state pressure to overhaul the tax system, in June 1999, the Commonwealth and the states signed an *Intergovernmental Agreement on Principles for the Reform of Commonwealth-State Financial Relations (IGA)*. These changes represent one aspect of the Commonwealth’s reforms to the tax system. A value-added tax (in the form of a Goods and Services Tax [GST]) was introduced, the Financial Assistance Grants (FAGs) and Revenue Replacement Payments (RRPs) to the states

were abolished and the Commonwealth wholesale sales tax and a number of other state taxes were removed (*Collins, 2001, 5*). Both “the level of vertical imbalance and the scope of fiscal equalisation are substantially increased by the GST associated changes” as the Commonwealth maintains control over the collection and subsequent transfer of the GST to states (*Collins, 2001, 1*). The GST is intended to provide the states with access to a secure and growing source of revenue and the capacity in the medium to long term to allocate additional funding for services, such as health and education. Collins writes that “this is a worthy objective given that the States deficiency in broad-based tax revenue sources has led them to the use of taxes which are narrow-based, inefficient and highly costly in terms of administration and compliance” (*Collins, 2001, 17*).

As part of the IGA, all of the revenue collected from the GST is returned to the states in the form of general revenue grants (GRGs) to be spent according to each state’s own strategic priorities (*Hull and Searle, 2004, 3*). That is, they are *unconditional*. This means that it is impractical for the Commonwealth government to be sure that the funds transferred to states are used efficiently.

The amount of GRGs provided to states depends on the amount of GST collected annually and is distributed to the states based on a determination of detailed and specific per capita “relativities” by the Commonwealth Grants Commission (CGC) (*Searle, 2002, 13*). In other words, GST revenue is not returned to states on the basis of the actual state of collection, but on the basis of a per capita formula determined by state relativities. This in effect entails a zero-sum result as the “have” states contribute funds to the “have-not” states. The IGA stipulates, however, that “the States budgets will be no worse off after the implementation of the GST until such time as GST revenue exceeds the funding which would have been available to the States under current, pre-GST arrangements (the Guaranteed Minimum Amount or GMA)” (*Collins, 2001, 7*). The GMA represents what funding to states would have been had the GST not been introduced. Furthermore, the rate of the GST (currently at 10%) can only be altered through legislation that has the unanimous support of the states and the Commonwealth. In 2005–2006, the amount of the GST pool to be transferred in the form of GRGs totaled an

estimated AUD \$37 billion and represented the largest single avenue through which “financial capacity” is delivered. The broad purpose of the IGA revisions is to ensure greater certainty in funding and to “make Commonwealth-State relations more harmonious” (*Searle, 2002, 13*).

In addition to the high level of vertical fiscal gap in the Australian system, there is also a considerable degree of horizontal fiscal imbalance (HFI) among the Australian states (and territories). Factors affecting differences in needs-capacity among the states include those arising from Payroll Tax, Land Revenue, Stamp Duty on Conveyances and Mining Revenue (*Searle, 2002, 10*). Furthermore, the higher a state’s average income, the greater will be that state’s capacity to raise revenues from taxes on payrolls, financial transactions, property, gambling, motor vehicle ownership and operation, and insurance of which states have jurisdiction over (*Collins, 2001*). The Commonwealth Grants Commission (CGC) is an advisory board, created by statute, responsible for making recommendations to the Commonwealth regarding how horizontal fiscal imbalances can be corrected through the distribution of transfers to the states as an equalization measure based on calculations of relative needs-capacity revenue-capacity imbalances among states. Though it has no official Constitutional status, the CGC is widely viewed as an integral element of Australia’s transfer system and its recommendations have always been accepted by the Commonwealth. It should also be noted that the CGC does treat the Commonwealth and states as equals in its deliberations, and while the CGC presents its reports to a Commonwealth Minister, it also generally releases its findings to states immediately afterward to enhance transparency (*Searle, 2002, 19*). Furthermore, all of the Commission’s inquiries are open to the public and it discloses all calculations behind its findings.

The “relativities” calculations made by the CGC to determine the amount of GRGs to be received by states are made on the basis of detailed needs-capacity and revenue-capacity assessments, “allowing for needs met by other federal transfers such as the significant specific-purpose transfers for health and education”, to be taken into account (*Bird and Tarasov, 2002, 16*). Re-calculations of relativities are made every five years. In essence, the formula “provides for an equal per capita

transfer (related to vertical gap) plus adjustments for differences in both delivery costs (for a standard set of services) and revenue capacity (the revenue a state could obtain if it applied average state taxes to its own tax bases)” (*Bird and Tarasov, 2002, 18*). The overriding objective of the CGC is to make possible (with reasonable taxation efforts) the provision of public services at an approximately equal level across states (e.g., to equalize the *capacity* of states to provide the average standard of State-type public services).

The first step in the capacity equalization process is for the CGC to determine which state services should be considered in the equalization assessment. In 1999 when the Commission looked at this issue the revisions made included: the inclusion of depreciation into equalization assessments for the first time, the exclusion of all capital transactions, the exclusion of state spending on functions which are the financial responsibility of the Commonwealth (e.g. universities) even though they may be the Constitutional responsibility of the states, and the exclusion of activities of most government business enterprises (GBE) (*Searle, 2002, 20*). An important factor to keep in mind is that the CGC is not intended to enhance actual *performance effects* through *performance equalization* among the states, but rather to address *capacity equalization* (*Collins, 2001, 2*). Collins writes that “states are to be put into the position of *having the ability* to provide average levels of public services while imposing taxes of only average severity. There is no requirement for any individual state actually to provide average levels of public service while imposing average tax burdens” (*Collins, 2001*). The only grants the CGC concerns itself with are “untied” (unconditional) grants. Thus, the only means that the Commonwealth can use to influence directly the delivery of services that are state competencies is through SPPs.

The CGC estimates a state’s needs-capacity imbalance through the measure of “disabilities”, which are “influences beyond a State’s control that require it to spend more (or less) to provide the same service as other States, or means that it cannot raise as much revenue as (or can raise more than) other States from the same tax rates” (*Searle, 2002, 21*). The Commission undertakes a series of expenditure assessments in the 43 categories that it classifies state-recurrent expenditures based on calcula-

tions of “disabilities” (Searle, 2002, 29). Disability factors include differences between states in (1) socio-demographic composition, (2) cross-border factors, (3) urbanization, (4) differences in economies of scale and (5) input costs and measures of state disabilities are based on a state’s position in a particular area relative to the Australian average for that category (Searle, 2002, 30–31). These expenditure assessments are unique to the Australian system. Detailed and quantified analyses of a state’s specific expenditure needs and capacity to meet expenditure responsibilities in each “recurrent expenditure” area is taken into account, rather than assuming needs-capacity requirements are uniform across all states (or accounting solely for differences in fiscal capacity as in the Canadian system).

Recent challenges to the Australian system of equalization include those surrounding *equity* and positive versus negative *incentive effects* and their impact on the *efficiency* of the system. For instance, the more heavily populated states of New South Wales and Victoria have been placing increased political pressure on the Commonwealth and Commission challenging the equalization system on the grounds that it results in “richer” states “subsidizing” the citizens of “poorer” states. They further allege that the system does not provide incentives for State’s with lower capacity to take the necessary steps to raise capacity through the strategic use of transfers received through equalization, “specifically, that it discourages efficiency-seeking agents in the States who realize that State gains from efficiency will be taxed or equalised away from them” (McLean, 2001, 15). Other challenges to the equalization system relate to issues of *accountability* and *democratic representation* in grant distribution. Searle writes that “to a very large degree, the existence and operations of the Commonwealth Grants Commission have minimised the involvement of politicians, both Commonwealth and State, in the grant distribution system. The Premiers and Treasurers of New South Wales and Victoria have become a little more politically active on the issue of whether equalisation should apply, but no politicians are involved in debate with the Commission” (Searle, 2002, 40). The “public” dissemination and availability of all of the Commission’s submissions, however, does strengthen the *democratic transparency* aspects of the system,

though the transparency of the CGC has been a source of criticism for the Commission (See *McLean, 2001*).

Among established federations worldwide, Australia is among the clearest cases in which a long-standing large vertical fiscal gap is considered “normal”. Australia employs an extensive system of fiscal transfers and revenue sharing arrangements from the Commonwealth government to the states to ensure that expenditure commitments of state governments are financed rather than having state governments raise the bulk of its revenues from “own sources”. The Constitution and related jurisprudence effectively enables the Commonwealth to control all the large revenue bases and to decide which ones the states are to share in, either directly via revenue transfers or indirectly via Commonwealth cash transfers to states. That is, Constitutional provisions allow for but do not require revenue sharing or for the transfer of funds from the Commonwealth to state governments. The Commonwealth is also able to use the Constitution (Section 96) to justify the imposition of conditions on specific purpose transfers to the states as well as to influence expenditure in areas it considers a national priority (i.e. education and health) but for which it does not have legislative authority. On the whole, conditions are *input-based* rather than output or outcome focused. We have not been able to find literature that judges their effectiveness.

The Commonwealth is also able to exert strategic influence over *performance effects*, in terms of equalizing performance across the states. In this sense, the Australian systems of transfers and revenue sharing privileges *nation-building* national programs relative to concerns for states’ *autonomy*.

Stated differently, the contractual relationship relating to the allocation of revenue in Australia makes the Commonwealth government the much stronger partner legally. For example, the Constitution places considerable power in the hands of the Commonwealth to intervene in the expenditure affairs of the states by setting conditions on the transfer of “surplus” funds. At the same time, political convention normally assures the sub-national level with some precision regarding its allocation of revenues.

Equalization represents a form of revenue sharing, whereby all of the proceeds of the federally-levied Goods and Services Tax are allocated to the states on the basis of an *equalization formula*. Equalization is formula-based and specific, intended to equalize *performance capacity* and not actual *performance effects* through *performance equalization*. All proceeds from the federally-levied Goods and Services Tax (GST) (less administrative costs) are allocated to the states on the basis of a formula that determines state per capita “relativities” (determined by detailed needs-capacity and revenue-capacity assessments) with respect to their capacity to deliver a detailed set of needs (services) to their constituents.

The allocation of equalization among is based on recommendations of the Commonwealth Grants Commission (CGC) and subject to final revision and affirmation by the Commonwealth (federal) cabinet. However, the CGC’s recommendations are traditionally accepted. Thus, the CGC is an integral institution of the Australian equalization system. The use of detailed “relativities” – based calculations for determining GST among the states means that the GST is not returned to states on the basis of place of collection (as in Canada) but instead that richer states contribute to the equalization of poorer states in an *indirect* horizontal system of equalization.

A common concern about this overall transfer system is that it appears to privilege *equity* across the federation but that it has adverse *incentive effects*. A further concern is that it is too complex making it difficult for the public to understand. In effect, the process for determining equalization shares is technocratic rather than political, taking important allocation decisions out of the political arena. This has advantages and disadvantages. The advantage is that it enables equity to be promoted. But it is deficient in transparency and simplicity. The intergovernmental contract leaves the great bulk of the power, both legally and politically, in the hands of the Commonwealth government.

Canada

Canada is a federation of ten provinces and three northern territories with a population of 33 million. The second largest country in the world, with an area of 10 million square kilometers, Canada is characterized by a substantial degree of regional, economic, linguistic, and ethnic diversity.

This diversity contributes to a considerable amount of regional tension including the ongoing desire of many French-speaking Quebecers for enhanced recognition of their distinctive character and thus enhanced autonomy. These tensions are managed within a tradition of peaceful relations and respect for rule of law.

Under Canada's 1867 constitution provinces and the federal government were both given extensive powers of taxation. The result, today, is that both orders of government have the constitutional authority to tax all of the main tax bases (personal and corporate income tax, sales and or value-added taxes, and payroll taxes). This affects the dynamics of inter-governmental fiscal relations today.

Over its roughly 140-year history the federation has undergone several shifts in the relative roles of the federal and provincial governments. With changing circumstances (e.g. war and peace, depression and prosperity etc.), it has undergone periods of centralization and then decentralization. The principal instruments for effecting these changes have been *fiscal*, especially intergovernmental transfers and harmonized systems of taxation with *constitutional* amendments much less commonly used. (The main constitutional amendments have related to the expenditure provisions, not the revenue-raising provisions. The most important changes included an amendment in 1940 that made unemployment insurance a federal responsibility and another after World War II that made old-age pensions a concurrent responsibility. Both had previously been exclusive provincial legislative competencies.) Over the last quarter century, or perhaps even a bit longer, the federation has become more decentralized with provinces enjoying more "own source" revenue (much more, for example, than Australia). Nonetheless, intergovernmental transfers remain a significant source of revenue for provinces, especially poorer provinces. These transfers are also a means for helping to achieve national objectives.

Intergovernmental transfers have been a component of the Canadian federal system since Confederation in 1867. Today Canada's federal-provincial fiscal contractual relationship is characterized by three large transfers from Ottawa to the provinces: (1) The Canada Health Transfer (CHT), (2) The Canada Social Transfer (CST) and (3) Equalization. To-

gether, they constitute about 90% of all the money Ottawa transfers to the provinces. The CHT, CST and Equalization Transfer are all based in federal law. They can, therefore, be considered “contracts” with the provincial government only in a “loose” political sense. Prior to relevant federal legislation being introduced into Parliament creating or amending these transfers, there is typically several years or more of intensive federal-provincial consultation and negotiation, usually leading up to a joint political statement by both levels of government. These political statements, however, have no legal standing. The provincial governments, therefore, have no legal way for effectively challenging transfers that they view as too low or too erratic provided that the terms of the transfer (i.e. the conditions) are not so intrusive as to be seen as an invasion of provincial constitutional legislative competence.

The Canada Health Transfer

Federal government support for health care dates back to the late 1940s. At that time, Ottawa instituted National Health Grants to help create the infrastructure that would be needed to build a national health care system⁷⁷. These grants were principally used for hospital infrastructure but also supported initiatives in areas such as professional training, public health research, tuberculosis control, and cancer treatments. In 1957, partly in response to pressure from some provinces, the federal Parliament enacted the *Hospital Insurance and Diagnostic Services Act*. It committed the federal government to paying half the costs of hospital operating expenses of any province that provided free hospital insurance to all of its residents. (The formula was in fact slightly more complex with the federal contribution equal to 25% of the national average hospital costs per capita multiplied by the provincial population and 25% of provincial hospital costs per capita multiplied by the provincial population). In the 1960s another program was established, the *Medical Care Act* (1966), to ensure that all Canadians had publicly insured access to physicians’ services and care outside of the hospital setting. Once again, the legislation provided that the federal government would pay half the costs of medical expenses incurred by provinces that provided universal

⁷⁷ See www.hc-sc.gc.ca/hcs-sss/medi-assur/transfer/index_e.html and www.fin.gc.ca/FEDPROV/hise.html for amore detailed historical overview.

and accessible physicians' services to its people. (The precise formula differed slightly from the hospital insurance formula with it in this case being equal to 50% of national average per capita costs for medical services multiplied by the size of the provincial population). Originally, both the *Hospital Insurance and Diagnostic Services Act* and the *Medical Care Act* thus used conditional open-ended matching grant systems to determine the amount that would be reimbursed to the provinces for expenditures on health services.

In fiscal year 1977–1978, this conditional matching grant or shared cost system was changed to a system of “block” transfers with only very light general conditions placed on the provision of transfers. The hope of the federal government was that because hospital and medical services were by then **established** programs, provinces would maintain these programs as stipulated in the new *Federal-Provincial Fiscal Arrangements and Established Programs Financing Act* of 1977 (also known as the EPF). The EPF provided a single block federal transfer to the provinces for insured hospital and medical care services and post-secondary education based initially on the per capita amounts Ottawa had been contributing to provinces in the three transfer programs it was replacing'. Roughly half of the value of EPF was paid for by the federal government transferring tax room to the provinces (a so-called ‘tax transfer’). The rest was implanted through cash payments. According to the legislation, that per capita transfer was to escalate based on a formula linked to GDP. EPF also included a new transfer for the Extended Health Care Service Program. Being a block transfer, EPF was no longer tied to provincial expenditures⁷⁸.

This switch from an open-ended “matching” grant to a “block” system of transfers altered the nature of Canada's contractual fiscal health care arrangements. While commentators often point to (1) the fact that EPF detached Ottawa's fiscal contribution from provincial spending thus potentially increasing the provincial incentive to tighten cost controls, or (2) to the apparent loss of the spending tool that would ensure continued pro-

⁷⁸ The Extended Health Care Services Program included services such as nursing home intermediate care, adult residential care, ambulatory health care and the health aspects of home care.

vincial compliance with national conditions, it was also the case that (3) provinces no longer had to provide data to Ottawa on “eligible” expenses and the federal government no longer had to approve such expenses and subsequently audit them. Together these impacts enhanced both the substance and the appearance of provincial autonomy. It also made it harder, however, for the federal government to be sure national objectives were being met and after a few years there were signs that some of the national objectives were in danger of being eroded. The federal Parliament therefore enacted a *Canada Health Act* in 1984 setting out the five broad conditions – universality, accessibility, comprehensiveness, portability, public administration – that provincial governments would have to satisfy to continue receiving their full EPF entitlements. Furthermore, two additional provisions, set out in regulation, can also be considered conditions of the health care transfer system: the principle of no extra billing for visits to doctors and no facilities fees (user charges) for hospitals⁷⁹. In the 18 years of EPF’s life, as a result of ongoing federal budgetary deficits, the federal government reduced the statutory growth rate in its EPF transfer several times.

The 1995 Federal Budget announced a restructuring of the major transfers. EPF was to be replaced by an even wider block transfer, the Canada Health and Social Transfer (CHST) that would merge EPF with the federal matching grant program for provincial welfare costs. Implemented in the fiscal year 1996–1997 to the end of 2004–2005, the CHST was thus a system of “block” transfer payments from the federal government to the provinces to help cover hospital insurance, medical care, and post-secondary education as well as social service and social assistance expenditures previously covered under the federal-provincial cost-sharing arrangements of the Canada Assistance Plan (CAP). It was allocated on an equal per capita basis to all provinces and essentially functioned with relatively few conditions, in the sense that the provinces could spend the funds as they saw fit, with the federal government determining the

⁷⁹ See: Canada Health Act, Sections 18, 19 (1) and (2) and 20 (1–6) (available online at: <http://laws.justice.gc.ca/en/c-6/233402.html>) and Consolidate Statutes and Regulations SOR/86-259 Extra-billing and User Charges Information Regulations (available online at: <http://laws.justice.gc.ca/en/c-6/sor-86-259/29963.html>).

amount that was to be distributed. The conditions of the *Canada Health Act, 1984* however, remained in force. In April 2004, health finance was moved out of the CHST, separating it from other “social” transfers and a new Canada Health Transfer (CHT) was created.

The CHT is now the primary federal transfer to provinces and territories in support of health care. It is made up of both a cash and tax transfer that will total an estimated \$31.8 billion in 2006–2007, of which \$20.1 billion will be in cash transfers and \$11.7 billion in tax transfers (Dept of Finance Canada – Canada Health Transfer). CHT transfers are allocated to the provinces and territories on an equal per capita basis to ensure that all Canadians regardless of their place of residency receive support from the transfer. The new CHT is intended to improve health-related **performance effects** by providing both greater *accountability* for, and *transparency* in, health care spending. Conditions with respect to where and how health funding can be spent (*input-based conditions*) have to a significant degree been replaced by conditions relating to ensuring access to health care (*output-based conditions*) and on provincial reporting of expenditures in terms of key outcomes achieved (*outcome-based conditions*) (Shah, 2003).

As just noted above, a component of the conditional provisions attached to the CHT is that the provinces must continue to abide by the five conditions of the *Canada Health Act, 1984*) and the two related regulatory conditions or face financial penalties. The federal government has, thus far, been able to set and maintain broad national minimum principles and attain a sense of national *equity* in health care using the CHT. In theory the implementation of such a system of “loose” or “relaxed” conditionality can create positive *incentives* to develop innovative, efficient and tailored approaches to health care delivery among the provinces while infringing only marginally on provincial *autonomy*.

Despite the increased use of output and outcome-oriented conditions, however, the *actual* impact on health care *performance* is far from easy to determine. This is because *accountability* criteria for measuring and assessing compliance with the five conditions that are set out in statute and the two additional regulatory conditions remain somewhat ambiguous. For example, there is currently a broad and great concern within Canada

about the timeliness of some medical services (an important element of the *accessibility* condition) but developing appropriate criteria for measuring performance in this area has to date been exceedingly difficult and obtaining relevant performance data at least equally challenging. The result has been intensive federal-provincial discussion and negotiation but, under the current federal Conservative government, a seeming recognition that Ottawa cannot impose detailed performance criteria in this area. At present, also, there are no apparent federal “checks” on inter-provincial portability nor is the condition of comprehensiveness well-defined as it relates to which treatments are included, and which are excluded, from provincial health care plans. In short, Ottawa only loosely monitors provincial compliance with the conditions of the Canada Health Act.

The trend to increased use of *output* and *outcome-based* conditions in the Canadian intergovernmental transfer system is also seen through an examination of the conditions attached to the Health Reform Transfer (HRT). The HRT was created as part of the 2003 federal-provincial Accord on Health Care Renewal and intended to “accelerate reform in priority areas identified by First Ministers: primary care, home care and catastrophic drug coverage” (Health Canada – Canada Health Act – Federal Transfers and Deductions). Under the HRT, annual public reports are prepared in each of the reform areas to inform Canadians on the progress achieved toward accelerating reforms (output-based), including enhancing the number of available diagnostic care and treatment services and reducing wait times, as well as the outcomes of the implementation of the associated reforms (outcome-based) (Health Canada – Canada Health Act – Federal Transfers and Deductions)⁸⁰. Under the 2003 Accord an “enhanced accountability framework” was also established under which all provincial governments have agreed to provide comprehensive and regular reports to the public based upon comparable

⁸⁰ For examples of provincial/territorial reports see: Canada Health Act Annual Report 2004–2005 – Provincial and Territorial Narrative Submissions available at: http://www.hc-sc.gc.ca/hcs-sss/medi-assur/pt-plans/index_e.html and 2006 Final Report of the Federal Advisor on Wait Times – Appendix D –Provincial/Territorial Wait Times Websites available at: http://www.hc-sc.gc.ca/hcs-sss/pubs/care-soins/2006-wait-attente/2006-wait-attente-app-d_e.html.

indicators related to health status and levels of service, health outcomes and quality of service. The condition of provincial governments reporting to their public is based on the notion that this creates added pressure for provinces to improve levels of public services for fear of losing constituent support. Contractually, these types of output and outcome-based conditionals are very different from the older input-based matching grants in that the federal government is not directly involved in monitoring the use of transfers and relies instead on federal-provincial relations and a belief in the power of public opinion.

Similarly, as part of the 2004 *10-Year Plan to Strengthen Health Care*, “all governments agreed to report to their residents on health system performance. Enhanced accountability to Canadians and improved performance reporting are essential to show Canadians that reforms to the health care system are occurring. The Canadian Institute for Health Information (CIHI) plays a critical role in ensuring that performance information is collected and made available to Canadians,” (Budget 2005 – Chapter 3, *Securing Canada's Social Foundations*)⁸¹. The federal government’s 2005 budget provided CDN\$110 million over five years to be used by CIHI to improve data collection and reporting of health performance information in accordance with the Accord and the 10-Year Plan (Budget 2005 – Chapter 3, *Securing Canada's Social Foundations*)⁸². Under the Accord, all provincial governments except Alberta and Quebec also “agreed to the establishment of the Health Council to monitor and make annual public reports on the implementation of the Accord, with an emphasis on its accountability and transparency provisions. This is intended to allow Canadians to monitor progress toward reform, the level of access to health services and the overall efficiency of the health care system,” (Federal Investments in Support of the 2003 Accord on Health Care Renewal). It must be repeated, however, that these outputs and outcomes are hard to measure. It is difficult to “track” how effective the specific provincial expenditures

⁸¹ Available online from: <http://www.cbc.ca/news/background/budget2005/documents/budget05/bp/bpc3e.htm>.

⁸² Ibid.

on wait time reductions are as well as whether the funds from the trusts are in practice being spent on measures that actually reduce wait times.

Recently, input-based conditions in health care, earmarked specifically toward priority service and delivery objectives, have also taken the form of more “relaxed” or “flexible” conditions. In an attempt to maximize both the *transparency* and *effectiveness* of the transfer system, federal law has created third-party “trusts” for provinces and territories to draw funds from as they see fit until the end of the lifetime of each “trust”. The previous federal Liberal governments developed the practice of creating arms’ length trusts into which they would move funds at the end of fiscal years in which they had surpluses. In turn, the trusts were given mandates about how they were to spend these funds and in some cases they were directed to transfer the funds to provinces for specified purposes. In essence these trusts have functioned like “block” transfers that have enabled provinces and territories to customize service and delivery programs to fit the needs of citizens provided they were done so in such a manner as to achieve the stipulations of the conditions attached to each transfer. For example, the 10-Year Plan to Strengthen Health Care signed includes provisions for a \$5.5 billion additional investment in efforts to reduce wait times in which the first five years, totaling \$4.5 billion, will be funded through a third-party “trust” enabling provinces and territories to have the “flexibility to draw on this funding according to their respective jurisdictional priorities to meet their wait times commitments” (Federal Investments in Support of the 10-Year Plan to Strengthen Health Care). The new Conservative government is likely to discontinue this practice.

The Canada Social Transfer

The 2004 revision of the Canada Health and Social Transfer that resulted in the creation of the CHT also saw the establishment of the Canada Social Transfer (CST). The CST is a “block” cash and tax transfer from the federal government to the provinces and territories to help support post-secondary education, and social assistance and social services, such as early childhood development and childcare. The CST is allocated on an equal per capita basis to ensure equal support for all Canadians. Like its predecessor, however, the “block” nature of the CST can cause

transparency concerns as it can be hard to track where specific expenditures have been made and how transfers have been used. In partial response to these concerns, recently certain *output-based* and *outcome-based* conditions have been applied to portions of this transfer in order to address *accountability* and *transparency* issues. The federal government transfers “the provinces money but instead of matching funding or meeting conditions, provinces are expected to spend the federal money for a designated purpose [...]. In place of conditions, the federal government seeks to ensure that its money is spent as designated through **accountability measurement**” (Mendelson, 2003, 1).

Regarding child care, for example, on 13 March 2003, a framework agreement was reached for the provision of funds intended to improve access to “affordable, quality provincially and territorially regulated early learning and child care programs and services”. in which provinces “committed to report to Canadians on progress achieved in improving access to early learning and child care programs and services,” (Federal Support for Early Childhood Development and Early Learning and Child Care). Other *output-based* conditions have since been established and include the earmarking of \$250 million per year for the creation of new child care spaces as laid out under the 2006 Universal Child Care Plan (Federal Support for Early Childhood Development and Early Learning and Child Care). These output and outcome-based conditions reflect incremental not general, or sweeping, additions and modifications to currently existing social programs. Nevertheless, they produced a less-rigid system of conditional transfers. The end result, however, is that while some developments have been made “at the margins” of the social transfer system leading to improvement in certain aspects of existing social programs, the deficiencies in the system noted above, including *accountability*, *efficiency* and *equity* concerns, remain intact. Ultimately, this raises questions over the *actual effects* of the revisions on provincial *performance*.

Input-based conditions have by no means become obsolete in the CST. For instance, the *Federal Initiatives in Support of Post-Secondary Education, Public Transit and Affordable Housing* (Bill C-48) uses a third-party “trust” or “flexible” input-based system of conditions to en-

hance the effectiveness of transfers earmarked for post-secondary education, transit and housing specific initiatives. Under Bill C-48, one billion dollars has been set aside for post-secondary infrastructure to support investments in innovation and enhance accessibility, \$900 million for public transit infrastructure investments as a means of reducing traffic congestion and other climate-related issues, \$800 million for affordable housing to relieve short-term pressures with regard to supply and \$300 million for Northern and off-reserve housing (Federal Initiatives in Support of Post-Secondary Education, Public Transit and Affordable Housing).

Equalization Transfers

Canada's equalization system is exclusively based on estimates made by the federal finance department of provincial revenue generating capacity. The concept of equalization is provided for under Subsection 36(2) of the Constitution Act of 1982 and 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," (Restoring Fiscal Balance in Canada 2006, 27). The Equalization Transfer "which is essentially intended (as mandated by the 1982 Constitution) to enable all provinces to provide a comparable level of services while imposing a comparable tax effect, is of course much larger in per capita terms in the poorer Atlantic provinces than in the other recipient provinces" (*Bird and Vaillancourt, 2004, 14*). While the Equalization system was created in recognition of the fact that provinces have varying levels of *fiscal capacity*, by ignoring possible differences in needs among provinces, it implicitly assumes that per capita expenditure *needs* are uniform across the provinces. Furthermore, historically, no explicit account was taken of other federal transfers" and "the total amount distributed (was) generated by the formula," and based on provincial *performance* (*Bird and Tarasov, 2002, 17*). The Equalization Transfer was thus traditionally an open-ended and unconditional formula-based transfer, "the mechanics of this formula in effect assume that per capita needs are equal in all provinces and focus on measuring 'representative' tax bases for over 30 different revenue sources" (*Bird and Tarasov, 2002, 20*).

In the 2005–2006 federal budget, however, former Prime Minister Paul Martin’s Liberal government laid out a series of revisions to the Equalization Transfer in accordance with a new *Framework for Equalization and Territorial Formula Financing* (TFF) that was put in place in October 2004, following the September 2004 First Ministers’ Meeting on health. These changes have since received almost unanimous condemnation by fiscal policy experts and the current Conservative government under Prime Minister Stephen Harper has pledged to undo the Liberal government’s changes and return the Equalization Transfer to a formula-based system. The central purpose of the Liberal revisions under Martin’s government was allegedly to attempt to reduce the uncertainty inherent in the traditional performance-based formula system that resulted from “swings” in the overall amounts of equalization payments received by provinces depending on their performance from year to year and, thus, to provide greater levels of predictability and stability in the equalization system. The 2006 Budget of Prime Minister Harper’s Conservative’s has also committed to laying the foundations for a more predictable and long-term system of fiscal equalization payments that will “provide equitable and predictable support for: a transparent, principle-based Equalization program” (*Restoring Fiscal Balance in Canada, 2006, 64*). The current government’s approach to the implementation of the plan for equalization transfers is also expected, however, to return equalization to the traditional formula system but one that is based on a “rolling average” scheme, making potential fluctuations in equalization payments received by the provinces more gradual, with the very controversial question of how to deal with differences in fiscal capacity related to differences in non-renewable natural resource endowments (mainly oil and gas) the key issue still to be decided.

Canada’s equalization system traditionally excluded at least 30% of offshore hydrocarbon revenues from the Equalization calculation (i.e. protected the province from reductions in Equalization payments to a minimum of 30% of offshore revenues). But under Paul Martin’s Liberal government this exclusion was increased to 100% for offshore oil and gas revenues with a view to shielding the Equalization entitlements of these provinces from the reductions that would have otherwise been expected

as their offshore oil and gas revenues increased. These provisions remain very controversial but it is not yet clear whether they will be amended by the new Conservative government.

Canada's intergovernmental transfers system is based mainly on federal law but influenced as well by the constitution and its interpretation by the courts. It is based in federal law in the sense that federal statutes determine the amount to be paid for the transfer programs and the allocation of the payments among provinces. Whether the federal government is also able to ensure that the provinces spend the money for the purpose it intends, however, depends on the form of transfer the federal government chooses and this choice of technique reflects political considerations more than legal ones. When the federal government uses open-ended matching grants as the instrument for achieving its policy goals, Ottawa is able to ensure the money it transfers is used by provincial governments for the purpose it specifies. But when the transfer is in the form of a block grant, the federal government is unable to ensure that the provinces use the money for the specified purpose. Moreover, the transfer system is also shaped by the constitution in the sense that any conditions the federal government wishes to attach to the transfers must not be so detailed as to detract from provincial legislative competence under the constitution. Thus, while the provinces do not have the kind of assurances regarding the amounts of transfers or revenue sharing that are enjoyed by their sub-national counterparts in Germany and Switzerland, they are protected from the kind of conditionality that is common in the United States. Indeed, in practice, much of the transfer system is unconditional or only lightly conditional. On this latter point, it should be added that the relatively light conditionality is not only due to the fact that there are constitutional limits on conditionality but also because the Canadian political culture attaches considerable weight to regional and linguistic diversity and the provinces that help to protect that diversity.

The transfer system has historically reflected a balancing act between nation-building goals—usually associated with Canada-wide *equity* and *efficiency* objectives and concerns to respect the *autonomy* of the provinces. The Equalization program throughout its life and the specific purpose open-ended major matching grant transfers of the 1950s-1970s reflected

the nation-building goals. The more recent use of block grants has been more reflective of the *autonomy* perspective. Similarly, the reduced conditionality of the system and the enhanced focus output and outcome conditions also reflects the *autonomy* viewpoint.

The attraction of block grants in recent decades has not only been due to the pressures to better respect provincial autonomy. Block grants have also been attractive because they are seen to eliminate open-ended spending commitments by the federal government while removing distortions in provincial resource allocation. For both reasons they may be *efficiency* enhancing. Similarly, the attraction of greater reliance on output and outcome conditions is not only because they too better respect provincial autonomy as compared to input conditions but that they also encourage provincial experimentation and innovation, thus also potentially improving program efficiency.

Whether the purposes of the block transfers are met depends in part on the effectiveness of the accountability measures associated with the output and outcome conditions. These conditions entail provinces reporting publicly to their own peoples (emphasizing autonomy), not to the federal government or Parliament. However, it must also be acknowledged that it is difficult to be sure that these systems of public accountability (via establishing performance measures and then collecting the relevant data) are difficult to implement in practice. Thus, whether the Canadian transfer system will actually produce the kind of results that is intended via this kind of loose accountability is still an open question.

In sum, the contractual arrangement between federal and provincial governments is influenced by constitutional considerations that limit the freedom of the federal government to impose conditions on transfers that are intended to shape policy developments in provincial areas of legislative competence (Recall that the federal government in Australia can impose whatever conditions it wishes). Under the constitution, the federal government can pretty much transfer as much or as little as it wants to provinces but the nature of the constitution implies that there are limits to the conditions it can impose on those transfers.

In practice, federal-provincial negotiation and related political considerations, perhaps more than the constitution determine the deals that are

struck. They reflect the tension between nation-building and provincial autonomy goals. Recent events have privileged the autonomy side of that equation.

Germany

With the reunification of East Germany and West Germany in 1990, Germany now has a population of 82 million and is composed of sixteen Länder (states), three of which (Berlin, Bremen and Hamburg) are city-states. At present Germany has an extensive transfer system in place intended to deal with both vertical fiscal imbalance (VFI) and horizontal fiscal imbalance (HFI). German federal democracy was restored in 1949 with the constitution, or Basic Law, enshrining the principle of “uniform living standards” as a goal for the entire federation. The main elements of the system were introduced in 1969, with alterations taking place in January 2005 and September 2006 and more changes scheduled to come into force in January 2007. As a consequence of the greater variation in actual living conditions in the east and the west post-reunification, in 1993 the previous goal of “uniformity” was scaled back significantly to the “establishment of equal living conditions” principle (Jung 2005)⁸³. The constitution authorizes the federal government to intervene (with the consent of the Bundesrat [the federal council that represents the 16 Länder at the federal level]) if this principle is threatened and, thus, asymmetry must not lead to unequal living conditions (Jung 2005).

Both Australia and Canada are referred to in the political science literature as examples of ‘dual federalisms’. That is, they assign different functions to the federal and regional orders of government and those orders – federal and regional – to a considerable extent legislate and then administer their own programs. Germany in contrast is generally referred to as an ‘administrative federalism’ with most of the important legislation enacted at the federal level, but with Länder and local governments implementing much of the federal law. The Länder, however, are able to influence the federal law by virtue of the fact that their representatives make up the upper chamber of the federal Parliament (the Bundesrat).

⁸³ Saskia Jung, German Federalism – Still a Model of Symmetry? *Asymmetry Series* 2005(11), IIGR, School of Policy Studies, Queen’s University.

The result of these arrangements is that the federal government raises close to two-thirds of total government revenues but spends much less directly with more than one-fourth being transferred from the federal to the Länder level. In other words, compared to Canada, the vertical fiscal gap in Germany is very large. It is even much larger than the Australian gap. Therefore, the intergovernmental transfer system is relatively more important.

The German system can be grouped into two general categories of transfers. The first category is *conditional specific purpose grants* transferred from the federal government to the Länder. Previously, general “cost-sharing” or “joint task” programs made up a significant portion of conditional specific purpose grants, covering 50% of the costs associated with higher-education and agreed upon investments (e.g. buildings) to develop regional infrastructure, 60% of agricultural support costs and 70% of shoreline preservation costs (*Bird and Tarasov, 2002, 20*). With the recent reforms made to the fiscal system in 2006, however, the cost-sharing programs have been significantly reduced (many even eliminated), with the exception of special transfers for higher education.

The second category of transfers is largely *unconditional equalizing transfers* that are awarded to Länder with below average tax revenues. These transfers are provided to “below average” Länder through supplementary transfers from both the federal government and other Länder with higher revenue yields through a “fraternal” equalization system. The central mechanism of Germany’s equalization system is revenue sharing of the income tax (15% to municipalities, the rest equally distributed to the Länder and federal level) and the value added tax (VAT) (which, in 2004, 48.4% was distributed to the Länder with a further 11% directed to the municipalities)⁸⁴. A series of special “additional” transfers has also been created in the post-reunification period, of which the German Unity Fund (1990–1994) was established as an interim program to raise the fiscal capacity of the former East German states. The special *federal supplementary grants* used at present under the “Solidarity Pact II” (paid

⁸⁴ See: http://www.bundestag.de/bic/analysen/2005/2005_08_08c.pdf.

since 1995, decreasing in 2006 and ending in 2019) are designed primarily to compensate states for costs associated with reunification.

The allocation of revenue and expenditure responsibilities in terms of legislation and administration is fixed jointly by the Bundestag (the federal or national Parliament) and the Bundesrat. As noted above, most legislative functions are assigned to the federal government – exclusively or with concurrent legislation that the federal level has authorized – with administrative responsibilities falling to the Länder. However, the 2006 reforms have attempted to give the Länder greater responsibilities. At present a high level of intergovernmental collaboration is still required between the federal government and the Länder in order to achieve policy objectives. Transfers from the federal government to the Länder are “intended to finance expenditures that the Länder incur in administering federally legislated programs” (*Boadway and Watts, 2004, 12*). However, the “power of the federal government in legislating such programs is not absolute because the Bundesrat with its representative drawn from the Länder must approve such legislation” (*Boadway and Watts, 2004, 12*). On 23 June 2001 the federal government and the Länder agreed to a reform agenda of the equalization system that came into force in 2005 and will last until 2019. Called the “Solidarity Pact II” (Solidarpakt II), the agenda included several reforms to the distribution of tax revenues, vertical grants and equalization transfers among the Länder. The most recent set of reforms to modernize the federal system was passed in parliament (Bundestag) on 30 June 2006 and in the Bundesrat on 7 July 2006.⁸⁵

“Specific Purpose Grants-Shared-cost” and “Joint-task” Transfers

Traditionally, “shared-cost” or “joint-task” transfers have been specific-purpose conditional grants made in the form of “grants-in-aid” to cover policy objectives that are considered the joint responsibilities of the Länder and the federal government. “Joint-task” responsibilities are defined as those responsibilities that “are important to society as a whole and that federal participation is necessary for the improvement of living conditions (joint tasks)” (*Watts and Hobson, 2000, 34*). Until recently “joint task” items included: “extension and construction of institutions of

⁸⁵ See: Bundesgesetzblatt Teil I 2006 Nr.41 31.08.2006 S. 2034.

higher education including university clinics; improvement of regional economic structures; improvement of the agrarian structure and of coastal preservation” (Watts and Hobson, 2000, 34). Furthermore, “joint-tasks” were constitutionally mandated and involved joint planning, decision making and implementation initiatives as well as shared financing responsibilities (Watts and Hobson, 2000, 34). These “joint-task” programs have been significantly reduced and many even abolished, however, through the 2006 reform initiatives.

“Cost sharing” transfers have two principal advantages in terms of *efficiency* and *equity*. The first is that efficiency in the internal common market is achieved as common government policies exist throughout the country no matter where one locates or chooses to engage in economic activity, thereby, reducing the ability of the Länder to create incentives to attract business away from other Länder. It must also be noted, though, that municipalities have the authority to fix and levy the trade tax (“Gewerbsteuer”), which can potentially result in the creation of important incentives to attract business to certain areas. Second, fiscally induced migration is also virtually eliminated among German citizens as all Länder provide a similar set of public services at essentially the same tax rates based on the “equal living standards” principle (Jung, 2005; Boadway and Watts, 2004).

There are, however, significant disadvantages to the German “shared-cost” system in terms of *incentive effects* to improve efficiency and innovation as well as upholding Länder *autonomy* and maintaining standards of *equity* for its inhabitants. While a strong sense of the *political unity of the state* is maintained through the uniformity of the German public service delivery system, “because the Länder act as administrators of major spending programs that are legislated federally, they have relatively little discretion to choose programs to suit their own needs” (Boadway and Watts, 2004 15). Furthermore, even though national equity objectives may be well-achieved through a federally legislated transfer system based on the “equal living standards” principle, “this high degree of uniformity implies that there is little scope for individual Länder to affect their own equity objectives should those differ from the national consensus” (Boadway and Watts, 2004, 17). Moreover, Watts and Hobson assert that

“the willingness of the federal government to bail out near-bankrupt states through federal supplementary grants might seriously compromise the principle of accountability in state budgeting,” (*Watts and Hobson, 2000, 47*). More recent decisions against the interests of “near-bankrupt” states in 2006, however, point to potential changes in this area (See: constitutional court decision in October 2006 for Berlin).

Revenue Sharing Transfers – Horizontal (“Fraternal”) Transfers among the Länder

Germany’s transfer system is unique in that it uses a specific interstate or “fraternal” horizontal equalization mechanism that is financed entirely from the revenue of states. The horizontal fiscal equalization between the Länder is intended to equalize the fiscal capacity of the Länder according to a defined set of goals. This system is determined on the basis of both size and population density. The “have” Länder normally have to contribute up to 72.5% of their above-average per capita revenue, to “have-not” provinces. Saskia Jung writes that “city states are favored in this asymmetrical arrangement, because a greater weight is attributed to their inhabitants (1.35 instead of 1). Since 2005, three thinly populated *Länder* (Mecklenburg-Vorpommern, Brandenburg and Sachsen-Anhalt) – all of them eastern *Länder* – also get a light bonus (1.02–1.05),” (*Jung, 2005*).

The system has been criticized, however, for being too “equalizing” and unduly penalizing more fiscally-endowed states for their wealth, resulting in the possibility of significant adverse incentive effects to arise in terms of revenue collection and enticing poorer states to “catch up” to rich ones. Helmut Seitz and Gerhard Kempkes ultimately conclude that “the strong equalization system brings about a rather weak correlation between state economic performance and per capita state revenues,” (*Seitz and Kempkes, 2005, 6*). However, former guarantees of minimum payments to the “have-not” Länder have been largely abandoned within this part of the recent equalization reforms on the request of the “have” Länder (*Jung, 2005*).

“Revenue Sharing” Grants – Vertical Transfer from the Federal Government to the Länder

The third component of Germany’s equalization program consists of revenue sharing transfers from the federal government to the Länder. A portion of these revenue sharing grants, made up of taxes raised by federally harmonized and largely shared taxes, are disseminated to the Länder on the basis of population demographics. The remaining balance is distributed to those states whose average tax income per capita (including personal and corporate income tax) plus “windfall profit” of mineral oil (which was a particularly important factor in the 1980s) is lower than the national average (*Bird and Tarasov, 2002, 20*). Equalization is predominantly revenue-based; adjusting the financial strength of the Länder in relation to their per capita tax revenue with expenditure needs playing only a small part in determining the amount of equalization transfers (*Jung 2005*). Jan Werner writes that “particularly because of Germany’s reunification and the resulting incorporation of the new federal states into the Federal Republic of Germany, this financial redistribution has gained enormous significance” (*Werner, 2003, 5*). It is important to note that these revenue-sharing arrangements are provided for in Germany’s Basic Law and thus, unlike in Australia and Canada, cannot be amended by the federal governments on their own.

Federal Supplementary Grants:

Since reunification of the Eastern and Western Länder a series of specific “additional” transfers, federal supplementary grants, has been implemented in order to bring the Eastern Länder up to levels of fiscal capacity that are comparable with those in the West. These include grants “to Eastern states at a minimum of DM 14 billion a year (€1,158,086,336), until the year 2004; grants to some financially weak Western States to compensate partly for the revenue losses due to integration of the Eastern States into the interstate equalization scheme, at DM 1.2 billion each year (€13,550,257), for a ten year period; grants to the States of Bremen and Saarland to help them deal with debt service problems” (*Ma, 1997, 14*). This program of equalizing transfers, however, is intended to exist only in the interim until the year 2019 (*Boadway and Watts, 2004, 12*). The allocation of tax revenues is based in the Constitu-

tion, not statutory law, suggesting a level of legislative equity between the federal government and the Länder as neither government can alter revenue sharing arrangements unilaterally⁸⁶.

Jonathan Rodden asserts that in the long run there is a direct correlation in the German equalization system between the strength of transfer-dependency and the size of deficits (*Rodden, 2001, 3–4*). This suggests that adverse performance and incentive effects may exist for “poorer” Länder due to the strong emphasis placed on realizing the “equal living conditions” principle through equalization. Ronald Watts and Paul Hobson also point to the fact that the redistribution of the VAT contains an “implicit horizontal equalization” component as evidence of the potentiality for adverse incentive effects to be created in the system (*Watts and Hobson, 2000, 36*). They conclude that it is this implicit and explicit (see below) system of horizontal equalization that “provides the ‘glue’ that binds the system together” and “results in a high degree of uniformity in terms of public infrastructure and government services” (*Watts and Hobson, 2000, 46*). In the light of the 2005 changes to equalization, however, it should be acknowledged that the incentives have slightly changed. Regarding these changes Werner concludes that “by changing this rate, a higher VAT volume altogether will be distributed, and more financially weak states will reap the financial benefits of the remaining share of the VAT” (*Werner, 2003, 9*).

The Fiscal Effects of the 2006 Reforms

One of the central effects of the 2006 reforms has been the constitutional changes made that are now enshrined in law. The main purpose of the reforms is to clarify federal and Länder responsibilities in order to reduce the number of federal bills that require the consent of the Bundesrat. This is intended to make legislation faster and more transparent. Under the new reforms, the Bundesrat has also gained the right to veto any bills that incur costs for the Länder since this kind of legislation must have the consent of the Bundesrat. The federal government is also prohibited from prescribing the institutions and processes to implement laws if

⁸⁶ Changes in tax sharing arrangements and the nature of revenue sharing grants between the federal level and the Länder are expected to be made as part of the 2006 reforms to federalism.

it is determined that there is no “special need” for national “equal living standards” in particular areas, and if “special need” is established it must be done so with the consent of the Bundesrat. To date, however, what “needs” specifically constitute a “special need” have not been defined raising questions regarding the legitimacy and equity of the decision-making process. Additionally, the Länder have the right to “opt out” of federal level decisions regarding the creation of specific institutions deemed necessary by the federal government to achieve the aims of specific laws and can put a claim into the constitutional court if they consider the federal law as not necessary for achieving nationally equal living conditions.

The possibility of specifically addressing reforms to fiscal federalism has been brought up as a potential second step to the 2006 Reforms. The wealthier Länder have been the principal actors in driving for fiscal reforms. They want to see a decrease in the amount they are required to contribute to fraternal equalization and specifically seek changes to the “Solidarity Pact II”. However, perhaps not surprisingly, the poorer Länder do not want to see these changes made and a meeting has been scheduled with Chancellor Merkel to discuss the possible fiscal reforms in mid-December 2006. Thus far, the introduction of “control mechanisms”, or conditions on inputs, regarding how and where equalization payments must be spent has been discussed as one possible fiscal reform. In theory the use of such conditions could help to decrease the magnitude of the negative incentive effects associated with unconditional fraternal (horizontal) transfers between “have” and “have-not” Länder. Other plausible reforms discussed include the implementation of a nation-wide system of tax administration to help alleviate criticisms of some smaller Länder pertaining to inefficiencies in their current tax collection and administration practices.

Conclusions

Unlike the Australian and Canadian systems, the details of the German transfer system are set out in the basic law or constitution. As a result, there is a more equal relationship between the Länder and federal orders of government than is found in these other two countries. The ‘contractual’ arrangement among governments, being anchored in constitu-

tional law, is not easily altered by the actions of one order or the other. The downside of this interlocking and at times cooperative system is the difficulty in effecting change. Constitutional amendments cannot be achieved easily (nor should they) making the system less flexible, but also more stable and predictable, than the Canadian system.

The German system can essentially be classified into two general categories of transfers. The first category consists of largely *unconditional equalizing transfers* that are awarded to Länder with below average tax revenues. The second system is made up of *conditional specific purpose grants* transferred from the federal government to the Länder. Overall, the German fiscal federal system embodies a strong equalizing component, including a unique “fraternal” system of horizontal equalization between “have” and “have-not” Länder.

The main revenue sources (income taxes and corporate taxes), according to the Constitution, “belong jointly” to the Federation and the Länder to the extent that they are not constitutionally allocated to local government. The Constitution also sets out how these revenue sources are to be shared including provisions ... to be determined by a federal statute that requires Bundesrat approval. This effectively requires political negotiation and agreement between the Federation and the Länder. Put differently, the Constitution and court decisions create a strong contractual relationship between the two orders of government that, together with the important role of the Bundesrat, make both orders of government in some sense equal partners. For vertical purposes, the financial contract enjoys constitutional protection.

As for Equalization, despite recent amendments to its provisions, it is again the Constitution that provides the specific rules for allocation among the Länder. It allocates the VAT among the Länder based on population but holds back a portion for equalizing. The main purpose of the 2006 reforms is to clarify federal and Länder responsibilities in order to reduce the number of federal bills that require the consent of the Bundesrat. This is intended to make legislation faster and more transparent. Under the new reforms, the Bundesrat has also gained the right to veto any bills that incur costs for the Länder since this kind of legislation must have the consent of the Bundesrat.

The goal of *equality* is strongly preserved in the German fiscal system. The principle of “equal living conditions” has replaced “uniformity” and is enshrined in the Constitution. The Constitution authorizes the federal government to intervene with the consent of the Bundesrat if this principle is threatened, thus, asymmetry must not result in unequal living conditions.

The German transfer system contains a unique horizontal or “fraternal” component that transfers funds from “have” Länder to “have not” Länder. The horizontal fiscal equalization between the Länder is intended to equalize *fiscal capacity*, which is intended to be identical among all the inhabitants of the Länder, according to a defined set of goals. This system has been criticized, however, for being too “equalizing” and as a result of complaints from the financing “have” Länder it seems likely that through the 2006 reforms certain “control mechanisms” will be implemented adding to the removal of the former guarantees of minimum payments to the “have-not” Länder, which have already been largely removed. The overarching emphasis of the German transfer system on equalization has also been criticized for the resulting disincentives that such a system may create in terms of Länder pursuit of economic development in light of the element of “implicit horizontal equalization” contained in the redistribution of the VAT. Furthermore, states may be less willing to engage in revenue collection when faced with progressive taxation of revenues to help compensate “poorer” Länder. It is this commitment to “equal living conditions” and equalization through vertical and horizontal transfers, however, which separates the German system of fiscal arrangements and equalization from that of many other federations.

Switzerland

Switzerland’s population of 7.5 million lives in 26 diverse cantons, each of which maintains a high degree of autonomy in fiscal policy. Switzerland is composed of three culturally diverse communities: German, French and Italian speaking. The two main organizing principles of the Swiss federal system are: (1) the protection of diversity and (2) the extensive participation of citizens in public affairs. Swiss federalism is based on several mechanisms designed to equitably balance decision-making between the 26 cantons and can, thus, be characterized as both a

consociational democracy (where political rules and institutions provide governance by equilibrating multiple and cross-cutting societal cleavages) and as a confederation (a group of states that come together to form a single political unit but retain most of their independence) (*Kubler, 2005, 1*).

Switzerland is unique in that it is one of the world's most decentralized countries. The Swiss fiscal federal transfer system employs a dual *equalization* system of both unconditional (non-specific) and a variety of conditional (specific) transfers. Bernard Dafflon writes that “fiscal federalism in Switzerland can be characterized in terms of overall fiscal restraint and minimizing the centralization of fiscal power. It is a ‘bottom up’ federalism [...] The subsidiarity principle – which recommends that competencies in the provision of public services should be vested to the lowest possible level in the fiscal hierarchy – has been probably more scrupulously respected in this country than in many other federations,” (*Dafflon, 2001, 3*). This principle is enshrined within the Swiss Federal Constitution that states that legal competencies lay first and foremost with the cantons. Furthermore, transfer payments and revenue sharing, comprising the equalization system, are constitutionally “guaranteed” through the provisions of the Constitution. Decision-making power over the provision of public services has, therefore, remained largely decentralized in Switzerland and a system of “co-operative federalism” (confederalism) has flourished.

Structurally, the Swiss confederation is made up of two legislative Chambers:

- the National Council (whose 200 seats are allocated to the cantons according to proportional rule and whose central purpose is to reflect the interests and ideologies of Swiss citizenry as a whole);
- and the Senate or State Council (whose purpose is to reflect the interests of the cantonal citizenry as the constituent entities of the Confederation, with each canton, depending on its size, assigned either 1 or 2 seats and with members elected to these according to majority rule).

The autonomy of the cantons is further guaranteed by the legislative power of the two Chambers each vested with equal powers of authority in the legislative process. All “bills and laws have to be approved by both to

take legal force. In case of disagreement between the Chambers, there is a lengthy procedure in order to find a consensus” (*Kubler, 2005, 5*). The Conferences of Cantonal Ministers have also become increasingly influential over the past decade in cantonal negotiations with the federal government making them an important component of horizontal cooperation both with the federal government and among the cantons. Furthermore, the federal government (or Federal Council) is composed of seven members who are elected by the Federal Assembly, each of which has equal weight in terms of decision-making power. The president is elected according to seniority, for a one-year term, and has a solely representative function.

While the Swiss of federalism is unique, it is similar to the German system in the one sense that the cantons normally implement federal law (the Federation has little delivery capacity). For this reason, the Constitution (art. 46.3) requires the federal government to leave adequate fiscal space to the cantons to pay for the costs of the programs it administers on behalf of the federal government. Also of interest in this regard is the fact that the cantons collect direct taxes on behalf of the Federation and distribute them according to shares set out in the Constitution (art. 128).

Fiscal Democracy

There are essentially four characteristics of the Swiss fiscal federal system: (1) the vertical division of power; (2) direct democracy; (3) initiatives and the use of referenda and (4) horizontal, co-operative federalism among the cantons (*Dafflon and Toth, 2005; Kubler, 2005; Dafflon, 2001*).

Vertical Division of Power

The Swiss system emphasizes the principle of the sovereignty (autonomy) of each order of government as a central principle of federal policy. The Constitution assigns the expenditure tasks of each level of government and also fixes their right to levy certain taxes, thus, guaranteeing the assignment of revenue sources and competencies at each level of government (federal, cantonal and communal). This vertical division or distribution of power is intended as a safe-guard to “prevent stable majorities from being able to exploit minorities” (*Dafflon, 2001, 4*). Article 3 of the Constitution strengthens cantonal sovereignty by stating that the legal

norm for the distribution of competencies and expenditure responsibilities will be that cantons may “exercise all rights” in all spheres of fiscal policy in which the Constitution does not explicitly lay out as the competencies of the federal government (*Dafflon and Toth, 2005; Dafflon, 2004 and 2001; Stauffer, 2001*)⁸⁷.

Further, under Article 42 those tasks and responsibilities that are determined to be under the jurisdiction of the federal government are limited to constitutional provision: “The Federation accomplishes tasks allocated to it by the Constitution” (Article 42(1), Switzerland Constitution) and “It assumes the tasks requiring uniform regulation” (Article 42(2), Switzerland Constitution). Moreover, the general principle that the Confederation must “respect the autonomy of Cantons” (Article 47, Switzerland Constitution) effectively prevents a top-down approach to *vertical* coordination. However, the Constitution does invite policymakers at all levels of government to cooperate (Article 44, Switzerland Constitution), which implies in particular that the Cantons may participate in federal decision making (Article 4(1), Switzerland Constitution), and that they must enforce federal laws (Article 46(1), Switzerland Constitution). In recent years the cantonal governments (which are not directly represented in the State Council since its members are directly elected to represent the interests of cantonal citizens and not cantonal governments) have increasingly used the Conferences of Cantonal Ministers (or Governments) to participate in federal-level decision-making. Ultimately, the provisions contained within the Constitution imply that any attempt to centralize powers and assign new competencies to the federal government requires a constitutional amendment, which requires majority voter support in the form of a referendum as well as majority cantonal support in the legislative chambers, thus, creating a significant barrier to centralization. The contractual relationship between the federal government and the cantons

⁸⁷ The Constitution of 1848 was replaced by an amended Constitution in 1999 that essentially reorganizes the Constitution and includes several new provisions that pertain to the autonomy of the communes (local governments), the consequences to the communes of the confederation’s activities and takes special account of cities, agglomeration and mountainous regions. See: Switzerland Constitution available electronically at http://www.oefre.unibe.ch/law/icl/sz00000_.html.

is, therefore, one that is characterized by a considerable degree of legislative equity and respect for autonomy enshrined in law by the Constitution.

Direct Democracy

Direct democracy is deeply imbedded in Switzerland so that citizens have the opportunity to participate in the decision-making process on important political and economic issues. A variety of direct democracy mechanisms are provided for at both federal and cantonal level, with Swiss voters given the chance to cast their votes in federal ballots on average four times a year. Besides direct citizen participation through referenda and the use of popular initiatives (discussed below), communal (local or municipal level governments) audit competencies are also a component of direct democracy in Switzerland. The “communal assembly of citizens, or the communal ‘parliament’ where it exists, elects a finance committee for the length of the political term of office. This committee has not only traditional audit competencies, but also the duty to report to the assembly about changes in taxation and user charges, and about the financial aspects of capital expenditures” (*Dafflon and Toth, 2005, 8*). The concern with representation inherent in the Swiss system also includes measures that enable voters to directly express preferences in political and economic decision-making via referenda. According to Dafflon, these measures generally result in a better “capacity to strengthen the system of checks and balances, by both dividing and sharing political decision-making power. They give citizens/voters/taxpayers multiple access to government, increase their capacity to control the budgets and reduce political and bureaucratic leeway in rent-seeking behaviour [...] and public expenditures are driven by the demand side” (*Dafflon, 2001, 5*).

The Swiss system of direct democracy implies that the cantonal policymakers have strong *performance* incentives to provide high-quality services to their citizens at a minimum cost as governments are directly responsible and reliant on the support of their constituents in implementing policy (*IMF Country Report No. 06/203 2006*). It is important, however, to consider the actual effects that direct democracy initiatives have had on the legislative issues that, in the other federations explored in this paper, are the responsibility of elected representatives.

On the one hand it can be argued that the impact has been somewhat limited as in the first century of using the initiative (1891–2004) just 14 initiatives were passed in Switzerland (ACE The Electronic Knowledge Network).⁸⁸ On the other hand this number ignores the indirect effects of direct democracy on Swiss federalism. Even though the majority of initiatives fail, the fact that an initiative has been raised increases publicity surrounding the issue as well as public awareness of the issue. Furthermore, this can also increase pressure on the government to introduce measures pertaining to the issue, even if it is not specifically required to do so. A further impact of the direct democracy mechanisms in Switzerland is that the government is forced to seek a wider consensus about the measures that it seeks to introduce than is the case in a purely representative system. This is because the possibility of an optional referendum being held if the initiative passes forces the government to ensure consensus with groups outside of Parliament so as to prevent the possibility of such groups seeking to overturn the new legislation (ACE The Electronic Knowledge Network).

Initiatives and the Use of Referenda

There are three basic principles of direct democracy that take the form of referenda in Switzerland and are outlined in the Constitution: (1) mandatory referenda (Article 140, Switzerland Constitution) (2) optional referenda (Article 141, Switzerland Constitution) and (3) popular initiatives (Articles 138 and 139, Switzerland Constitution). Mandatory referenda submit important parliamentary decisions automatically to a popular vote; important decisions are defined by the Constitution (e.g., the signing of all international treaties is submitted to a mandatory referendum). Optional referenda are held against parliamentary bills as parliamentary approval of a bill can be challenged by submitting it to a popular vote if a specific quota of citizens signs up within a certain time period (e.g., an optional referendum about a parliamentary bill must be held if 50,000 citizens or 8 cantons have signed up within three months from the date of approval of the bill by federal parliament). Optional referenda are signifi-

⁸⁸ See ACE The Electronic Knowledge Network's section on Swiss Direct Democracy for more detailed information. Available electronically at: http://www.aceproject.org/ace-en/topics/es/esy/esy_ch02.

cant because they serve as a check on the actual exercise by the federal government of its legislative powers. In the case of popular initiatives, a quota of citizens who signs up within a certain timeframe can propose changes to the federal constitution to be submitted to popular vote (e.g., at the federal level a vote on popular initiative is held when at least 100,000 citizens sign up for it within 18 months) (*Kubler, 2005, 7*).

Cooperative Federalism

During the 19th century, there existed a clear division between the expenditure responsibilities and tasks of the federal government and those of the cantons. Since the end of the Second World War, however, expenditure and task integration between the two levels of government as well as the number of tasks and expenditure responsibilities assigned to the federation as opposed to the federal government have increased significantly. Today policy making in the Swiss federal system is “highly dependent on co-operation between the three state levels, and there is a complex network of co-operation and co-decision” (*Kubler, 2005, 16*). Cooperative federalism is thus, an important component of the Swiss system and an important factor in upholding the principle of “fiscal equivalence”. Many important fiscal policies are determined through horizontal cooperation among the cantons rather than through the use of direct vertical or horizontal transfers. Dafflon writes that the “cantons and communes [local governments] are free to conclude agreements with one another on co-operation in the most varied areas and so establish themselves with optimal size of area necessary for the performance of government tasks, for example the provision of certain public goods, from University funding (inter-cantonal co-operation) to school districts and water provision (inter-communal co-operation) (*Dafflon, 2001, 6*).

Cooperative federalism in Switzerland has also taken the form of inter-cantonal Committees, or the Conferences of Cantonal Ministers, that are intended to influence federal-level fiscal policy decisions and arrangements. The Conferences were created as a response to the lack of influence that cantons have over national politics as the federal government and Parliament are free to make decisions, subject to the will of the people as exercised through voting in referenda. There exists no constitutional court in Switzerland and the State Council is composed of either

one or two members from each canton that represent the people of the canton and not its government. Therefore the conferences are the mechanism by which cantons are able to represent their interests in national level political discourse. The most influential of the Conferences is the Conference of the Cantonal Ministers of Finance (CCMF) that acts as a powerful pressure group to “discuss fiscal/financial matters which are of common interest to all or a large number of the Cantons. It has been organised not so much to co-ordinate and harmonise fiscal and financial affairs of the Cantons [...], as to intervene more persuasively in federal-cantonal relations and to interfere in federal-only fiscal and financial matters” (Dafflon, 2001, 6). These conferences are not formally guaranteed by the constitution but nevertheless serve as a primary instrument for the cantons to negotiate collectively with the federal government and, thus, play an important part in consultations on federal fiscal administration. Furthermore, if in passing a new law the cantons believe that the federation will interfere too greatly with the interests of the cantons they can launch a referendum using the provisions of the optional referenda under Article 141 of the Constitution that stipulates that cantons can launch a referendum if at least 8 cantons demand it. The first of such referenda was held in May 2004 in response to a proposed tax reform that would have altered the base for the taxation of owner-occupied houses and apartments. The referendum was successful and the reform was rejected.

The Swiss system has, however, been criticized for the high degree of regional (cantonal) autonomy inherent in its federal system. Bird and Tarasov write that “Switzerland, more than any other country, is a ‘bottom-up’ federalism, in which change can come about only when virtual unanimity is achieved” (Bird and Tarasov, 2002, 22). Changes to the system are therefore likely to be lengthy, slow processes, with such possible *negative effects* on policy goals as significant logjams in decision-making and sacrifices to the *efficiency* of the Swiss system in favour of *equity* and *autonomy* in the form of a more balanced power-sharing arrangement between the federal government and the cantons. Furthermore, “relatively important regional disparities across cantons due to autonomy in public expenditures, direct access to many revenue sources and above all differences in the Cantons’ economic potential have led to relatively important

regional disparities, expressed in the fiscal [tax] burden of the Cantons and in their financial capacity” (Dafflon, 2001, 3). As the cantons have the basic power to tax income, wealth and capital a significant degree of inter-cantonal tax competition exists in Switzerland. For example, recent studies have shown that choice of cantonal residence for high-income earners often depends upon a canton’s tax rate and the amount of income tax they will have to pay to reside in a particular canton. Such studies have also found that huge discrepancies in the tax burden, thus, exist between “rich” and “poor” cantons, owing to the fact that “rich” cantons have a greater capacity to meet expenditure responsibilities despite lower tax rates and thus attract more affluent residents (Feld and Kirchgässner, 2001; Kirchgässner and Pommerehne, 1996).

The significant degree of decentralization cantonal responsibility for its own fiscal discipline also raises concerns for maintaining *macroeconomic control* and *stability* at the national level. Dafflon writes that “this is because cantonal and communal accountability involves the access to own revenue sources together with the right of the Cantons and the communes to borrow. Uncontrolled access to capital markets and mismanagement of the budgets by cantonal and local government could jeopardize the efforts, if any, to stabilise the economy” (Dafflon, 2001, 19). In effect this suggests that in Switzerland macroeconomic policy cannot be driven by the federal government alone, but instead requires some form of collaboration between the three governments (federal, cantonal and communal). Furthermore, even though monetary policy is a strictly federal issue, in practice this responsibility has been delegated to the Swiss National Bank (SNB). Ultimately, “fiscal and budget policy plays only a limited role in stabilisation, compared to the position of the monetary governments through the Swiss National Bank” (Dafflon, 2001, 20). For their part, however, the cantons have taken steps to maintain the macroeconomic stability of the nation through the implementation of internal constraints to cantonal fiscal policy contained within cantonal constitutions and laws. In general two rules in particular are upheld: (1) the requirement of maintaining a more or less balanced budget and (2) debt limitation, public debt is allowed in many of the cantons only for financing capital expenditures and only if the cantonal government has the fi-

financial capacity to pay the interest and amortization of the debt out of its current budget (*Dafflon and Toth, 2005, 53*). These represent attempts to maintain the principles of *accountability* and *fiscal responsibility*. In practice, however, there is some question regarding how effective these provisions have been as they did not prevent cantonal debt from increasing substantially during the 1990s. Finally, the Swiss *equalization system*, and specifically the new reforms to equalization that are expected to come into effect in 2008 have been created in part to help mitigate the negative impact of relatively large discrepancies in the tax burden between the “rich” and “poor” cantons and to maintain the cohesion of the nation while preserving cantonal tax sovereignty.

Equalization Programs

The first equalization programs in Switzerland were implemented in 1938, through a conditional grants program that graded the amounts transferred according to the tax capacity of the cantons. It was not until 1958, however, that an equalization system was formally included in a constitutional Article giving the federal government the power to “equalize disparities” (*Dafflon, 2004, 14–15*). Up until recently the Swiss fiscal equalization system has been comprised of three programs: (1) the use of conditional “grant-in-aid” transfers from the federal government to the cantons, (2) revenue-sharing (unconditional) transfers of certain tax revenues and (3) contributions of the cantons to specific federal social security expenditures. Regional disparities between the cantons in terms of size, geography, population and economic potential (including disparities in tax burden) have resulted in the need for a system of equalization in order for cantons to be able to provide a minimum level of public services to their respective populations as well as to fulfill their constitutional expenditure responsibilities. As the current system has been unable to sufficiently equalize inter-cantonal disparities a series of reforms to the system have been created that are expected to take effect in 2008.

Although “there are no constitutional provisions and no claims from the cantonal governments or the citizenry that equalisation measures should compensate entirely for differences between the Cantons [...] the pragmatic objective is to render regional disparities politically acceptable so that remaining differences do not endanger the cohesion of the Con-

federation” (*Dafflon, 2001, 30*). Thus, equalization transfers have been used primarily to equalize the distribution of resources between cantons and have been supplemented by three other fiscal policy measures: (1) agricultural aid policy, (2) investment assistance to mountainous areas and (3) aid to restructuring economic areas (previously called assistance to industrial depressed areas or “Bonny’s decree”) (*Dafflon, 2004, 14*). Specifically, equalization is intended to help compensate for differences in revenue-raising capacities among the cantons, but the overall amounts of transfer payments remain modest in comparison to the objectives of budget responsibility and the financial autonomy of the cantons as equalization transfers account for only 10% of total cantonal revenues (*Vaillancourt and Bird, 2005, 17*). However, despite this relatively low overall degree of cantonal reliance on the federal government, individual cantonal reliance on transfers from the federal government varies widely from as low as 10% to as high as almost 50% (*Dafflon, 2004, 14*). This implies that the appearance of relatively high levels of cantonal *autonomy* is somewhat deceiving and imbalanced in favor of wealthier cantons due to (1) fiscal competition in the form of taxes and the resulting discrepancies in the amount of tax burden between “rich” and “poor” cantons and (2) differences in economic potential of the cantons.

Conditional “Grants-in-aid”

Conditional “Grants-in-aid” are determined on a rates-basis that is made up of two components. The first is a “basic rate” formula that represents the federal-level or national interest in achieving a minimum standard of service for a particular public service and which varies according to incentive or technical criteria (e.g., economies of scale or the extent of spillovers/externalities that arise from provision of the service). The second is an equalization supplement inversely, or negatively, correlated to the index of financial capacity and expenditure differential indicators for the receiving canton (*Vaillancourt and Bird, 2005, 17; Dafflon, 2001, 31*). Three revenue generating capacity indicators are used: (1) national income per canton, (2) tax revenue per capita for both cantons and communes and (3) a tax efforts or burden index (*Vaillancourt and Bird, 2005, 17*). The two differential expenditure indicators used are: (1) proportion of agricultural land in mountainous regions (a cost variable) and

(2) population density (a needs variable) (*Vaillancourt and Bird, 2005, 17*). “Grants-in-aid” are “always specific, mostly conditional and for some of them block grants based on **performance output**” (*Dafflon and Toth, 2005, 36*). On average, approximately 17% of cantonal public revenues are made up of conditional “grants-in-aid” (*Dafflon, 2004, 11*).

(Unconditional) Revenue Sharing grants

Revenue Sharing grants derive from various sources in the Swiss tax system. In terms of unconditional transfers, one central transfer involves the assignment of 30% of the federal direct tax (FDT) to the cantons. Likewise, 10% of the revenue from federal withholding taxes (WT), approximately 12% of customs duties on motor fuel and two-thirds of the earnings of the Swiss National Bank are distributed to the cantons (*Bird and Tarasov, 2002, 22*). Half of the receipts from the collection of “normal” duties and all “supplementary” duties are attributed to “road” expenditures (*Dafflon, 2001, 33*). Historically, “revenue sharing was implemented either in order to compensate for fiscal imbalance when a previously cantonal revenue source was centralized (customs, alcohol monopoly, coinage, stamp duties) or because newly introduced federal taxes were concurrent to cantonal taxation (the federal direct tax and the withholding taxation). The main revenue sharing programmes have been connected with equalisation repayments” (*Dafflon, 2004, 20*). These types of transfers take the form of “block” payments and are unconditional, meaning that the cantons are totally free to use them as they see fit so that “the constraint – of the loss of financial autonomy – is by far much more limited than is the case with specific grants-in-aid” (*Dafflon and Toth, 2005, 37*).

Contributions to social security

Contributions to social security are the third category of transfer payments from the federal government to the cantons. These include cantonal contributions to three federal social security programs: the old-age and survivors insurance (AVS), the disabled pension scheme (AI) and family allowance in agriculture (AFA). These are jointly funded programs and the cantonal share is part of equalization because the per capita contribution for each canton differs and determined based upon a modified version of the financial capacity index.

Reforms to Equalization

Over the last two decades, however, these programs have come under criticism in terms of their *efficiency*. In 1994 the federal government and the cantons initiated a reform process based on 5 factors: (1) the existing system has not succeeded in reducing inter-cantonal disparities, (2) the system has become increasingly entangled with responsibilities between the two levels becoming blurred and resulting in increased centralization, (3) inefficiencies in the existing revenue equalization policy, particularly cantonal contributions to social security expenditures, (4) the conditional grants system of matching grants advantages “rich” cantons as the “poor” are unable to fund their portion of the expenditure and (5) there is general confusion in the present system between incentives, efficiencies and equalization (Dafflon, 2004, 30)⁸⁹. Following a decade of negotiations between the cantons and the federal government, the equalization system in Switzerland has undergone significant reforms. The necessary constitutional changes to the current equalization system were accepted by the Swiss people in 2004 and in 2005 a draft of the proposed legislation was drawn up and Parliament is scheduled to discuss the changes in 2007 to come into effect in 2008. The reform of the equalization system and of the distribution of expenditure tasks between the federal government and the cantons, the *Neuordnung des Finanzausgleich* or NFA, is designed to improve *incentives* to lower costs at the cantonal level, clarify the tasks of federal government and the cantons and mandate coordination among the cantons in key areas, such as education and health” (*IMF Country Report No. 06/203 2006*, 7).

The objective of the proposed reforms is two-fold: to re-assign the responsibilities between the federal and cantonal governments and among the cantons themselves. The reforms essentially consist of four components. The first involves the separation of some of the tasks that are at present the joint responsibility of the federal government and the cantons

⁸⁹ See: Dafflon, Bernard. “Federal-Cantonal Equalisation in Switzerland: An Overview of the Present System and Reform in Progress.” University of Fribourg: BENFRI Centre for Studies of the Present System and Reform in Progress, Working Paper No. 356, Updated May 2004. Available online at: [http://www.unifr.ch/finpub/doc/WPfulltext/ WorkingPaper356.pdf](http://www.unifr.ch/finpub/doc/WPfulltext/WorkingPaper356.pdf).

in order to minimize the scope for coordination failures based on the subsidiarity principle, although some tasks will remain the joint responsibility of the federal government and the cantons. The second reform pertains to new kinds of “joint-task” collaboration between federal and cantonal governments and new types of financing to be introduced. The traditional system of matching grants will be replaced by a system in which the cantons get all financial means necessary for those tasks where the federation is in the charge of strategic issues and the cantons are responsible for “operation” or implementation aspects. The objectives for these tasks will be fixed and outlined in an intergovernmental contract taking the form of conditional “block” grants, giving this reform an *output* and *outcomes-based* orientation in terms of meeting expenditure requirements as the amount to be transferred is based on goals rather than costs. Third, there will be new forms of horizontal collaboration between the cantons for those cantonal tasks that contain “spillover” effects, with the intention of preventing free-rider behavior. For example, if a group of cantons agree to collaborate on tasks they cannot perform independently and if the outcomes of these activities have benefits that “spillover” to other cantons outside of this group, the federal government can require those cantons outside the group to participate if at least half of the co-operating cantons request such an intervention. The fourth component of the reforms refers to equalization in the traditional sense that equalization is often understood as a form of strictly revenue-sharing.

These particular reforms consist of three elements: (1) revenue equalization, consisting of implementing a combined system of horizontal (30% from the rich cantons) and vertical (70% from the federation) unconditional grants to equalize fiscal capacity up to 85% of the average cantonal fiscal capacity measured by tax potential, (2) a cost-equalization scheme of vertical compensation of “special needs” financed by the federation for geo-topographic (e.g., percentage of overall area that is mountainous) and socio-demographic factors and (3) there will be a “cohesion fund” that is intended to protect cantons with weak fiscal capacity that currently receive equalization from suffering from worse conditions due to the implementation of the reforms. Two-thirds of this fund will be financed by the federation and one-third by the cantons, with full payment for a pe-

riod of 8 years, and a decrease of 5% for the next 20 years, meaning that lifespan of the entire fund is 28 years. The goal of these reforms is to reduce cantonal financial disparities and to ensure that the cantons have the means necessary to meet expenditure responsibilities (*Dafflon, 2004, 33–47*).

In some ways similar to that of Germany, the Swiss Constitution assures the cantons of either primary or exclusive access to certain key revenue bases. Moreover, vertical tax coordination is written into the Constitution with the understanding that the federal claims on direct taxes will be moderate and also with the cantons sharing in the federal claim.

Thus, revenue shares and/or transfers, including equalization payments from the federal government to the cantons, are constitutionally “guaranteed” through requirements outlined in the Constitution. Article 46(3) of the Constitution specifically states that the federal government must take into account the “financial burden” of federal laws on the cantons and lays out the constitutional basis for a system of revenue sharing and intergovernmental transfers. In particular the Swiss Constitution protects cantonal *sovereignty* and maintains a degree of legislative *equity* between the different levels of government through the subsidiarity principle that states that legal competencies lay first and foremost with the cantons.

The principles of *sovereignty* and *autonomy* are also upheld in the Swiss system as the two Chambers of Government are vested with equal powers of authority. All bills and laws have to be approved by both Chambers to take legal effect. In recent years the Conferences of Cantonal Ministers have also become increasingly influential as a means of enabling the cantons to participate in federal decision making. The combination of the constitutional guarantees of transfers and the equality of decision-making power inherent in the legislative assembly provides a strong legal basis for challenging transfers that are seen as too low or otherwise inappropriate as well as suggesting a measure of control over the types of transfers that are implemented. The provisions contained within the Constitution imply that any attempt to centralize powers and assign new competencies to the federal government requires a constitutional amendment, which in turn requires majority voter support in the form of a

referendum as well as majority cantonal support in the legislative chambers, thus, creating a significant barrier to centralization.

Furthermore, *sovereignty* and *direct accountability* are also maintained through the vertical distribution of powers and through the use of direct democracy (e.g., the use of referenda). Regarding direct democracy, direct accountability is achieved as citizens have direct access to and influence on government, thus, raising *performance incentives* for governments to provide high-quality services.

The Swiss system has been criticized for its reliance on regional (cantonal) autonomy and legislative equity over the greater use of intergovernmental transfers that could aid in enhancing the system's *efficiency*. The high degree of decentralization and substantial discrepancies in canton tax burdens also brings up potential concerns about national-level *macroeconomic control* and *stability*. The Swiss *equalization system* and in particular recent reforms to equalization were created in part to help mitigate the negative impact of these factors. Although conditional transfers are still used in the form of "grants-in-aid", the recent reforms to equalization indicate a general shift toward the greater use of a vertical *and* horizontal system of both conditional *output* and *outcome-based* block grants and unconditional equalization grants on the basis of *revenue-generating (tax)* potential.

The United States

The United States' (US) population of close to 300 million resides in 50 states and one territory. The history of fiscal federalism in the US dates back to 1789 and to the US Constitution (Bill of Rights) that delegates limited powers to the federal government and the tenth amendment of the Constitution that reserves powers for the states. The amendment reads: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people," (Amendment 10, The United States Constitution Online)⁹⁰. The duty of the Legislative Branch of the American government is to make the laws of the nation. It consists of two houses, the House of Representatives (the lower house) and the Senate

⁹⁰ See: <http://www.usconstitution.net/const.html> for a complete overview of the Constitution.

(the upper house). The duty of the Executive Branch is to enforce the laws of the United States. The branch is headed by the President. The Constitution does not explicitly require revenue sharing and/or transfers including equalization, but implicitly allows the federal government to transfer funds to sub-national governments and to mandate conditions for the transfers.

In the century following the Civil War the responsibilities of the federal government and its involvement in the affairs of the states rose substantially. Over the past half century, intergovernmental transfers have risen in importance in terms of both the proportion of total government expenditures and the actual dollar amount transferred to states. In the late 1960s an era of “coercive” or regulatory federalism emerged to displace the period of “cooperative” federalism that preceded it⁹¹. According to John Kincaid, “although cooperation continues to be the hallmark of daily intergovernmental relations, that cooperation occurs within a highly federalized environment, under conditions often dictated by Congress and presidents, rather than forged by cooperative agreements among federal, state and local elected officials” (*Kincaid, 2002, 26*).

Since the late 1960s, Congress has preempted more state laws than in the previous 180 years of US history and there has been an unprecedented increase in the types of conditions attached to large federal-aid programs, especially in areas that states cannot feasibly “opt-out” of such as surface transportation. This has resulted in a “trade-off between lower governments’ autonomy in programme design on the one hand and their financing responsibilities on the other, notably through a switch from open-ended matching grants to earmarked, lump-sum grants (referred to as block grants in the US context, despite their earmarked nature)” (*Laubach, 2005, 12*). In addition, almost all mandates that have been enacted in US history have been implemented since 1969. Kincaid writes that “although the number of unfunded mandates has declined since enactment of the Unfunded Mandates Reform Act (UMRA) of 1995, it is

⁹¹ For a detailed historical overview of the transition from cooperative to coercive federalism in the US see: John Kincaid. “From Cooperative to Coercive Federalism.” In *Annals of the American Academy of Political and Social Science*. V. 509, American Federalism: The Third Century. (May 1990): 139–152.

unclear as to how much of the decline is due to UMRA [...] Furthermore, while the number of unfunded mandates has declined, the total cost of unfunded mandates has not clearly done so” (Kincaid, 2002, 26). The Constitution delineates the expenditure responsibilities that are under the jurisdiction of the federal government with the remaining responsibilities reserved for the states, who then in turn assign certain powers to local governments. Local expenditure responsibilities, therefore, vary significantly between local governments across the US (Vigneault, 2005).

Currently federal aid accounts for approximately 23% state-local expenditures. Historically, the federal government has favored the use of **conditional transfers** over **unconditional transfers**, whether for equalization or other general purposes. In the early 1990s, conditional grants accounted for around 90% of the intergovernmental transfers of the federal government (Ma, 1997, 4). There have been three principal types of conditional grants used by the federal government, **closed-ended matching**, **open-ended matching** and **non-matching “block” grants**, with close-ended matching grants being most favored. Another common way of categorizing federal grants is categorical grants, project (program) grants and block grants. Project grants are normally competitive. The majority of categorical grants are distributed to states and/or local governments by formula. Even though the American system is characterized by a high degree of federal intervention, states do possess considerable independence in terms of expenditure responsibilities, particularly with regard to education, and access to a wide variety of tax sources. In essence states act as “agents of the federal government, although they have considerable leeway in many details” (Bird and Tarasov, 2002, 23).

Conditional Grants

The extensive use of conditional grants to help manage revenue shortfalls is a relatively unique feature of the American intergovernmental transfer system. Arguments supporting the use of conditional grants are rooted in “the principle of financial responsibility and accountability, i.e. that the federal government that has the nasty task of raising the funds by taxation should, in the interests of accountability to the tax-payer, control and set the conditions for the use of these funds

by the state governments” (Watts, 1999, 49). The issue of accountability arises from the fact that Congress seeks to ensure that the money it authorizes for transfer to other levels of government is spent for its intended purpose. This leads Congress to establish conditions on many of its transfers to state and local governments. One of the end results of this use of conditional transfers is thus that the federal government often intervenes in the design of state or local programs, infringing more substantively on state *autonomy* than the national-level governments of the other federations discussed elsewhere in this paper. Recently, though, there have been moves to enhance the expenditure and program design autonomy of states through the increased use of “block” grants. The degree of conditionality imposed on grants varies ranging from conditions on specific program design to general “block” grants.

In the early 1980s, non-matching conditional “block” grants became a popular means of transferring funds to the states under the administration of former President Ronald Reagan. This increase in the use of “block” grants in part relaxed the use of **input-based conditions** on federal transfers in favour of more **output and outcome-based conditions**. This marked an increase in the degree of flexibility in terms of where and how funds could be allocated and diverted some *expenditure autonomy* to the states. For example, the Job Training Partnership Act created in 1982, “provided funds from federal revenue to finance human resource training programs administered by state and local governments designed to be tailored to the particular needs of workers and employees in local labor markets” (Ma, 1997,5). This Act shifted expenditure responsibility to the states and oriented conditionality to outputs: the realization of a human resources training program. Despite the increased prevalence of “block” grants since Reagan, however, close-ended conditional grants remain the dominant form of intergovernmental transfers used by the US and, thus, expenditure autonomy varies considerable across transfer programs. Furthermore, it should be noted that block grants have never amounted to more than 16% of all federal aid money despite increases in the use of such transfers.

Health-related transfers as well as those intended to fund welfare programs, education and transportation expenditures, are among the most

important transfers from the federal government to states. Jointly, transfers in the above four areas account for almost two-thirds of total federal grants to the states and though “earmarked” for specific expenditure, “there is considerable variation across programmes in the freedom the receiving governments have in allocating these funds” (*Laubach, 2005, 13*). In some cases, however, conditional grants “specify program design features with which state spending must abide [...] without associated funding” (*Boadway and Watts, 2004, 7*). States, therefore, having relatively varied levels of *discretion* in program design and *autonomy* over expenditure policy depending on the type of grant administered, the degree of conditionality attached and the amount of funds allocated to the program (e.g., whether they are open-ended or closed [“capped”], matching or “block” grants). A recent example can be found in the conditional requirements associated with the No Child Left Behind Act (NCLB) passed into law in 2002.

Transfers for Education

The NCLB “entails unprecedented federal interventions into core areas of state responsibilities for education and preempts many state laws governing testing, data collection and education standards” (*Kincaid, 2002, 27*). It “alters federal-state relations by expanding the federal role further into a primary function of state and local governments and raises questions about how federal, state, and local policies interact – that is, conflict or reinforce each other” (*Sunderman and Kim, 2004, 9*). The NCLB has been criticized by both state and local officials on a number of grounds including the **outcome-based** requirements that: (1) “adequate yearly progress” toward proficiency for all must be demonstrated through the administration of math and reading tests for third through eighth graders that is an inflexible measure of a school’s effectiveness, (2) the federal definition of a “highly qualified teacher” is too rigid and (3) the changes that are required to be made to a school labeled “in need of improvement” are themselves “counterproductive” (*Dinan and Krane, 2006, 334–335*). Furthermore, “the extra federal funds intended to compensate states for these federal directives are considered by many state officials to fall well short of meeting the full costs of preparing students to meet these requirements” (*Dinan and Krane, 2006, 334*).

Recently, however, a number of state requests for waivers from particular requirements have been granted. First, in 2005 waivers were administered granting schools an additional year to meet the “highly qualified teacher” requirement. Second, regarding the consequences of a school being labeled “in need of improvement” a pilot project was approved that will permit states to receive tutoring assistance *before* being permitted to transfer to another school in the district. Third, in terms of “adequate yearly progress” a 2 percent rule has been implemented that allows states to develop alternative ways of assessing the progress of children with severe cognitive disabilities (up to 2 percent of students) (*Dinan and Krane, 2006, 336*). In part this has helped to decrease some of the inflexibility and rigidity surrounding the conditions on education reform mandated by the NCLB.

Transfers for Health and Welfare

In 1996 federal legislation (for an initial five-year period) in the area of public assistance programs fundamentally altered the structure of welfare programs for low-income families in the US. The new system of transfers implemented under the Temporary Assistance for Needy Families Act (TANF) replaced the previously open-ended federal matching grant program, Aid to Families with Dependent Children (AFDC), with a “capped” (closed-ended) “block” grant. Along with “imposing an upper limit on the federal contribution to welfare spending, the welfare reform removed many federal eligibility and payment rules, thus devolving to states much greater authority in programme design” (*Laubach, 2005, 14*). However, “TANF is not true devolution because while states are accorded considerable administrative discretion, they are mandated to achieve specific performance objectives” (*Kincaid, 2002, 28*). To prevent states from substantially reducing their welfare programmes and diverting block grant funds to other purposes, the legislation includes a ‘maintenance-of-effort’ requirement by which states have to maintain at least 75% of their 1994 spending on programmes replaced by TANF, including AFDC-related child care (*Laubach, 2005, 14*).

In 2005 TANF was re-authorized for a further five years. Under the final TANF reauthorization states are subject to several new rules and not nearly as many expenditure requirements as were previously considered

in earlier drafts of the reauthorization. The principal changes that must be adopted under the new TANF reauthorization are formulaic and involve the percentage of each state's welfare recipients who must meet work requirements. By 1 October 2006, states were required to: show that these work requirements are met by at least 50 percent of all families receiving assistance. Moreover, states now have to include in these calculations not only families receiving TANF assistance, as in the past, but also families receiving assistance through separate state welfare programs. Finally, these work participation requirements will be adjusted downward in each state by 1 percentage point for each percentage-point reduction in the families receiving assistance, starting with 2005 as a baseline (*Dinan and Krane, 2006, 337*).

Consequences for failing to meet TANF reauthorization requirements are also significant. States "can lose between 1 and 5 percent of TANF funds in the first year and be penalized up to an additional 2 percent in each subsequent year for noncompliance" (*Dinan and Krane, 2006, 337*). Therefore, although states have some control and autonomy over program design of welfare programs they are also constrained by the "reporting" conditions of TANF reauthorization that attempt to ensure a measure of accountability as to where and how program funds are allocated.

Medicaid was enacted in 1965 to provide public health insurance to low-income citizens and as of 2003 covered 1 in 7 (approximately 40 million) Americans and at present is estimated to have increased to 1 in 6 Americans. Costs for Medicaid exceed US\$ 300 billion per year and account for nearly 43 percent of all federal aid (*Dinan and Krane, 2006, 337*). Medicaid is now on average the second largest component of states' budgets. The federal government funds states for approximately 50 percent to over 75 percent of Medicaid's costs, depending on each state's per capita income (*Kincaid, 2003, 28*). There are several reasons why costs continue to be driven up for Medicaid aid. These include healthcare inflation, rising caseloads, higher premiums for private healthcare insurance, increases in the number of children and adults eligible through an easing of eligibility requirements and increases in the costs of care for the elderly (*Kincaid, 2003, 28*).

Pressures for reforms to the Medicaid program began in 2005 with President Bush's budget proposal that called for US\$ 60 billion in Medicaid savings over 10 years (*Dinan and Krane, 2006, 337*). Consultations between the House and Senate on Medicaid reform resulted in the 8 February 2006 signing of the Reconciliation Bill. The Reconciliation Bill is expected to bring US\$ 4.7 billion net savings in Medicaid spending over five years and, of particular importance to states, will give states an added degree of *flexibility* in implementing certain aspects of the Medicaid program (*Dinan and Krane, 2006, 338*). States will "be permitted to adopt cost-sharing measures, impose higher premiums, and reduce benefits for certain Medicaid recipients and services. In addition, current and future Medicaid recipients are required to provide proof of U.S. citizenship. Changes have also been made in the rules governing asset transfers and home equity for nursing home benefits, and added penalties are imposed for violating these rules" (*Dinan and Krane, 2006, 338*). Finally, in the first four years of the Bush administration a variety of waivers have been granted to states in an attempt to deal with the rising costs of Medicaid coverage.

Despite recent increases in the use of **output** and **outcome-based** conditions and the use of waivers to help cover the costs to states of implementing federally mandated programs, **input-based** conditions still play the dominant role in the American transfer system. According to Boadway and Watts this detracts "from a key advantage of the federal system, which is to allow state governments to have the discretion to design their programs in a way that are most suitable to the need and references of their constituents" (*Boadway and Watts, 2004, 12*). It should be noted, however, that as a result of pressure from state officials for increased discretion in the implementation of federal programs executive waivers have been introduced that allow for more state discretion and experimentation in the implementation of federally mandated programs. For example, TANF "was based on welfare-reform experiments conducted by states under waivers" (*Kincaid, 2002, 29*). However, the use of waivers has not been without criticism. Kincaid writes that waivers "jeopardize the integrity of the rule of law and potentially enhance executive power over legislative power in both

Washington and in state capitals. They also pose issues of democratic accountability insofar as they are negotiated and implemented by executive officials outside the floodlit legislative process. They raise questions of equity as well, because they introduce variability in the implementation of law” (Kincaid, 2002, 29).

A further outcome of the American system has been a degree of complexity in terms of the extensiveness of transfers that raises questions regarding coordination (efficiency) and the level of public understanding achieved by such a system. For example, the “considerable discretionary power of the federal government in both revenue-raising and expenditure decisions, and the checks and balances between the executive and Congress at the federal level have resulted in an extensive but uncoordinated system of federal expenditures and intergovernmental transfers in many areas of both concurrent and exclusive state jurisdiction. This complexity has resulted in low transparency and public understanding of these arrangements” (Boadway and Watts, 2004, 19).

Equity without Equalization?

Despite the absence of a formal formula-based equalization system in the US, the structure of conditional grants is such that it does implicitly incorporate aspects of equalization into the transfers. Boadway and Watts write that “the fact that some significant grants are matching, or are related to state expenditure needs, implies that the federal system is to some extent equalizing with respect to needs. On the other hand, states with greater revenue-raising potential are better able to take advantage of these grants” (Boadway and Watts, 2004, 11). A significant proportion of conditional transfers made in the US are also for the purposes of achieving national *equity* and achieving national *expenditure priorities* and *efficiency objectives*. The high number of conditional federal transfers is, therefore, linked to influencing state expenditure priorities and programs in a manner that is consistent with national objectives.

While “relatively common standards of equity can be achieved [...] the absence of an explicit system of equalization transfers implies that horizontal equity is likely violated: states differ in their capacities to provide public services” (Boadway and Watts, 2004, 18). Furthermore, although there has been some attempt “in many of these programs to

relate transfers to such indicators of need as per capita income, there is no general system of equalization and no apparent concern that the result is that states with lower fiscal capacities cannot provide services at levels similar to richer states” (*Bird and Tarasov, 2002, 23*). It must be acknowledged, however, that federal aid today has shifted focus and now predominantly redistributes income among persons rather than places. In 1978, “32 percent of federal aid to state and local governments was dedicated for payments to individuals (e.g., health and welfare). By 2001, 63 percent of the federal government’s \$316.3 billion in aid was dedicated to individuals, leaving 17 percent for capital investment and 20 percent for all other programs” (*Kincaid, 2002, 27*). This change has had the effect of enhancing *equity* for citizens regardless of which state they reside in and is appropriate for the American case of federalism, which is characterized by considerable inter-local and inter-state mobility.

At the same time, however, there have been some negative outcomes that have had an enduring fiscal impact on state and local governments. For instance, “reduced federal aid for capital investment and other purposes has increased state-local fiscal responsibility for education, economic development, infrastructure and the like. Simultaneously, because most aid-to-person programs, such as Medicaid, which accounts for more than 40 percent of all federal aid, involve state matching funds, state spending is driven up by inflation and federal policies” (*Kincaid, 2002, 27*). Ultimately, the shift from places to persons in the composition of federal aid has helped to ensure that aid in important areas such as health and welfare is able to reach recipients despite high mobility rates in and between US states.

Thus, there has been some attempt in the US to include equalization components through the conditionalities attached to specific purpose transfers. The resulting *performance-related effect*, however, is that there remains the potential for *inefficiencies* in resource allocation to result due to the fact that differences in fiscal capacity are allowed to persist despite the relative fiscal autonomy that states have in certain transfers.

In the US, revenue sharing and/or transfers including equalization are not constitutionally required or even explicitly provided for in the

Constitution as in Germany and Switzerland. But the Constitution implicitly allows the federal government to transfer funds to sub-national governments and to mandate conditions for the transfers. Sub-national governments have no legal recourse to challenge these conditions although some states have recently enacted laws that stipulate that state law takes precedence over certain federal aid programs, particularly regarding the implementation of the NCLB Act (See *Dinan and Krane, 2006*, and *Kincaid, 2002*). State and local governments raise around three-quarters of their revenue with the remainder transferred from the federal government. Congress transfers funds to state and local governments through three types of grants (project, categorical, and block). Categorical grants are formula driven. The terms of these transfers (i.e. the conditions) are decided by Congress.

Furthermore, conditions can be imposed on the delivery of services without a corresponding transfer of funds. The federal government can mandate spending requirements on sub-national governments without providing the funds needed to implement the mandate (so-called unfunded mandates) although many programs and conditions on the delivery of federal aid allow for considerable state discretion.

The large number of states and the absence of a systematized nationwide arrangement for coordinating fiscal transfers between the states and the federal government in the US have led to a wide but relatively diffused and uncoordinated set of intergovernmental transfers. The widespread use of conditional transfers from the federal government to the states has also added a layer of interdependence to the already somewhat *ad hoc* character of the American fiscal federal system. Conditional grants are favored as a means of providing a measure of accountability for the spending of federal tax money by states. This is rooted in the principle of “financial responsibility and accountability” that the government body (e.g., federal) that raises funds through taxation for grants should also set the conditions of use in the interests of accountability to those contributing the funds (e.g., taxpayers). The degree of conditionality on transfers varies considerably across the different federal aid programs, ranging from specific and close-ended

categorical and program design transfers to “block” grants with only limited and non-specific conditionalities.

Block grants remain “Congress’s least preferred way to distribute federal aid, preferring instead the control and targeting that can be achieved through categorical grants. Efforts to block grant major programs, such as Medicaid, have failed in Congress. Furthermore, congressional earmarking of federal funds for specific projects in members’ states and districts, [...] has increased significantly since the late 1980s” (Kincaid, 2002, 28). Thus, states assume varying degrees of expenditure *autonomy* depending on the nature of specific transfers but, generally speaking, a high amount of *flexibility* is maintained in the system.

The policy areas in terms of fiscal transfers that hold the most importance at present are in education (particularly the NCLB) and health and welfare (especially TANF and changes in Medicaid). Recent reforms in these areas reflect attempts to increase the *flexibility* and decrease some of the costs associated with implementation of the conditions of federal aid programs through the use of waivers. Waivers have been used to enhance some areas of state autonomy and relax some federal control over program design components of transfers as well as requirements that must be met in order to receive aid.

Despite the absence of a formal formula-based equalization system in the US, the structure of conditional grants is such that it does implicitly incorporate aspects of equalization into the transfers. The high number of conditional federal transfers is, therefore, linked to influencing state expenditure priorities and programs in a manner that is consistent with achieving national *equity* and achieving national *expenditure priorities* and *efficiency objectives*. Furthermore, that much federal aid today has shifted focus and now predominantly redistributes income among persons rather than places reflects a consideration of the high degree of inter-local and inter-regional mobility in the US and has had the effect of enhancing *equity* for citizens regardless of the state in which they reside.

Summary

The first section of this paper spoke to three of the principal economic functions of systems of fiscal federalism as presented in the literature: (1)

macroeconomic stabilization, (2) *income (re)distribution* and (3) *resource allocation*. A fourth rationale, generally under-explored in the literature, namely, the preservation of the polity, was also discussed briefly. Several economic rationales for implementing a system of intergovernmental transfers were then delineated: in order to address (1) *vertical fiscal gaps* (the expenditure-revenue mismatch), (2) *horizontal fiscal imbalances* (capacity-needs imbalances) and (3) *externalities* or “*spill-over*” effects. Second, the paper explored key criteria and considerations in the design and implementation of effective transfer systems, including some of the “trade-offs” and tensions inherent in such systems. Among these were ensuring *resource adequacy*, *autonomy* versus *accountability* debates and considerations of *efficiency* and *equity*. Finally, the various types of intergovernmental transfers were examined: (1) *conditional vertical grants*, (2) *unconditional vertical grants* and (3) *equalization (horizontal) grants*, as well as existing mechanisms for the delivery of these transfers from national to sub-national levels of government.

The second section of the paper presented country assessments for five different federations describing and assessing the design characteristics and effects of various intergovernmental transfers with respect to their impact on equity, accountability and power relationships and incentive and performance effects. A conceptual framework was utilized that enabled conditional transfers to be evaluated based on conditions linked to inputs, outputs and outcomes. Ultimately, the paper has revealed that there is no one kind of transfer system that fits the design needs of every country and no simple set of factors to explain differences in the types of policy preferences that states adhere to. Equalization transfers can be significant in systems where both a strong sense of national unity and preservation exists as well as in nations characterized by regional conflict or competition and where separation tensions run high.

Nevertheless, some general conclusions and insights can be gleaned from the case studies explored throughout this paper. First, different federalisms can and do successfully operate their intergovernmental transfer systems in different ways. Second, these systems are not inherently static. Significant changes are made to transfer systems to deal with changing political and economic realities that shape decision-making and governance

processes. Thus, intergovernmental transfers function primarily as instruments that can help to balance power-relationships and shape accountability mechanisms with varied incentive effects and impacts on efficiency, equity, autonomy, transparency, economic and political stability and the political integrity of the state.

Perhaps one of the key factors in evaluating the nature of the ‘intergovernmental contract’ among the levels of government has to do with whether or not its details are based in the constitution. In the two continental countries discussed here, the contract is laid out in the constitution, This tends to afford the regional (e.g. canton or Länd) government a more stable and predictable stream of revenue than is the case in the three Anglo countries (Canada being a partial exception) where the constitutions are less detailed and more is left to statutory law. In contrast, there is more flexibility in the latter countries.

Unconditional revenue sharing is commonplace in Australia, Germany, and Switzerland, and there is no indication that this is likely to decline. Put differently, the argument about ‘soft budget constraints’ does not appear to have much influence in discussions about intergovernmental revenue sharing in those federations. In this regard, we are not aware of any evidence that regional level governments in these countries are less financially disciplined than in the US and Canada, which do not use such schemes extensively. This, however, is worthy of further research.

All the federations also make conditional transfers for either nation-building or equity reasons generally using input-based conditions. In Australia, in particular, the Commonwealth (federal) government uses the Constitution to impose conditions on transfers and intervene in the affairs of the states to influence spending in areas it considers a national priority (e.g., education and health). There is, however, some discomfort in these federations with input conditions in part because they offend regional autonomy but also because they are thought to be inefficient economically. The different federations have therefore been experimenting with output and outcome conditions that enable significantly more regional-level discretion in program design and the allocation of funds. Contractually, these types of output and outcome-based conditions are different from input conditions in that the federal

government is not directly involved in monitoring the use of transfers and relies instead on federal-regional relations and a belief in the power of public opinion and accountability. However, the output and outcome conditions are not easy to implement effectively even if, in principle, they are often considered superior from an autonomy and efficiency perspective. The difficulty is that measuring output and especially outcome success is often very long-term work. In the interim, it is hard from an accountability perspective to know if the conditions are leading to the desired results.

2.1.6. A Typology of Federal–Regional Contractual Relationships

This paper has sought to address some of the principal issues and concepts found in the literature on fiscal federalism and to provide an assessment of the different kinds of federal-regional contractual relationships that were found for a cross-section of existing federations. The following typology or schema attempts to make sense of the different kinds of contractual relationships that have been explored in this paper by classifying the federal-sub-national relationships for each of the five case study federations into contractual “types”. The contractual relationships are classified based upon (1) the nature of the contractual relationship and (2) the implications of that relationship. This includes a consideration of different forms of contractual relationships, such as constitutional, statutory and politically-based arrangements as well as a focus on which arrangements enable sub-national units of government to have the most (and least) influence over fiscal transfers and provisions for revenue-sharing, including the collection and distribution of important revenue (tax) bases. Under Type I below, sub-national units have maximum power and under type V they have minimum power. Type IV is subdivided because, while IV A and IV B differ, we consider the amount of power residing in the sub-national units in these two schemas to be roughly equivalent.

Contractual Types

TYPE I: Provisions for sub-national units of government to have **primary and/or exclusive access to important revenue-bases** (sources)

and to collect certain tax revenues are provided for in the Constitution. Often, the distribution of collection authority between the two orders of government is based on a formula that specifies the percentage of revenues that each order is responsible for collecting and distributing. In Type I all or most of the key revenue sources of the federation are collected by sub-national governments, and it, in turn, may transfer revenues upwards to the federal government. Under this schema, **revenue-sharing arrangements flow in the opposite direction of what is most commonly associated with contractual provisions for revenue-sharing between federal-sub-national units** of government, where revenues collected are transferred downward from the federal government to sub-national units.

TYPE II: Transfer payments and revenue sharing arrangements are “guaranteed” through the provisions of the Constitution. The specific distribution of and arrangements for revenue shares and inter-governmental transfers etc. are again generally formula-based and explicitly provided for in the Constitution. This provides a strong political and legal basis for sub-national governments to be as confident as the federal government about the share of money it is entitled to and the certainty of receiving it. In this sense the **sub-national order of government is seen as a more or less equal partner in the “contractual” understanding about how governmental revenues are to be allocated.**

TYPE III: Sub-national units have a constitutional right of access, generally shared with the federal government, to important and lucrative revenue (tax) sources. These constitutional provisions place sub-national units of government in a potentially powerful position in terms of access to revenue sources, although for political and economic reasons they must exercise some restraint in order to avoid overtaxing taxpayers on revenue bases that are available to both federal and sub-national governments. On the other hand, to the extent that the federal government chooses to transfer some of its revenues to the sub-national units, those revenue allocations and transfers are based in federal law only. Thus, sub-national governments have little or no legal basis for challenging transfers that they view as too low or otherwise inappropriate provided that the terms of the transfer (i.e. the conditions) are not so intrusive as to be seen as an invasion of the constitutional jurisdiction of the sub-national gov-

ernment. Sub-national units can, however, challenge the allocations in the political arena.

TYPE IV (A): Constitutional provisions enable the federal government to transfer funds to or provide revenue sharing arrangements for sub-national units, but the specific nature or formula for determining revenue sharing arrangements and transfers is not constitutionally mandated. Thus, any such transfer or sharing arrangements are determined legally by the federal government alone. **In this schema, the contractual relationship relating to the allocation of revenue makes the federal government the much stronger partner legally but political convention normally assures the sub-national level with some precision regarding its allocation of revenues.** This also implies that the federal government can impose stricter conditions and intervene more substantially in the affairs of the state because the constitutional provisions that allow for transfers from the federal level to sub-regional units of government do not limit its freedom to impose conditions.

TYPE IV (B): The constitution allows both orders of government to access major tax bases. With regard to the revenues collected by the federal government, revenue sharing and transfers, including equalization, are not constitutionally required or even explicitly provided for. But **neither does the Constitution preclude the federal government from transferring funds to sub-national governments and attaching conditions to those transfers.** Sub-national governments have no legal recourse.

TYPE V: The federal government can mandate spending requirements on sub-national governments without providing the funds needed to implement the mandate (so-called “unfunded mandates”). This makes the **federal government by far the stronger party in the intergovernmental contractual relationship.**

Schemas

The charts below display both which case study federations “best fit” into each type of contractual schema. They also summarize what kinds of conditions on transfers are attached to each contractual “type” and the overall impacts based on our performance indicators.

Table 2.1 summarizes the extent to which countries associated with the different schemas have the constitutional and actual access to own source revenues (column 2) relative to non-own source revenues (column 3). Columns 4 and 5 decompose non-own source revenues into unconditional and conditional components.

Table 2.2 decomposes column 5 of *Table 2.1*. It shows which types of conditional transfers are most common and also indicates relative trends.

Table 2.3 summarizes the impact of the different contractual schemas on our performance indicators.

Table 2.4 is wrap-up summary of the overall analysis.

Table 2.1

Nature of the Contractual Relationship between Federal and Sub-national Governments According to Contractual Type

1 Contractual Descriptors ⁹² Contractual Types	2 Constitutional and Actual Sub-national Access to Own-Source Revenue	3 Sub-national Access to Non-Own Source Revenue (All Revenue Sharing and Transfers)	4 Unconditional Revenue Sharing and Transfers as Share of All Revenue Sharing and Transfers	5 Conditional Transfers as Share of All Revenue Sharing and Transfers
I Switzerland	High	Medium/Low	Low	High
II Germany	Low/Medium	High	High	Low
III Canada	High/Medium	Medium/Low	Low/Medium	Medium/High
IV (A) Australia	Low	High	Medium/High	Medium/Low
IV (B) USA ⁹³	Medium	Medium	Very Low/None	High/Very High
V Unfunded Mandate Share of USA System	Medium	None	None	Very High

⁹² The terms used to describe how the descriptors are expressed in each contractual type are relative to each of the other descriptors.

⁹³ Aspects of the contractual relationship between the federal government and the states in the US fit into both Type IV B and Type V.

Table 2.2

**Significance of Different Kinds of Conditional Transfers
as a Share of All Conditional Transfers**

1 Types of Condi- tions Contractual Types	2 Conditional Transfers with Input Conditions	3 Conditional Transfers with Output Condi- tions	4 Conditional Transfers with Outcome Condi- tions
I Switzerland	Medium, but decreasing	Low, but increasing	Low, but increasing
II Germany	Medium	Low, may increase in near future	Low, may increase in near future
III Canada	Low-Medium, but decreasing	Low-medium and increasing	Low-medium and increasing
IV (A) Australia	Medium	Low but increasing	Low but increasing
IV (B) USA⁹⁴	Very High	Low but increasing	Low but increasing
V Unfunded Man- date Aspect of USA System	Very high	Low, some increase recently	Low, some increase recently

Table 2.3

**Merits and Drawbacks of the Contractual Relationship between
Federal and Sub-national Governments for the Contractual Types**

Performance Indicators/Characteristics Contractual Types	Autonomy and Accountability	Efficiency (Innovation- related and National Efficiency)	Equity (Horizontal and Vertical)
I Switzerland	High on auton- omy and ac- countability	Potentially high on efficiency-related inno- vation. Low on national efficiency ⁹⁵	Medium at best on horizontal equity and maybe even lower on vertical equity

⁹⁴ Aspects of the contractual relationship between the federal government and the states in the US fit into both Type IV B and Type V.

⁹⁵ By innovation-related efficiencies we mean the incentive for the sub-national government to experiment with new policy designs and delivery systems. By national efficiency we mean the disincentive for factor inputs (labour, capital, technology) to not move from one sub-national unit to another for reasons of net fiscal benefits only or, viewed from the opposite perspective, to move from one sub-national unit to another when the result is productivity enhancing only.

Performance Indicators/Characteristics Contractual Types	Autonomy and Accountability	Efficiency (Innovation-related and National Efficiency)	Equity (Horizontal and Vertical)
II Germany	Medium on autonomy. Traditionally low on accountability	Low on efficiency-related innovation Medium-high on national efficiency	Very high on horizontal equity and high on vertical equity
III Canada	Medium-high on autonomy and accountability	Medium high on efficiency-related innovation and national efficiency	Medium on horizontal and vertical equity
IV (A) Australia	Low on autonomy. Medium on accountability	Low-medium on efficiency-enhancing innovation	Medium high on vertical and horizontal equity
IV (B) USA⁹⁶	Low-medium on autonomy. Medium on accountability	Medium on innovation-related efficiency and Medium on national efficiency	Medium on horizontal and vertical equity
V Unfunded Mandate Aspect of USA System	Low on autonomy. Medium on accountability (with federal government accountability but local low)	Low-medium on innovation-related efficiency. Medium on national efficiency	Medium-high on horizontal equity. Vertical equity uncertain

Table 2.4

Characteristics of the Contractual Relationship between Federal and Sub-national Governments for the Case Study Federations

Contractual Descriptors Contractual Types	Sub-national Access to Own-Source Revenue	Unconditional Revenue Sharing and Transfers	Conditional Transfers-Input Conditions	Conditional Transfers-Output Conditions	Conditional Transfers-Outcome Conditions
I Switzerland	Exclusive or near-exclusive cantonal access, large differences in tax rates across cantons	Mainly for equalization	Fairly common in order to achieve national objectives	Relatively small use, some performance output reporting requirements	Relatively small use, some goals-based requirements in reforms to equalization
II Germany	Sources belong to both levels of government,	For equalization, includes the collection of	Common in Germany, although "veto"	Not common	Not common

⁹⁶ Aspects of the contractual relationship between the federal government and the states in the US fit into both Type IV B and Type V.

Contractual Descriptors Contractual Types	Sub-national Access to Own-Source Revenue	Unconditional Revenue Sharing and Transfers	Conditional Transfers-Input Conditions	Conditional Transfers-Output Conditions	Conditional Transfers-Outcome Conditions
III Canada	common tax rates due to “equal living standards” principle Shared jointly between the federal government and the provinces	income and VAT taxes and horizontal equalization Mainly for Equalization	power of Länder can block such federal legislation Relatively small use, generally “relaxed”	Becoming more widespread, includes provincial reporting mechanisms	Becoming more widespread, includes provincial reporting mechanisms
IV (A) Australia	Commonwealth controls major sources of government revenue	Equalization through federally-levied GST, transferred to states based on “relativities” calculations	Common, fairly “relaxed”, mostly for health and education	Relatively small use, but some recent reporting requirements	Relatively small, some recent standardization of testing and evaluating programs
IV (B) USA	Shared jointly between the federal government and the states	Not usual	Most often used	Relatively small but becoming somewhat more common associated with small increase in use of “block” grants	Relatively small but becoming somewhat more common associated with small increase in use of “block” grants
V Unfunded Mandate Aspect of USA System	States can apply for waivers to be <i>exempt</i> from certain requirements based on levels of available own-source revenue	None.	Common with conditions in some cases very difficult	Less common.	Less common.

Policy Implications

- There is a generally observable trend in federal/national-sub-national contractual relations toward the increased use of output and outcome-based conditions on transfers. Broadly speaking, the greater use of these types of conditions is directly correlated to enhanced levels of sub-national *autonomy* within federations and helps to facilitate accountability. They are also potentially *efficiency* enhancing to the extent that they encourage sub-national experimentation and innovation in program implementation. However, “nation-building” *equity* goals

may be compromised by the differences in programs and outcomes among the different sub-national units associated with the increased use of these output/outcome conditions. Similarly, “nation-building” efficiency goals may also be adversely affected to the extent that sub-national program differences cause factor inputs to move from one sub-national unit to another as a result of differences in net fiscal benefits.

- This suggests that output/outcome-based conditions may be most appropriate in long-standing federations in which nationwide standards in areas such as health and social-welfare are already well-developed. Furthermore, because the effectiveness of output/outcome conditions rests on the principle of “public accountability” of government, they may also be most appropriate where sub-national governments rely on public approval and opinion (e.g., popular vote) to remain in power.
- Levels of sub-national *autonomy* also appear to be directly correlated to levels of sub-national influence over the levying, collection and distribution of important revenue (tax) bases and/or to the presence of contractual provisions within the constitution that make sub-national units of government more-or-less equal partners with the federal government. There are varying effects on *horizontal equity* depending on the intensity of tax competition that is allowed to persist between sub-national units, the degree of specificity of measures for determining horizontal equalization and a consideration of “capacity”, “needs” and or “capacity and needs” imbalances among sub-national levels of government in equalization transfers.

Possible Implications for Situation in Russia

It is not easy to tease out implications of the above analysis for the current situation in Russia and specifically for the President’s decision to replace elected governors with appointed governors. So what follows is more in the nature of speculation than firm conclusions.

First, there are benefits and costs to all systems of intergovernmental fiscal relations. Therefore, it is not possible to look to the foreign experiences cited here and find a schema that would, if adopted in the current Russian context, provide only benefits and no costs.

Second, schemas that are most decentralized from an “own source” revenue perspective facilitate policy and program experimentation and innovation and also offer advantages from the viewpoint of transparency and accountability. This can be achieved through constitutional provisions that assure sub-national governments of the right to levy taxes on important tax bases or through constitutional revenue sharing arrangements. The Russian Federation is highly centralized from a revenue perspective and, other things being equal, Russia would benefit from revenue decentralization as this would potentially lead to a better trade-off in benefits and costs in intergovernmental fiscal relations. But other things are **not** equal and our analysis suggests two reasons why a large decentralization of revenues might not be appropriate at this time.

- If there is additional revenue decentralization in the Russian Federation resulting in regional legislatures levying taxes that are spent through an administration headed by someone effectively appointed by the Russian president, then the autonomy and accountability, and perhaps even the innovation benefits normally associated with revenue decentralization seem likely to be lost.
- While revenue decentralization offers important benefits in most federations, they may also entail costs which can include potentially jeopardizing nation-wide vertical and horizontal equity goals and may also adversely influencing nation-wide efficiency goals. In federations that have fairly similar levels of development and fiscal capacity among sub-national units (such as the United States and Australia), the cost of revenue decentralization might not be large since the sub-national units would at least have the means to maintain roughly similar levels of social programs and taxation if they so chose. But in federations where there are large differences in development and fiscal capacity among sub-national units this theoretical concern can become very important in practice. The Russian Federation is such a case. The costs of revenue decentralization might therefore be large from the viewpoint of both the national economy and society thus possibly jeopardizing political stability in the Russian Federation.

Third, we understand that the revenue collection capabilities of the Subjects of the Federation are still not well-developed in some regions. Thus, to the extent that there is a desire to increase revenue decentralization (which would be a decision opposite to what we just concluded), revenue-sharing would seem the better choice than direct taxation by those sub-national units.

Fourth, assuming that a large vertical fiscal gap between the Federal Government and the Subjects of the Federation will remain for a long time, there will necessarily be a system of intergovernmental fiscal transfers from the Federal Government to the governments of the Subjects of the Federation. An important question that arises in this kind of context is whether the transfers should be unconditional or conditional and, if conditional, what kinds of conditions would be most useful. The benefit of unconditional transfers or unconditional revenue sharing is that it encourages sub-national autonomy and accountability in the sense that the Subjects of the Federation can be seen to be responsible for the productive use of the transfers or revenues. They are not encumbered by requirements from the Federal Government and thus can potentially also be innovative. The disadvantage is that the transfers may be used for widely disparate purposes thus detracting from nation-wide equity and efficiency goals. However, if the head of the regional government is appointed by the federal President, then to the extent that it the regional head carries out the wishes of the President, the differences in advantages and disadvantages between formally unconditional and formally conditional transfers becomes much less important because, in this case, the regional head can probably be presumed to be setting priorities that are established in the presidential administration.

Finally, if, despite the above point, it is decided that transfers must be conditional, or at least partly conditional, the further question is whether the conditions should be input, output, or outcome based. The above discussion has suggested that there may be a small trend in western federations toward output or outcome-based transfers with a view to respecting autonomy in sub-national units, encouraging transparency and accountability, and fostering innovation. To be effective, however, these kinds of conditions depend on the publication of information on the results of pro-

grams for which the transferred funds have been used (e.g., the implementation of reporting mechanisms). And in order for that information to serve as a spur for sub-national units to strive for improvements, those sub-national units must be concerned about the effects of that information (program results) on public opinion. The appointed governors in the regions may be less concerned about public opinion, however, than would be the case if they were elected. Other things being equal, therefore, the move from elected to appointed governors has probably weakened the case for output or outcome-based conditions and strengthened the case for input conditions.

2.2. Assessing the Executive Functions of Regional Governments in Multilevel Governance Systems: Review of International Experiences

Over the last 20 years many scholars have noted that the global economy is influencing the politics of inter-governmental relations. This literature underscores such key elements as the global economy, new technologies, free trade, neo-liberal views that transform the relations of central governments with other levels of government, and market forces. Scholars suggest that governing is much more complex because what is at stake is the articulation of individual-local-regional choices in the global marketplace. Unitary and federal states adapt and mediate these changes with varying difficulties but one general conclusion by Saskia Sassen is that the new legal regimes underlying these reforms “denationalize territories” and impact each states’ “distributive justice and equity”. In the same vein, there is a literature in public management that points to the influence of New Public Management (NPM) ideas on these recent reforms. Scholars point to the fundamental difference between traditional and NPM reforms. There is no debate on the neo-liberal origins of NPM: first, that public-sector organizations need rationalizing and should be re-sized smaller by privatization and public-private partnerships; second, that public service activities should be monitored and performance should be measured and managed, and elected officials should refrain from interfering in daily affairs and focus instead on accountable outputs.

Recent comparative assessments of these major regional governance reforms find the following trends across Western states. First, states have decentralized functions from the centre to local/regional governments. Second, states have enhanced the power of elected regional institutions, increasing the democratic accountability of local/regional governments and increasing participation and the rights of local citizens. Third, NPM ideas have progressed and government performance is increasingly measured. Fourth, market liberalization in the European Union and in North America has increased competition among local governments.

The following essay is a discussion of these themes. The argument is made that as states struggle in an increasingly competitive global marketplace, they must change the executive function of their regional governments. Central to this argument is that states must attempt to structure – or restructure – their regional governance systems to articulate the social construction of each of their regional territories into the global economy. This multiplies the number of tier-level of government and scales of intervention. Also, it has a tremendous influence on the implementation of regional executive systems, which, and are composed more often than ever of elected officials and tightly accountable to their local and regional electorates and markets. These regional executives are typically under increasing democratic and managerial pressure. Central government officials monitor their performance using policy measurement systems and then make the publication of their results an exercise in democratic accountability. These regional executives are also increasingly responsible for a larger number of functions in a complex policy environment, where a multiplicity of funding agency and policy actors are involved.

Part 1 of this essay is a review of the literature that focuses on what is at stake and why the form and function of regional executives matter. Part 2 develops a frame of analysis of regional executive systems that focuses on the form, the size, the efficiency, and the democratic principles of government and applies them to the general model of regional executive systems. In parts 3, 4 and 5, the focus is on the archetype of the centralized system of government – France; both sections review the historical evolution of the nature, range, political dimension, and mediating role of regional executives. Part 6 is on the fiscal position of regional executives.

And finally, the conclusion is an assessment of the current trends affecting regional executives in comparative perspective.

2.2.1. Territory and Institutions: What is at Stake and Why Do the Form and Function of Regional Executives Matter? A Review of the Theoretical/Conceptual Literature on the Executive Functions of Regional Government

As many scholars have noted, the global economy modifies the politics of state relations in the intergovernmental arena⁹⁷. New technologies of information and communications also change the global economy and affect states: free trade integrates the economies of Europe and North America and free-trade regimes pressure governments to ease regulations and open new markets⁹⁸, while seemingly enhancing sub-national entities as economic players⁹⁹. The North American Free Trade Agreement (NAFTA) regime promotes free trade and, some argue, enhances sub-national entities as independent economic players¹⁰⁰. The global economy, new technologies, and free trade transform the relations of states and other government tiers with market forces and make governing much more complex.

In addition, for the last 20 years, scholars have increasingly questioned the relationship between market forces and territories. The traditional views that focused on territorial competitive advantage and infra-

⁹⁷ See, for instance: Ivo Duchacek, *Perforated Sovereignties and International Relations: Trans Sovereign Contacts of Subnational Governments* (Greenwood Press, 1988); Earl Fry, *States and Provinces in the International Economy* (1998); Thomas Courchene, *From Heartland to North American Regions State* (University of Toronto Press, 1999); Richard Balme, *Les Politiques du NeoRegionalism* (Paris: Economica, 1998); Michael Keating, *The New Regionalism in Western Europe: Territorial Restructuring and Political Change* (Edward Elgard Publishing, 1998); and Robert Young, *Stretching the Federalism* (Institute of Intergovernmental Relations, Queens University, Kingston, ON, 1999).

⁹⁸ Robert Keohane and Helen Milner, *Internationalization and Domestic Politics* (Cambridge, 1996).

⁹⁹ Kenishi Ohmae, *The Borderless World* (Harpers Business Books, 1991).

¹⁰⁰ Thomas Courchene, *From Heartland to North American Region State: The Social, Fiscal and Federal Evolution of Ontario* (University of Toronto Press, 1998). Thesis work on competitive advantage...citation.

structures have progressively given way to new ideas that point to the social construction of a territorial economy. For instance, the European debates on the nature of different capitalisms¹⁰¹ and on the rediscovery of regional economies (the “Italian industrial districts”) both suggest that modes of production are culturally embedded and take different forms in different times and places¹⁰². This also suggests that it is the articulation (institutionalization) of culture and individual choices that make a difference in the global marketplace. Thus institutional arrangements, in particular, become critical to the capacity of every local community to compete in the market economy.

Yet a considerable body of literature also suggests that local/regional governments should do nothing about the economy. The central argument promoted by scholars holding this view is that they cannot influence market forces; all they can do is be as competitive as possible in a highly constraining economic environment. Peterson’s public-choice approach makes a strong case by identifying the influence of market-economy mechanisms on the offer of public goods¹⁰³. He suggests that fragmented, overlapping, and competing jurisdictions may permit more efficient provision of services. Based on the assumption that the provision of competitive services is in the interest of consumer-voters, he proposes that lowering taxes is the ultimate economic development policy.

Other scholars, however, hold a different view, pointing to the influence of political entrepreneurship that links economic performance and democratic choice¹⁰⁴. Clarke and Gaile, for instance, in *The Work of Cit-*

¹⁰¹ Michel Albert, *Capitalisme Contre Capitalisme* (Seuil: Paris, 1991).

¹⁰² The works of Piore, Sable or Porter are central to those views: Michael Piore and Charles Sable, *The Second Industrial Divide: Possibilities for Prosperity* (Basic Books: New York, 1984); Michael Porter, *The Competitive Advantage of Nations* (MacMillan: London, 1990).

¹⁰³ On the limited capacity of cities: Peterson, Paul, *City Limits* (University of Chicago Press, 1981), particularly Chapter 7; Michael Peter Smith, *City, State and Market* (1988); Schneider, M., *The Competitive City* (University of Pittsburgh Press, 1989); King, D., *Fiscal Tiers, The Economics of Multi-Level Government* (London: Allen and Unwin, 1984).

¹⁰⁴ On economic development intervention: Logan, J. and Molotch, H., 1987, “Urban Fortunes” (University of California Press); Stone, C. (1989) *Regime Politics* (Kansas

ies, challenge public-choice approaches by arguing that the articulation and alignment of local groups with local economic issues is central to regional economic development successes. Their research shows that since the 1970s urban regions have shifted economic development policies away from locational strategies toward providing strategies that facilitate a climate of growth. Governments have withdrawn from specific policy sustaining sectors or even specific firms in order to provide strategies that facilitate economic performance.

This shift has created local/regional institutions/infrastructures that bridge market needs with local democratic values and priorities. These are multi-scalar institutional and intergovernmental arrangements. They articulate the government of different activities on a multiplicity of geographic and functional scales. This explains why this paper discusses the executive functions of regions along with the discussions regarding other local governments i.e. French Departements, counties, provinces and municipalities, and other local government institutions and districts.

This shift in the approach to the question of economic development and performance reflects the legal, economic, and social features of each community/constituency and of their perception of the global world. Each community/constituency may choose “contextually specific paths in responding to globalization”¹⁰⁵, which means that focusing on performance and innovation results in policies that are different from programs serving other interests and values. What remains essential for our purpose is that

University Press); Stone and Sanders in *The Study of Politics of Urban Development* (1987); Stone, C., *Regime Politics – Governing Atlanta* (Lawrence: University of Kansas Press, 1989); Reese, Laura, and Rosenfeld, Raymond, *The Civic Culture of Local Economic Development* (Sage Publications, 2001) and Reese, Laura, *Local Economic Development Policy: The United States and Canada* (Garland Reference Library of Social Science, Vol. 1109 (1997)); Sbragia, Alberta, *The Debt Wish* (University of Pittsburgh Press, 1996); Clarke and Gaile, *The Works of Cities* (University of Minnesota Press, 1998). On the redistributive role of local government, see: Michael Keating, *Comparative Urban Politics* (Edward Elgar, 1991), particularly Chapter 6; Ladd and Yinger, *America’s Ailing Cities* (John Hopkins University Press, 1989); Maioni, Antonia, *Decentralization in Health Policy: Comments on the Access Proposals*, in Young, Robert, *Stretching the Federation*, Queens University Press: Kingston.

¹⁰⁵ Susan Clarke and Garry Gaile (1998), *The Works of Cities* (University of Minnesota Press).

those policy initiatives link localities to global markets and to critical investment in human capital and new information technologies.

Clarke and Gail conclude that unsuccessful strategies result from community fractures. They insist that it is the articulation and alignment of local groups with local and global economic issues that are central to regional economic development successes. Their work demonstrates that successes do not depend on private or public strategies, but rather are grounded in community-based consultation and decision-making processes. They also maintain that it is the creation of institutional processes of policy decision-making that are fundamental to economic development policy successes and regional economic performance.

In the end, this literature clearly underlines the importance of governance changes and points to the fundamental role of social capital in matters of regional economic performance and particularly to mechanisms that bridge local to global interests. In Russia, a reform that affects the interplay of market and local-state relations has to consider these elements because the literature on economic development underlines the importance and strategic strength of local/regional decisions.

The literature notes that federal and unitary states adapt and mediate these international market and governance changes with varying difficulties¹⁰⁶. Focusing on the impact that globalization has on states, Saskia Sassen explains that new legal regimes “un-bundle sovereignties” and “denationalise territories”¹⁰⁷. a process that also reconfigures the links between rights and territories and thus has “disturbing repercussions for distributive justice and equity”¹⁰⁸. Keating, focusing on multi-nation states in Europe, finds that along with constitutional reforms, an asymmetry of rights develops that further differentiates local and regional constituencies in a process where federal and centralized states seem to pro-

¹⁰⁶See Robert Young, *Stretching the Federation* (Queen’s McGill University Press, 1999); Saskia Sassen, *Losing Control* (Columbia University Press, 1996); Trevor Salmon and Michael Keating, *The Dynamics of Decentralization* (School of Public Policy, Queen’s University Press, 1999).

¹⁰⁷ Saskia Sassen, *Losing Control* (Columbia University Press, 1996), 28.

¹⁰⁸ Saskia Sassen, *Losing Control* (Columbia University Press, 1996), 29–30.

gressively resemble each other¹⁰⁹. When looking at economic development policies in the Spanish regions of Catalonia and Galicia, he finds it is not culture or leadership that is key there; instead, different forms of institution building are central to understanding variances in development and policies.

This literature suggests that constitutional reforms of decentralization and devolution have implications for institutional structures and allocation of functions, particularly for the governing capacity of lower-government tiers. Central governments are also less able to regulate, to organize fiscal equalization, and to reduce inter-regional or provincial competition. In some instances, central governments actually encourage intergovernmental competition at lower-government levels. Free trade and increasing market competition become central features of government relations as capital mobility increases, and higher-government levels shelter lower levels less as intergovernmental competition is also on the rise. These changes in territorial and constituency politics are best described as tendencies toward greater legal, institutional, and functional complexity and an asymmetry of rights, while institutional capacity, as well as functional allocation, increasingly characterizes disparate and decentralized politics¹¹⁰.

These issues of government size, form, and function are tightly woven with issues of efficiency and democracy, all of which exert tremendous weight on the form of regional executives. These issues and their contemporary reforms, however, are not unique to Russia nor do they signal a new trend. Throughout Europe and North America, for instance, in Germany, the Netherlands, the United Kingdom, or even France, central

¹⁰⁹Michael Keating, *Asymmetrical Government: Multinational States in an Integrating Europe*, *Publius* 29 (1) (Winter 1999): 71–86; *Les nationalités minoritaires d'Espagne face à l'Europe* *Etudes Internationales* 30 (4) (1999): 729–743. Trevor Salmon and Michael Keating, *The Dynamics of Decentralization – Canadian Federalism and British Devolution* (School of Policy Studies, Queens University, Kingston, ON, 1999).

¹¹⁰This is Michael Keating's argument in Michael Keating, *Challenges to Federalism, Territory, Function and Power in a Globalizing World* (pp. 8–27), in Robert Young, *Stretching the Federation: The Art of the State in Canada* (Institute of Intergovernmental Relations, Queens University Press, 1999). An argument is also found in Salmon and Keating, *The Dynamics of Decentralization* (1999).

governments have either reformed or attempted to reform the executive function of their regional governments, while in the United States and Canada, central governments have followed suit by increasing or decreasing the size and changing the form, efficiency, and democratic accountability of the executive of their regional governments¹¹¹.

2.2.2. Territory and Institutions – How to Evaluate a Regional Executive System – Form, Size, Efficiency, and Democracy: A Review of Appointed, Elected, and Mixed Regional Executive Systems

The form and size of regional institutions and the policy choices enhancing values of efficiency and/or democracy in a territory may be informed by local culture and history. However, form, size, efficiency, and democracy are values that may also be informed by trends; for instance, as urban regions expanded at the turn of the last century, amalgamation or annexation was viewed as the best method to expand services, and today such reforms are at the core of a complex debate¹¹². Similarly, in the past, economies of scales justified the expansion of large multifunctional governments, whereas, today, both large governments and their multifunctional responsibilities are in question.

Whenever the reform of a regional government is in question, the issues are always about form, size, efficiency, and democracy. These four analytical criteria are actually reflected in the institutional form, that is, the institutional arrangement of each regional executive. The fundamental question is which principles are primarily accommodated by the regional

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In

Belgium:

http://www.cor.eu.int/resolutions/down/studies/decentralisation/bel/Belgique_EN.pdf;

in Germany: [http://www.cor.eu.int/resolutions/down/studies/de/allemanie_en.pdf](http://www.cor.eu.int/resolutions/down/studies/decentralisation/de/allemanie_en.pdf);

in the Netherlands: http://www.cor.eu.int/resolutions/down/studies/decentralisation/de/allemanie_en.pdf;

and in France: http://www.cor.eu.int/resolutions/down/studies/decentralisation/fr/france_en.pdf.

In all four countries executive powers have been devolved progressively to local governments. In some instances, this devolution of executive powers includes some legislative authority or mandatory consultation in legislative matters, as well.

¹¹² See, for instance, the first three chapters of Andrew Sancton, *Merger Mania* (Queen's-McGill University Press, 2001).

executive institutional arrangement: Is it democracy and representation? Is it efficiency and central government priorities? Is it managing large expanses of territory? Or, finally, is it managing one function or a multiplicity of functions? These questions are addressed next.

Although there are basically two categories of regional executive systems – those that are elected and those that are appointed – there are exceptions to both systems. The first exception occurs when the system’s primarily efficient principles are challenged or adapted to allow for some democratic input from appointed or elected chambers. In the second exception, the system’s democratic principles are either challenged or “bent” by the existence of strong central-state appointees who control and verify regional decisions. All systems basically address the issues of efficiency or democracy and attempt to mediate history and cultural trends according to the variants of the system. The issues of size and form did not become prominent until the 1900s, when large urban regions emerged due to migration from country to city at the time of the Industrial Revolution. Historically, most systems have struggled with the two issues of democracy and efficiency. The issue of form and size were dealt with by decisions that addressed concerns about local regional traditions and transportation; a government had to be able to reach its constituents before it could either control or even influence them.

Form and Size of Regional Government – Multi Tiered and Scalar Governments

During the 1960s and 1970s – a period of vast expansion – there was a trend towards the consolidation of local governments or to upper-tier reform. The basic assumption at that time was that consolidation of local government institutions into metropolitan and/or upper-tier governments would lead to economies of scale and, thus, more efficient governments. It was assumed that efficiency required larger units for the delivery of services and that economies of scale would bring costs down and allow services to be extended from urban to rural areas alike, hence, providing constituencies with equitable access to services. At the time, regional executives were necessarily technocratic in nature, as they designed and implemented those regional reforms across each state, while central-state

officials and specialists of each policy arena implemented national policies on behalf of the central government.

Another argument in favour of consolidation assumed that larger units would provide a wider tax base for services. This expanded tax base would, in turn, distribute the tax burden more equally and reduce the complexity of relations with higher-level governments, that is, the systems of redistribution and equalization across territories, through grants. It can also be argued that, at the time of the expansion of the neo-Keynesian model, senior governments encouraged regional governments to spend more to complete the development of the welfare state; for instance, planners suggested that cities and their rural hinterlands should be planned together.

Hence, planners in the United Kingdom or Canada and ministry of transportation officials in France, for instance, conceived of large and coherent regional units that would encompass most of the economic and social activities – the living, work, recreation, and shopping patterns – of the population of those regions. Infrastructures would be needed for these larger areas, and plans had to coordinate current and future development of services, including schools in relation to housing, housing in relation to the workplace, and the workplace in relation to shopping. Concomitant with this theoretical push for expanding the range of services that was required and expected of local governments was the sense that local governments should expand their bureaucracies, as needed, to fulfill obligations imposed upon them by central governments. During these periods of massive changes, regional executive functions expanded along with their staff. In most cases, new forms of regional government emerged and central governments delegated the key managerial responsibilities of these regional governments to field state officials. In effect, this was a period when regional executives were responsible for managing policy deliveries over much larger territorial spans. The institutional arrangements were either one or two tiers, and regional executives were appointed with the responsibility to consult with local communities.

Trends in the United Kingdom, Germany, France, and the United States exemplified these transformations of local-government forms. In the United Kingdom, the central government imposed extensive consoli-

dation on its municipalities, shrinking their number to 500 from about 1,500. Similarly, Germany reduced its municipalities from 24,000 to 8,500. France was less successful because its municipalities are the power bases of nationally elected officials who also hold parliamentary and senatorial mandates. These officials have always opposed such legislative changes because these changes would sever their ties with their local fiefs and limit their electoral roots. But it is at this time, in 1972, that French engineers conceived of and implemented the “region” as a new territorial unit that grouped Departements (counties) and municipalities for consultation on most economic and social policies. In the United States, local parochialism and concurrent local political rivalries and racial politics also reduced the success of local and regional government reforms.

In the 1980s, these trends aimed at expanding the reach of central government were reversed. A number of structural and ideological transformations that occurred during this period shed new light on the arguments against these early consolidations. First, there was a growing disenchantment, among academics as well as public officials, with the economies-of-scale argument; instead, arguments that upheld the efficiency of smaller units gained ascendancy. Second, the economic crises of the 1970s taught that planning in an unpredictable world was difficult, if not impossible. Third, public-choice scholars, reflecting neo-liberal ideologies, asserted that competing local governments better served democracy, efficiency, and consumer choice. Finally, problems had arisen out of the design of upper-tier governments, in particular, with their modes of election and their powers. Higher-level governments feared directly elected upper-tier governments might become too powerful, to the point where they would become assemblies of municipalities fighting for their own interests rather than for the good of a region, a province, or a state.

A prime example of these trends was then British Prime Minister Margaret Thatcher’s decision to abolish metropolitan councils, including the Greater London Council. Other similar examples were the dismantling of the regional governments in Spain (Barcelona) and the Netherlands (Raandstaat). These changes were all symptomatic of key ideological shifts in which the emphasis was not on service delivery or economies

of scale but rather on economic development and planning in the global economy. During the 1990s, these reforms and counter reforms continued as central governments tried to enhance regional service-delivery efficiencies, download responsibilities, and increase the democratic accountability of regional and local governments. These trends continue today but the issues of fragmentation and amalgamation affect the debate on the size of government and therefore are informed by views on the importance of local democracy.

In the end, questions regarding the appropriate scale of government interventions dominate these debates. A central question in the debate on size is: Is a small or large municipality more, or less, efficient? Size is important with regard to governing capacity. Because smaller local governments may not have the financial capacity of larger ones, they may suffer from their inability to embrace large projects. However, although it is very difficult, local governments can co-operate in order to get better market interest rates. Equity is also important, and local communities may choose to be equitable or not. Clearly, tax systems and mechanisms of redistribution may be a local choice or, alternatively, higher-level governments may impose them.

Size and equity may also be mutually reinforcing. Large municipalities are praised for their ability to provide equal access to local services, as are smaller municipalities. Large municipalities, however, have the ability to expand their services to larger regional communities and provide equal service access to a larger population. Development is also very important because the income of local government depends on local economic wealth. Should local governments invest in economic development policies? Or is this the responsibility of higher levels of government?

To sum up the debates on the form and size of local government and related issues regarding the regional-executive function, it is clear that since the 1950s central governments have struggled with the form and size of their local/regional governments. In the 1950s, they expanded the reach of the centre through large and skilled bureaucracies that managed their functional and multi-scalar policy objectives attempting to articulate local, municipal, with county and regional programs and dealing with increased government scope and increased government services; The

multiplication of local levels of governments in Canada (up to seven in Ontario in the 1990s), in France (five), but also in Italy, Spain, or the U.K. are as many examples of these multi-scalar transformations. Then, in the 1980s and 1990s, a number of central governments attempted to reverse these changes and were more or less successful, depending on the specific aspects of each community. One central aspect was the growing influence of local democracy and citizen participation in local and regional decisions. In France and in the United States, these changes were mostly unsuccessful because of the importance of local and regional politics. Thus, although the size (the territorial scope) and the form (centralized, decentralized, or multilevel) of government may be informed by local culture and history, currently these debates are very much informed by issues of efficiency and democracy. The following section addresses these issues in turn.

Why the Efficiency and Democratic Debates Regarding Regional Government Matter

The efficiency of service delivery is another concern of higher-level governments, and in most countries this concern entails finding the appropriate tier level of government for each governmental function. Defendants of the economies-of-scale argument inform such choice. The public-choice view that market regulation (competition between local or regional governments) keeps service costs competitive is also influential. In other words, the size and form of governments are critical to efficiency, which becomes clear when one looks at what the constitutional prerogatives of governments of countries such as Belgium, France, Canada, or the United Kingdom enable them to do. Belgium and Canada have been able to enforce or limit consolidations upon local municipalities. Municipalities in the United States and France have not been subject to this, however, because of a strong tradition of local democracy that protects them against state initiatives. In the United States, only indebted municipalities have had to amalgamate. In most cases, local pro-fusion referendums are the necessary condition for consolidation; the pro-consolidation argument is that efficient local institutional structures will result in efficient growth. Nonetheless, it should be noted that cities might not develop as a result of their institutional framework – the market regu-

lations of the local economy may be distinct from its economic successes. Local economic policies, however, are multi-dimensional, rarely relying exclusively on market forces or institutional frameworks. Hence, most institutional arrangements of urban regions lie in between these two opposite views.

In Europe and North America in the 1950s, regional-metropolitan governance policy-making seemed to be extremely complex due to the high degree of fragmentation in the largest urban regions; for example, the Paris (France) region encompassed 11 million inhabitants and the Toronto (Canada) region had six million¹¹³. As urban development led to greater demands on service provision and planning, the complexity of urban regional governance increased. Structural reforms attempting to catch up with economic growth suggested new amalgamation or the creation of multi-tiered systems of local government to maintain political accountability. The issue of efficiency has remained at the forefront of current government reforms. Today, provincial governments in Canada suggest that service delivery at the local level can be more efficient, and the economic literature agrees that inter-urban, market-like competition leads to efficiencies. However, the literature favouring consolidation maintains that economies of scale are found in the provision of large-scale services. One argument is that the market regulates cost-efficient services to the best level; another is that economies of scale are possible in larger local governments. In the same vein, some scholars make the case that the scale of service delivery only impacts specific types of services, those that clearly benefit from large-scale distribution¹¹⁴.

A public management literature points to the influence of New Public Management (NPM) ideas on these recent reforms. Scholars have noted

¹¹³ Donald Rothblatt & Andrew Sanction (1999), *Metropolitan Governance* (Institute of Governmental Studies, UC Berkeley Press).

¹¹⁴ See LGI reports: R6, *The efficiency of residential recycling services in Canadian local governments: National survey report*, by Dr. James C. McDavid & Verna Laliberté (School of Public Administration, University of Victoria, June 1999); and R5, *Local government service production in the capital region*, by Robert L. Bish, Professor Emeritus (School of Public Administration, University of Victoria, April 1999). Available at: <http://web.uvic.ca/padm/cpss/lgi>.

the fundamental difference between traditional reforms that were generated in the 1960s and 1970s in Western countries and the current neo-liberal views on NPM. The traditional reforms basically led to the strengthening of the political and administrative institutions of the advanced neo-Keynesian welfare state, the primary function of which was to constrain free trade and related market failures and to increase the economic and social cohesion of Western welfare states. Because of the political orientation of these traditional reforms, redistribution policies focused first and foremost on the strengthening of institutional policies that furthered the redistribution goals of the welfare state. In contrast, NPM supporters contend that state bureaucracies are inefficient and need to be leaner, that public policies may be measured, and that the management of performance is central to good administration. David Osborne and Ted Gaebler's 1992 book *Reinventing Government* is considered the starting point of this revolution. NPM relies on the theory of the marketplace and on implementing a business-like culture in public organizations.

It is clear that the last 25 years have been witness to a growing interest in performance measurement. This trend has its roots in the NPM literature, which argues for improved modes of evaluation on how governments function¹¹⁵. In the late 1980s, this literature was prominent, particularly in the United Kingdom and the United States. In both countries, professional organizations such as the Government Finance Officers Association or the Government Accounting Standards Board encouraged governments to use performance measures to increase financial accountability and accounting rigour in measures of inputs and outputs and outcomes of public-service production processes.

Originally, a performance measurement system was conceived of as a managerial tool and implemented for the management of public services.

¹¹⁵ Bouckaert, G. and B. Guy Peters (2002), "Performance Measurement and Management: The Achilles' Heel in Administrative Modernization". *Public Performance & Management Review*. (London: Sage Publications), 359–362. See also, Peters, Guy and Donald Savoie (1996), "Managing Incoherence: The Coordination, Empowerment Conundrum". *Public Administration Review*, 56(2), 281–90; and Peters, Guy and Donald Savoie. (1994). "Civil Service Reform, Misdiagnosing the Patient", *Public Administration Review*, 54(5), 418–25.

The literature agrees that performance measurement is not value laden and views performance measurement as measurement systems that can be applied across cultures, organizations, and institutions in the public sector. In most instances, it is assumed that political leadership, in concert with managerial staff, initiates the implementation of performance measurement.

Despite the assumption that performance measures are value free and very technical, most governments attach them to their budgetary and accounting processes. Hence, performance measurements develop into “performance-based budgeting systems”, an improvement from “line item budgeting systems” because performance measurement focuses on “outcome based government management”. Performance measurement is also associated with personnel performance information systems, also called “Management by Objectives”. These tools are strongest when used with control and audit functions, but weaker when strategic management concerns are raised because their input-based measurement systems look primarily for efficiencies, not for measures of effectiveness.

NPM places the emphasis on the citizen as customer (consumerist participation). The values associated with this assumption are not necessarily congruent with the values of democracy and citizenship¹¹⁶ in that the customer emphasis may obscure that which the citizen might actively contribute to the community. The customer is a passive recipient rather than an active partner, and NPM encourages citizens to be passive by giving citizens the power of exit, while discouraging the “original power of voice”¹¹⁷. Eran Vigoda argues “the term client or customer, which is so applicable in the private sector, contradicts the very basic notion of belonging, altruism, contribution to society, and self-derived participation in citizenry actions”¹¹⁸.

Given the increasing interest in citizen engagement and the potential for new partnerships, the primary responsibility of citizens is to become actively engaged in running their lives and communities. This can be

¹¹⁶ Sharpe, 1990.

¹¹⁷ Vigoda, 2002, p. 533.

¹¹⁸ Vigola, 2002, p. 534.

accomplished at the individual, group, or institutional level¹¹⁹. For the administration, the implications of this shift mean that skills in communication, team building, meeting facilitation, and listening are of critical importance. In addition, the administrator must come to value experience as well as expert knowledge¹²⁰. Some of these shifts speak to a cultural shift within an organization, and the degree to which this paradigm is new will impact the degree to which the administration will need to adapt.

As higher levels of government increasingly seek to regulate and standardize practices across municipalities, they are complying with accounting principles and a government philosophy of business accountability. However, as citizens increasingly demand participation and are critical when they are not given sufficient opportunity, local governments are being forced to respond to a different definition of accountability. What emerges from this literature is that over the last 25 years central governments have developed new tools to measure and manage their programs and have been successful at implementing them across departments and government levels. The current critiques actually address the level of involvement and participation of citizens and elected officials, which is the topic of the next section on democracy and participation.

As discussed above, the debate on the efficiency of government has been analyzed as a tension between efficiency and democracy. Yet, in an attempt to sum up the debate, Keating has argued that technocratic views of the functions of regional/local governments tend to neglect the debate on the issue of “community” and that this has given rise to many definitions of community. For example, Deutch’s *Gemeinschaft* is about solidarity and attachment to place¹²¹; Tiebout’s definition is about protecting private space and, hence, inclusion and exclusion¹²²; and Malibeu’s holds that regions emerge out of a cultural and historical

¹¹⁹ King et al, 1998.

¹²⁰ King et al, 1998.

¹²¹ Deutch on Political Communities.

¹²² C. Tiebout (1956), A Pure Theory of Local Expenditures, *Journal of Political Economy*, 64(4), 416–424.

construct of social interactions and politics, which derives its legitimacy from the recognition that politics sets territorial boundaries¹²³.

Clearly, neither the NPM nor the public choice views of individual utility maximization nor the functionalist-technocratic perspective can protect this liberal democratic equation. In other words, local/regional government institutions not only set the space for individual choices about services and taxes, as defended by the public choice approach, but also involve taking collective decisions, an important aspect of the role of politics in liberal democracies. Hence, the debate over whether larger or smaller governments are more democratic. Democracy, as it is presented in the literature, may vary with local government size and form, specifically, according to the size of electoral constituencies and tier levels of government. Democracy also depends on the electoral mechanisms that organize a direct or indirect representation of the electorate. In the end, the debate on democracy is not conclusive because higher governments may decide to increase or decrease the number of local constituencies, their size, and the number of elected officials per constituency.

To sum up these discussions on efficiency and democracy, central governments may be struggling with priorities that are affected by the size and form of local governments and may be enhancing efficiency and democratic principles, which result in very different types of regional executives. Traditional efficient systems privilege executive officials who are trained and appointed at the center and then sent to manage peripheral regional and local governments. Clearly, such systems are still very much in use but, with the NPM literature, new systems of control have emerged to ensure efficient government even when it is elected. Central governments have led regional executives into a democratic and policy bind. First, they are more likely to be elected and accountable to their constituency; second, central governments legislate that regional executives must measure and manage their performance and make these measures public yearly. Also, central governments have modified the form and size of their regional government system often leading to the

¹²³ A. Malibeu (1989), *Political Participation in Britain and France*, Cambridge University Press.

emergence of multi-tiered system of local governments addressing multi-scalar issues with multiple functions and scales of interventions so as to enhance both the efficiency and democratic principles of their model regional executives. The overall general trends are not only to diversify the forms and vary the size, depending on function, and enhance the democratic accountability of local and regional multifunctional governments but also to increase their efficiency by implementing performance measurement systems.

Two Basic Categories of Regional Governments: A Brief History of the French Departements and Regions and their Executive, the Prefect

The Departements and prefect systems of local/regional government in France are good examples of the two basic categories (and exceptions) of regional governments and the structure of their regional executive function. They have influenced most southern European systems of governments and are considered to be archetypes of such systems of regional government.

In the late 1700s, France implemented a new government tier, the Departements, and instituted the prefect as its executive branch, primarily for military and security concerns. At the time, issues of control and security were at their height because France was at war with the rest of Europe. Napoleon Bonaparte divided the country into 100 Departements and designed and implemented its first “prefect” system on 17 February 1800.

A Departements is generally the size of a British, Canadian, or American county; any corner of the territory of a Departements was to be accessible by less than a day’s horse ride. Each Departements was under the authority of a prefect, who was also called a “Napoleon with small feet” to express his overwhelming power; in effect, each prefect represented the Emperor in that constituency. Prefects were appointed by Napoleon I in person, on the basis on merit and skills. They quickly emerged as one of the first French “Grand Corps,” a group of public servants with the same training background. Originally, prefects were trained lawyers but soon were emerging from the ranks of the army and from the new engineering schools of “mines” and “roads and bridges” that Bonaparte created.

The initial function of the prefects was to ensure the political and military stability of the empire. One of their first tasks was to organize systematic drafts of young men for the Napoleonic wars. Security and the control of opposition movements were central. Prefects were deemed faithful to the Emperor and, thus, from 1800 until 1871 did not have to consult with any appointed chamber in their constituency. In 1871, however, Napoleon III decided to strengthen the role of consultation, and each prefect's constituency now was to have a chamber of appointed representatives chosen from civil society; the prefect remained the executive head of the administration of the Département. For nearly a century after, the development of the welfare state resulted in the expansion of the scope and range of policy responsibilities of prefects. By the time of the First World War, prefects officially represented all government departments and implemented all policies in their constituency, except in the areas of education, justice, and finance. During that extended historical period, prefects and their staff had full control over all the Département's activities and were able to control all the decisions, legal or technical, taken by municipally elected officials, a mechanism called *tutelle*, or tutelage (literally, the tutelage of all the activities of locally and regionally elected officials).

The first reforms to this system did not take place until 1974, when French officials believed that the centre and the periphery were at odds and that the prefects were unable to implement centrally designed policies without the approval of local communities. The first reforms declared that each Département needed an elected president. The executive function of the Département was to be shared between the prefect and the newly elected president. Second, the region became the third level of representation – the regional scale typically grouped four or five Départements. Central government also set a regional-prefect function to coordinate the activities of all prefects in charge of Départements. Hence, the creation of a new tier-level of government addressing issues at the regional scale. These reforms were followed by a period of intense adjustment, which included strict application of the tutelage rule on the recommendations and decisions of elected chambers and on the public behaviour of locally and regionally elected officials.

In 1986, a further major reform gave Departemental and regionally elected officials full executive powers over their own bureaucracies and policy arenas. The roles of prefects and their centrally appointed staffs were reduced to representing the view of the central government and protecting the general interest. To this end, they kept some power of control – their *tutelage* power was limited to highly technical issues involving the expertise of state engineers. This power of tutelage disappeared in 2003.

What is interesting about this example is that the issues that dominated the original French debate regarding regional executives are those of efficiency and democracy. Size and form only appear in the late 1970s. Originally, Departements and their executives were primarily efficiency driven, modelled as they were on a military organization, their priority to ensure the effective security of the Empire and the efficient draft of young soldiers for the Napoleonic wars. The issue of democratic accountability only became relevant during the period of the construction of the welfare state between 1870 and 1950. This was a long period of great wealth and unprecedented expansion of central-state functions from security to planning, to economic development to education, and since the 1930s to health and social services.

By the mid 1960s, however, the issues of size and form had become more important because the central government was having difficulty implementing its centrally designed policies, particularly in the areas of economic development and planning. The territorial size of the Departements was too small to address issues of greater scale, including certain infrastructure or economic development programs. The French government of the time decided to create the regions, whose scale/size was deemed large enough to address policy concerns regarding the scale of those new programs. Originally, regions were a representative body responsible to the prefect for consultation and opinion. Their form, however, progressively emerged as a directly elected body responsible for few specific functions. In 1986, they became a fourth-tier level of government, which now includes the municipality, the Departement, the region, and the central government. This is critical because it clearly underscore the contemporary importance of multi-scalar governments, which is

institutional articulation of local social construction into the global economy. Clearly states intergovernmental institutions organize the division of labor of multiple scales and functions.

The next three sections of this paper review in greater detail the transformation of French territorial politics and underline the transformation of the regional executive functions over time. First, the nature and range of functions are discussed, along with their implications for the regional executive function. Second, the political dimension and role of mediation of the regional executives are reviewed. The third part is a review of their fiscal position. In each case, the size and form and the primary value system of democracy or efficiency are discussed. In some instances, the review includes examples from regional systems that have emerged from the French system, as well as from the Italian and Spanish systems.

2.2.3. Description, History, and Assessment of the French Systems of Regional Executive Functions (with examples from Italy and Spain)

The ability of regional executive reforms to institute either democratic or efficient local government institutions are matters of ongoing debates. Democracy as it is presented in the literature may vary with local government size, specifically, the size of electoral constituencies. Democracy is also influenced by the electoral mechanisms that organize direct or indirect representation of the electorate or citizen participation in policy-making. The issue of efficiency is found in the economic literature favouring inter-urban, market-like competition, as well as in that favouring consolidation. One argument is that the market regulates cost-efficient services to the best level; the other argument is that economies of scale are possible in larger local governments. The following sections review the French experience and when necessary refers to other cases.

The Executive Function of Regional Governments of France (Italy and Spain)

Regional governments may have primarily administrative, legislative, or judicial government functions, depending on the political tradition of the state in question. In the European continental tradition of centralized presidential systems of government, government functions are divided between the legislative, the judicial, and the executive authorities and

concurrent government bodies. In such instances, the traditional regional executive government functions have been primarily administrative, but this is being challenged by contemporary reforms.

Historically, in France, the executive function was administrative. Local-central interactions have a long history of strict top-down control called *tutelle*; however, this tutelage system was phased out during the last part of the 20th century¹²⁴. Originally, prefects were the executive heads of Departements (also called General Councils) and of municipal councils, with a staff made up of central-state field officers. Their control was over municipal and general council “opinions” until the late 1800s, and in some instances, “decisions” was tightly framed legally. Tutelage spanned issues such as the behaviour of elected officials on council, most local-government decisions, including budgetary matters, and the prefect’s prior approval of decisions that were presented to council.

Early in the 20th century, prefects were powerful administrators. The 1910s and 1920s were a period of increased and tighter control, which eased after the Second World War, particularly in the 1960s. Jean Pierre Worms and Pierre Gremion have illustrated that a period of strengthening of local political power occurred at that time, despite the weak beginning of the new Fifth Republic¹²⁵. In 1982, the tutelage system disappeared in principle but remained in application for some budgetary matters and some technical issues. Municipalities, general councils, and the newly created regions could not vote on an unbalanced budget and were expected to request the technical views of central-government field officers on a long list of questions, including road widths, sewage tanks, and water quality.

¹²⁴ Jean-Luc Boeuf, *Décentralisation et Recomposition des Territoires: 1982–2002, Problèmes Politiques et Sociaux* (Paris: La documentation Française, 2002); Yves; Gaudemet and Olivier Gohin, “La République Décentralisée” (2004), Brigitte; Masquet, Isabelle; Domergue, and Charif; Kiwan, eds., *Décentralisation, Regard sur l'Actualité* (Paris: La documentation Française, 2002); Jacques Moreau, *Administration Régionale, Locale et Municipale* (Paris: Dalloz – Mementos Dalloz, 1978); Bruno Rémond, “Décentraliser: Vraiment ? Enfin !”, *Pouvoirs Locaux* 55, no. 4 (2002), Jean-Claude; Thoenig, “La Décentralisation 10 Ans Après”, *Pouvoir* 60 (1992).

¹²⁵ Jean Pierre; Worms and Pierre, Gremion, *Aménagement du Territoire et Développement Régional*, 2 vols., vol. 1 (Grenoble: Institut d'Etudes Politiques, 1968).

Today, tutelage basically disappeared as it has been replaced by a basic legal control of local government decisions. However, mayors still work with central-government officials on all municipal accounting matters, and the influence of central-government agents regarding their technical expertise, despite being challenged daily, remains important in some policy arenas such as those concerning roads and bridges, water mains and sewage tanks, and policing matters. There is some evidence that, in most instances, these are policy arenas where local governments have chosen to limit their staff development due to the expertise and the well-known over involvement and control of certain professions, such as road and bridge engineers. The relevance and influence of the control of legality – as the remains of the tutelage system and as a mechanism that works against non-central-government decisions – have become matters of debate. The general view, however, is that elected officials are not constrained by this control of legality because it is not used against them for two main reasons.

First, the prefects' staffs do not have the resources (human or financial) to monitor all local-government decisions. Indeed, they review few of them and refer even fewer to administrative tribunals. In theory, prefects are supposed to review about 7.5 million acts yearly, yet only about 1,500 to 1,700 acts are brought in front of an administrative tribunal. In practice, when prefects suspect something illegal has occurred, their office is to prepare a letter of "observation" to ask for an "explanation" and then to send the case to an administrative tribunal. In 1989, no acts were referred to administrative tribunals in seven départements. Overall, only 0.022% of acts were transferred to administrative tribunals, and of those, 420 were deemed to desist, and only 1,293 were actually sent in final. As well, local governments can ask for a certification of non-deferment from an administrative tribunal, and both a prefect and an administrative tribunal can transform an illegal act into an exception.¹²⁶ Second, prefects and sub-prefects' relationships with elected officials is central to their administrative careers; thus, they do not frustrate influential elected officials or their political friends unless their reasons are very serious.

¹²⁶ See the State Council decision of Oct. 06, 2000, Ministry of interior versus Commune of St. Florent.

Furthermore, there is some evidence that, due to their functions and delegated powers, both prefects and general council presidents are able to keep a large number of mayors of smaller municipalities within their networks of influence. There are about 450 sub-prefects, 100 prefects, and 22 regional prefects across metropolitan France, all of whom know that their career success is proportional to their ability to work well with prominent and successful elected officials and their networks of friends and political allies (this is further discussed in section 4 of this paper). Their primary career objective is to serve on a ministerial team for a time, rather than to systematically review all new municipal decisions.

In the past, prefects had the power of tutelage to control all non-central governments. Today, however, because prefects work in a highly politicized environment, they depend on powerful elected officials. Also, because decentralization has led to an increased number of local/regional government decisions, the control of legality is not a threatening formality. The central government could limit its arenas of investigations or hire more staff to implement better controls; such decisions, however, are the responsibility of elected officials who sit in the National Assembly and the Senate. Hence, the traditional balance of power between central and non-central governments has shifted in favour of the periphery.

The histories of executive functions in Italy and Spain broadly follow similar sets of reforms over the same time period. Both local and regional systems emerged from the period of Napoleonic occupation in the early decades of the 19th century; Centrally appointed Prefects supervised the activities of each communes and provinces (equivalent to French Departments). In Italy, the constitution of 1947, however, established 15 “ordinary status” regional governments as a primary contribution to a stronger Italian democracy, which would break from the centralism and clientilistic nature of the pre-existing fascist regime. However, the Christian Democratic party resisted the regionalist constitutional clauses until the late 1960s. Central government department and agencies of the state were able to monopolize funding and policy formation, for instance controlling over 90% of all regional funding through specific grants, and dictating the lists of regional elected officials, while relying heavily on its central government field administration – Prefects and central officials in

post in the regions and provinces – to control and oversee the activities of elected officials. Hence, Italian regions did not break through the centralist mould of Italy until the 1996 reform that reasserted their general competency to oversee and promote all matters of regional general interest. These reforms allowed regions to emerge as staff followed along with further devolution of functions. But the interlinking of administration and politics, of clientilism and patronage, limited the strength of regions in the face of central government. Today, Italian regions remain a weaker example of regionalism in Europe.

In Spain, regions emerged in the late 1970s carried by a strong regionalist tradition that seeped through centralist and authoritarian Franco regime. Strong historical regions (Catalonia, the Basque Country, Galicia for example) pushed for major reforms of decentralization, which for some have led Spain to become a federal state. The 1983 reforms set a process leading to the establishment of 17 autonomous communities, each one of them with various powers and functions. Those reforms were to address the specific historical, linguistic and socio-economic demands of those varied regions. They led to an important transfer of function and staff (about 850,000 staff in during the 1980–90s) from the centre to the regions and other local governments. Today the politically strong regions are well staffed and balance the centralist tradition of Spain; this is particularly true regarding the Basque country, Catalonia, Galicia, Andalusia, Valencia, Canary Islands and the province of Navarre that have extensive powers. Other regions such as Aragon or Madrid, the Asturias or Balearics have lesser powers.

The Range of Functions of Regional Heads in France (Italy and Spain)

The functional capacity and range of functions of regional executives rely on two general types of local institutions. The first type is a government-like institution made up of an elected council, with a president or chair, and its bureaucracy, and is typically a multi-functional or multi-purpose regional or local government. The second type may also have an electoral representation, although this is uncommon, but is typically a uni-functional regional or local government or a special purpose authority.

Regional governance mechanisms seem to be stretched along a functional continuum, which at one end defends the imperative guiding principles of democracy, responsiveness, and accountability of regional institutions and, at the other end, defends the fundamental requirements of functional and efficient service delivery. Hence, some institutional designs give structural priority to democratic accountability, while others associate governing capacity with efficiency. A broadly defined taxonomy of these institutional arrangements suggests four forms of local governments: single tier, lower tier, upper tier, and special purpose authority¹²⁷.

Regional governments, or regional municipalities as they are called in North America, are elected bodies with a wide number of functions. In contrast, special purpose authorities are rarely elected and mainly deal with only a single government function. The inherent accountability of special purpose bodies relies on the function they deliver to a community, which is neither territorially identifiable nor even homogeneous. Most multi-functional local governments, however, are in essence territorially identifiable and accountable and responsive to a community of individuals. Most special purpose bodies are not accountable to electors, but instead answer to appointed officials or service consumers. Although this limits direct public involvement in their affairs, private-sector stakeholders scrutinize them closely.

A single-tier municipality or regional government is a multi-functional government that manages a wide range of functions. An upper-tier government has a limited number of functions but is not a special purpose body because it is multi-functional and overlaps a number of lower-tier local governments. In other words, the functional capacity of an upper-tier regional government spans a much larger territory, which encompasses all that of the constituent lower-tier local government. A classic example exists when the planning function is allocated to an upper-tier local government; other functions that have been allocated to upper-tier governments include regional transportation, water, sewage, garbage disposal, and policing. When an upper-tier government body exists, the lower-tier bodies deal with local policy responsibilities. The assumption

¹²⁷ Tindal, Sancton, Bish, Keating, etc.

is that matching the allocation of functions to the appropriate level – or appropriate tier – of local government may result in greater efficiency and attend to the regional dimension of service that is needed. It should be noted, however, that single-, lower-, or upper-tier bodies often have multi-functional policy capacities, are often elected, and never deliver services beyond the boundaries of their constituting local municipalities. Tiered-level governments are rooted in the political space from which they emerge. Each level is accountable to an electorate, either directly or indirectly. In most cases, a lower-tier body is directly elected and an upper-tier body is indirectly elected; hence, although their democratic accountability and responsiveness vary, they are entrenched in local communities.

A variant of this model is the Joint Services Board, also called a regional district in British Columbia, Canada, a special purpose authority or public authority or district in the United States, a SIVOM or SIVU in France, and a “Quango” in the United Kingdom. The flexibility of this model allows regional governments to cater servicing arrangements to an optimum economy of scale and may allow municipal agreements that focus on efficient service delivery. The flexibility of such an institutional arrangement, however, loses its appeal once the number of functions to be managed by the board expands. Proponents of this model assert that the board remains accountable to the local level because it allows for strong accountability and responsive governance¹²⁸. Others contend that complex inter-municipal agreements result in unclear bureaucratic overlaps and functional responsibility and lack of local control¹²⁹. Melville McMillan, upon comparing eight large metropolitan arrangements, suggested that above a certain metropolitan size and number of functional responsibilities, there is a greater need for more accountable upper-tier institutions¹³⁰.

¹²⁸ Andrew Sancton (1994), *Governing Canada's City Regions*, IRPP.

¹²⁹ Richard Tindall (2000), *Local Government in Canada*, Nelson. Also see, Patrick Smith & Kennedy Stewart (1998, June), *Making Accountability Work in B.C.*, Report for the Ministry of Municipal Affairs and Housing.

¹³⁰ Melville McMillan, *Urban Government and Finance*.

The clear strength of the uni-functional special purpose body is the delivery of services to a specific community, sometimes with disregard for local and municipal boundaries. The functional accountability of such bodies supports the non-territorial logic that emerges out of the level of satisfaction of their functional community, which often shows support by paying a direct fee for service and may be an advantageous tax instrument for municipalities not wanting to raise property taxes. The councils or boards of these public bodies often are appointed, and such bodies have been used extensively for the administration of parks, hydroelectric services, transportation services, education, and policing. Until the late 1990s, Vancouver, Canada, had, for instance, 17 such special purpose boards with responsibilities spanning education, civic theatres, parks and recreation, policing, and public housing. Today, France has over 26,000 of these bodies. Opponents of this form of institution argue that an excessive reliance on boards and commissions leads to a greater fragmentation of local government institutions and that the efficiency of service delivery does not compensate for the lack of democratic accountability, for instance, with regard to the real cost of services¹³¹.

The functional range of regional executives follows this variable geometry of institutional arrangements that have evolved from traditional multi-functional government into a multitude of uni-functional governance arrangements, all of which can be more or less cost efficient, as well as accountable and responsive to a local community. Placing primacy on political accountability and responsiveness seems to anchor governing capacity in the regional politics of a place, while shifting the priority toward the efficient delivery of services results in servicing the needs of market forces. Multifunctional governments governing large territories are rooted in the politics of place, whereas uni-functional special purpose bodies are anchored in the servicing of the functional requirements of market forces. Clearly, regional communities and central governments must struggle to establish the appropriate institutional framework to meet the needs of their constituencies and their economic region. Each regional institutional structure is also indicative of broad normative views that

¹³¹ See Dale Richmond & David Siegel (Eds.) (1994), *Agencies, Boards and Commissions in Canadian Local Government*, Toronto: IPA.

frame and inform the policy capacity and choice of a regional government. In short, depending on its functional range, the function and skill set of regional executives vary. When more than one function is involved, regional executives may be elected. This usually varies according to constituency tradition but budget size and political accountability are central. In contrast, technocrats typically manage uni-functional regional government or special purpose bodies.

Central to this issue is the functional capacity of regional government as a factor of its legal authority as much as its territorial responsibility. Territorial and legal authority varies from one country to another. In Canada, local governments have limited political and legal authority; they are creatures of the provinces, and provincial government departments are able to use their granting relations to scrutinize the activities of local governments. In the United States, state control is constrained by local governments' constitutional rights, yet numerous scholars have noted the difficulties that cities encounter when dealing with social and economic issues. Keating has argued that, in the United States, despite a strong democratic tradition, local politics is closed and governing capacity is limited¹³². Similarly, Sbragia has made the case for the narrow policy-making capacity that has resulted from the politics of circumvention, which have shaped local governments' investments since the 1980s and shifted the politics of development from multi-functional institutions to uni-functional special purpose bodies, or "public authorities", as Sbragia calls them¹³³. In France, Spain, and Italy, the legal authority of regional governments has expanded rapidly since the 1980s. French regional governments have become increasingly multifunctional, with policy responsibilities that impact the policy capacity of all other levels of government. French regions became elected bodies in 1986 and their political clout has increased ever since as downloading has taken place and as local political networks have entrenched themselves in local and regional politics.

¹³² Michael Keating (1991), *Comparative Urban Politics*, Edward Edgard, pp. 25–26, 203.

¹³³ Alberta Sbragia (1997), *Debt Wish*, Pittsburgh Press, chapter 8, pp. 163–187, details the process that led to the creation of those authorities and the emerging politics of circumvention. See also pp. 211–216, which summarize this central argument.

The central issue in both Europe and North America is that regional governments must struggle for the legal and functional authority and territorial comprehensiveness that are necessary to address major development issues. They must vie with the pressing hand of higher-government levels, such as provinces, states, or central and federal governments, which share some of these concerns and have a larger jurisdictional and functional authority. When comparing the precise functions or activities of local/regional governments in North America and Europe, it is difficult to offer a comprehensive description of responsibilities. However, as presented in the table below (*Table 2.5*) these include land-use planning, building regulations, parks and recreation, culture and recreation, policing, economic development, collection and distribution of solid waste, water, local roads, public transportation, primary and secondary education, and, in some instances, health delivery and welfare administration.

Table 2.5

Allocation of Functions to Levels of Government

	USA	Canada	U.K.	France	Italy	Spain
Land Use Planning	L	<i>L</i>	<i>L</i>	<i>L</i>	L	L
Refuse Collection	<i>L</i>	<i>L</i>	<i>L</i>	<i>L</i>	L	L
Culture and Recreation	L	<i>L</i>	<i>L</i>	<i>L</i>	L	L
Local Roads	L	<i>L</i>	<i>L</i>	<i>L</i>	L	L
Urban Transport	L	<i>L</i>	<i>L</i>	<i>L</i>	L	L
Water	L	<i>L</i>	<i>L/P</i>	<i>L/P</i>	<i>L/P</i>	<i>L/P</i>
Electricity	L/P	<i>L</i>	<i>P</i>	<i>P</i>	P	P
Police	L/State	<i>N/L/Provinces</i>	<i>P</i>	<i>N/L</i>	<i>N/L</i>	<i>N/L</i>
Primary and Secondary Education	L	<i>L</i>	<i>L</i>	<i>N</i>	L	L
Vocational Education	L	<i>Province</i>	<i>L/N</i>	<i>L</i>	L	L
Health	L/P	<i>Province</i>	<i>N</i>	<i>N/L</i>	<i>N/L</i>	<i>N/L</i>
Personal Social Services	L/V	<i>L</i>	<i>L</i>	<i>N/L</i>	<i>N/L</i>	<i>N/L</i>
	N/State	<i>N/Province</i>	<i>N</i>	<i>N/L</i>	<i>N/L</i>	<i>N/L</i>
Cash Welfare						

Note:
L = Local and regional
N = National
V = Voluntary sector
P = Private

Both in North America and Europe, the traditional and expensive functions are education and land servicing. Both functions have a tremendous influence on the economic welfare of cities, and education is increasingly important in the new economy (parents will settle close to good schools). In *The Work of Cities* (1998), Clarke and Gail contended that education, particularly universities, and airports are the highways of the 1950s and the train stations of the turn of the 20th century¹³⁴. In other words, the future welfare of cities depends on these amenities¹³⁵. Servicing property is also crucial to a community's growth. In North America and Europe, local governments seem to relate exclusively to property because the tax system allows them to levy taxes on local properties, and economic growth is greatly influenced by the politics of land regulation and planning¹³⁶.

The Range of Responsibilities and Functions of Regional Heads in France (Italy and Spain)

Two principles organize the division of labour between non-central and central governments: proximity and national coherence. It is clear from the previous section on the nature of the executive function that until the 1980s French non-central governments were under the strict tutelage of the centre, their responsibilities and functions specific and under control. However, over the last 25 years this relationship between proximity and national coherence has changed in line with the European principle of subsidiarity, whereby each government takes decisions at its level for the entirety of its responsibilities, while central government officials work in partnership with all local governments to design and implement nationally coherent policies.

No one level of government, however, can impose its tutelage on any other. Local and central governments are expected to work together in partnership. Responsibilities are shared. In socio-economic and education

¹³⁴ Susan Clarke & Gary Gail (1998), *The Works of Cities*, University of Minnesota Press, p. 21.

¹³⁵ This argument is found across a large spectrum of the literature on the economic development of cities.

¹³⁶ Robert Bish (1999), *Local Government in British Columbia*, UBCM, chapter 10.

policy arenas, few fields are the exclusive responsibility of a particular government level. Because of downloading, the central government shares parts of all local-government responsibilities, making partnerships necessary for the proper design and implementation of all policies. Each level, however, is assigned broad and vague leadership functions over specific areas of policy that do not translate into clear authority. A region, for instance, takes the lead in policy areas that include economic development and tourism, while social and solidarity policies are primarily the responsibility of the general councils, municipalities de facto seem to govern over planning and housing issues, and the central government has no specific area of primary responsibility. Yet a municipality also has responsibilities in these policy areas delegated to local/regional governments. Hence, they are also able to take economic development initiatives and set up tourism bureaus and are responsible for local airports, seaports, and the building and maintenance of local roads. In the areas of social action, they can manage public social housing (for the poorest and elderly) and student housing, as well as set minimal housing standards. In matters of education and culture, they manage all local schools, including all art schools, and monuments of historical significance¹³⁷.

All in all, it seems that the best characterization of the local government system is that it is tightly entangled with governing at the central level. French municipalities and other local governments seem to be as reliant on other government levels as those other government levels are on them. Obviously, this raises issues of accountability and makes policy-making extremely complex. Overall, about one-third of all public-sector employees work for a local government. In 2001, the 56,700 local governments had about 1.6 million public-sector agents (these numbers do not account for the City of Paris and the General Council of Paris, which would add about 35,000 employees). Of those 1.6 million local government agents, about 50,000 work for regions, 500,000 for general councils, and just over 1 million for municipalities or inter-municipal organizations. It is also interesting to note that the central government and its de-concentrated services, central departments, and ministries have just over

¹³⁷ Xavier; Cabannes and Olivier; Gohin, "Compétences Et Ressources Des Communes", *Pouvoirs* 95 (2000).

3 million staff. These numbers exclude about 850,000 public health and 1.5 million education employees. This entanglement is further highlighted by an analysis of the respective budgets of these different tiers of government. The annual budget of the central government is about 288 billion euros, while municipalities spend about 90 billion euros; Departments, 40 billion euros, and regions, 14 billion euros. Overall, the financial and staff size of local governments are about half that of the central government, which shows the relative influence of the centre in regions, despite the important changes regarding the tutelage and primacy of prefects' decision-making authority in all non-central policy decisions.

Similarly, in Italy and Spain the size of regional staff and budget are still notably smaller than that of central government and agencies. In Spain about 65% of public spending are controlled by central government. Autonomous communities and other local governments are responsible now for about 35% of public spending with the Autonomous Communities gaining greater financial autonomy and policy influence than other local/regional governments. Between 1978 and 2006, the number of central government civil servant changed from about 1.7 million to 546,000. Most were either eliminated and/or transferred to regional or local governments. All in all, central government transferred 850,000 civil servants to the Autonomous Communities and municipalities. In Italy similar trends have led to a decreasing influence of central government with overall public spending reduced from over 70% to 63% today, and regions gaining from 3% to 22%, while other local governments also lost some control over public funding from 23% to 14% of all public expenditures. However, Italy is also a known example of poor quality of public service, which is generally attributed to the politicization of the central, regional and local bureaucracies. Despite a strong legal tradition in the bureaucracy, a national culture seems to prefer to bypass formal channels of administration, hence primarily relying on political interventions and 'bustarella' (an envelop full of money) to ease bureaucratic obstacles. This system is made more complex by a dense network of public agencies, another source of patronage for the parties. Today, estimates account for about 60,000 such local and regional agencies. The system is called the 'sottogoverno,' a reference to subterranean government.

In conclusion, the nature and the range of functions of regional executives have tremendous impact on their organizations. The larger the number of functions and/or the territorial span of regional governments, the more likely they will have to be elected. The smaller their number of functions and the more specialized they are, the more likely they will be managed by experts and technocrats. Central and other non-central governments may find it advantageous to place one function in the hands of experts with no electoral accountability. On the other hand, it might be more beneficial to see other specific functions dealt with by elected chambers and elected regional executives. In France, Italy, and Spain, central governments decentralized resources and empowered regions and other local governments. Government chose to enhance the democratic accountability of lower-level governments and allow local and regional governments to up-load specific functions to uni-functional organizations managed by experts.

2.2.4. The Political Dimension of Regional Executives of France (Italy and Spain)

What is the influence of regional elected officials on French politics and policies? Patrick Le Lidec has argued that the authority of mayors is essential and has become particularly important over the last 25 years¹³⁸. Mayors have always been influential because mayoralty offices and municipal councils are the foundation of the French political system; the region has always been weaker. Le Lidec's doctoral thesis is a study of the role of French elected officials and the association of elected officials in the design of successive French regimes. He argues that the recent rise in the influence of locally elected officials predates the 1969 referendum that originated from a conflict between then-president Charles De Gaulle and French elected officials. Regarding all recent decentralization law, Le Lidec argues that for the last two decades local elected officials, particu-

¹³⁸ Documentation Française, "Le Cumul des Mandats et des Fonctions", Les études de la Documentation Française (1998), Christian; Le Lidec, "Les Maires dans la République, L' Association des Maires de France, Eléments Constitutifs des Régimes Politiques Français depuis 1907" (Université de Paris 1, 2001); Reformistes et Solidaires, Tout Savoir sur le Cumul des Mandats (2005 [cited July 25, 2005]; available from http://www.re-so.net/article.php3?id_article=565.

larly their national representations – the Association des Maires de France, the Association des Maires des Grandes Villes de France, the Assemblée des Départements de France, and the Assemblée des Régions de France – were extremely influential in their interactions with the central government and the personnel who drafted the reform proposals, as well as with members of both the National Assembly and the Senate.

Why are locally elected officials so influential at the national level, Le Lidec asks? His historical description of the genesis of their influence underlines that the very nature of the political system is built on the century-long practice of officials getting elected locally and then protecting this mandate as their political “base camp” before they attempt to gain influence regionally and nationally. They rely on small local networks of political “friends” (their spouses and their close and trusted political companions) to “accumulate”¹³⁹ electoral mandates. The history of the accumulation of mandates, according to Le Lidec, is part of the genesis of the French Republics, particularly the Third and Fourth Republics when all elected officials were constantly worried about protecting their own political careers during very unstable governments. Over the 70 years of the Third Republic (1870–1940), there were 51 prime ministers and governments, and during the 12 years of the Fourth Republic (1946–1958), there were 13 prime ministers and governments. Indeed, from 1870 to 1958, the average length of a central government was about 12 months; the average since the beginning of the Fifth Republic in 1958 has been 46 months. Hence, for the last 47 years, elected members of parliament, senators, and ministers and other members of the central government have not had to worry about unstable governments. Yet the practice of accumulating a local electoral mandate within other mandates, including départements, regions, the Senate, the National Assembly, or the European Union, has remained the foundation of the system.

Often the accumulation of mandates reinforces the position of a mayor, particularly in the case of a large municipality. Such a mayor may also control a general council’s or a region’s presidency or both. George Frêche is the archetypical example of a feudal political lord. After being

¹³⁹ The French expression is “cumul des mandats” that suggest an accumulation of electoral mandates.

mayor of the City of Montpellier for nearly 20 years, he resigned as mayor but remained on city council and was nominated by his peers to become president of the “agglomeration of communes” for the Montpellier region. He is also currently the president of the Regional Council and a member of the National Assembly for the Montpellier constituency. Mayor Frêche also controls what happens in the Département of Hérault because David Vezinhet, the president of its General Council, is his political friend and vassal. Vezinhet started his political career in 1977 on the municipal council of Montpellier. At the time, he was one of Frêche’s closest allies and political friends in the Socialist Party and as Frêche’s political career succeeded, so did Vezinhet’s. In 1983, Vezinhet became deputy mayor and a member of the Regional Council, in 1985, a member of its General Council, and in 1998, its president. Today, he is also very active as chair of three local governments – special purpose bodies – that manage transportation, planning, and economic development policies for Montpellier and its surrounding municipalities.

Such an accumulation of mandates exemplifies that, although the reform act of 1985 limited the kind of mandates elected officials could have, it did not abolish the practice. This inability to accumulate a European mandate along with a national one led to increased specialization and division of labour among elected officials and their political teams. Today, important political figures are able to accumulate by “delegation.” A typical elected official wins a mandate, establishes a team, selects lieutenants, and resigns from office, giving the office to his designated deputy, and then starts the process again but always protecting his first local mandate. In 1988, for instance, 133 members of parliament resigned from their mandate, often opting for a mayoralty or a general council mandate rather than a regional one.

The April 5, 2000, “reform of the reform” of the accumulation of mandates set out that a member of parliament could not accumulate that mandate with those of a general or regional council member or a mayor of a municipality of more than 3,000 inhabitants. Furthermore, an elected official could not resign from a recently won mandate. However, elected officials may still rely on their spouse and head of staff. For instance, Jean Pierre Fourcade is the mayor of Saint Cloud. He is also a senator and

vice president of the Regional Council of Iles de France. He used to be on the city council of Boulogne Bilancourt, but alternates with his spouse and deputies to remain in control. Similarly, the Minister of Interior, Mr. Sarkozy, is an elected member of Neuilly and of the General Council of Neuilly, after being both mayor and president of each for over a decade. Today, most nationally elected officials hold a local mandate, with over 85% of all members of Parliament and the Senate accumulating at least two mandates. In 2003, 90.8% of the 577 members of Parliament and 80.7% of the 239 Senators held a local elected office as well¹⁴⁰.

Clearly, these vertical networks of elected officials link local politics to national decision-making processes and frame the relations of each level of government. These relations are critical to the efficiency of French policy-making and today further the political and functional integration and coordination of each level of government contracts, as detailed in the next section. Similarly, in Italy and Spain, regional politics also enhanced the regionalism movements. These were powerfully rooted in the local political culture of Spanish regions, and less successful in Italy. In both cases, though, opposition politics weakened re-centralizing trends and furthered the decentralization and Regionalist trends.

To summarize sections 3 and 4, it is clear that past regional executives in France, but also Italy and Spain, were powerful prefects, trained and educated at the center (Paris, Rome, or Madrid) and sent to the periphery to manage regions, local governments, municipalities and Departements, or counties and provinces. Today, on the contrary, influential regional heads include the mayors of the largest regional cities and other local political leaders. Indeed, political factors affect the executive function. A mayor may become particularly powerful as a result of accumulating mandates and reinforcing his or her position by placing close and trusted allies in a few key electoral positions. Political forces in all three countries have been successful at seeking a local government level of larger scale and greater functional capacity, and with greater political and policy

¹⁴⁰ Le Lidec, "Les Maires dans La République, L' Association des Maires de France, Eléments Constitutifs des Régimes Politiques Français Depuis 1907", Philippe; Tronquoy, "Décentralisation, Etat, et Territoires", Cahiers Français- La documentation française, no. 318 (2004).

capacity than local governments such as municipalities. There are centralizing and decentralizing trends at stake, which either see the extension of the reach of central government in planning and coordination, or the transformation of the state into a more democratic, pluralist, and competitive system.

Does this mean that regional government is mediating local-central relations? The next section suggests that regions are not powerful enough; however, the regional scale is where every policy negotiation that counts takes place.

2.2.5. Regional-Central Relations in France (Italy and Spain)

In the French experience, regional governments do not mediate local-central relations, although most actions are mediated at the regional level. In other words, the regional level is the appropriate scale for most public-sector initiatives but this does not translate into stronger regional governments.

There are three reasons for this. First, regions are “young” local-government institutions, only created in 1982, and they did not catalyze regional political movements in France as they did in Italy or the United Kingdom. Second, the “state-regions contracts” are a quarter-century old and constitute a well-established tradition of broad economic development and planning exercises that bring together all levels of governments, with a large number of public and private organizations also around the negotiating table, and hold them accountable to each other through contracts that span at least five years. The current contracts for 2000–2006 address the 12th plan. For instance, in the last round of negotiations regarding the Nord-Pas de Calais 2000–2006 contracts, the region was a key partner alongside each level of government – central, both Departments, and a number of key municipalities (Dunkerque, Boulogne-sur-Mer, Lille-Roubaix-Tourcoing, Lens-Liévin, Valenciennes, Maubeuge-Val de Sambre) – and the European Union. All partners funded the contract for a total of 28 billion francs (sources in French Francs): the central government contributed 10.4 billion, the region, 7 billion, the Departement

ments, 2.6 billion, and the European Union, 8 billion¹⁴¹. Third, the European Union Structural and Social Funds, launched in 1974, and its Community Initiatives policies, introduced in 1989, have chosen the regional level as their key territorial unit for all policy negotiations and all processes involving partnerships, funding, applications, implementations, and evaluations. However, regions are not the exclusive partners of the European Commission; its funds and policies bring a multiplicity of government levels and public and private organizations to the negotiating tables¹⁴².

During the 1980s and 1990s, after the creation of regional governments, a few scholars predicted the rise of regional governments. They believed that the regional governments' role as key signatories for contracts and their general responsibility for economic development policy might lead to the disappearance of *Departements* and to the fusion of regions that could compete with the German *Lander*. This scholarly debate, however, did not influence the recent reforms.

The 2003 constitutional reforms and the subsequent strengthening of all local governments revealed that regions are now a well-established level among local governments but with no authority over any other government. Indeed, the constitutional reform of March 28, 2003, entrenched the principle of co-operation among all governments (article 72.5). Also, when compared to other local governments (see section 3 of this paper), regions have remained relatively small in terms of both staff and budget, and the further downloading of 2003–2004 did not affect this balance of power among local governments. As for further downloading, the early proposals to transfer the Ministry of Education's technical and administrative staff to the regions did not take place, although their responsibili-

¹⁴¹ Conseil Régional du Nord-Pas de Calais, *Contrat De Plan Etat-Region* (2005 [cited November 20 2004]); available from <http://www.cr-npdc.fr/instit/cper/intro.htm>.

¹⁴² Jean-Bernard Auby, "Décentralisation 2003 : le Modèle Français en Mutation", *Pouvoirs Locaux* 59, no. 4 (2003); Daniel (2002) Béhar, "Au-delà de la Décentralisation : Repenser le Pouvoir Local", in *Pour en Finir avec la Décentralisation*, ed. Charles Floquet (Paris: Editions de L'Aube, 2002); Daniel; Béhar and Philippe; Estèbe, "Etat et Politique Territoriales: de la Discrimination Positive à la Dérogation", in *L'Etat de la France*, 97–98 (Paris: La Découverte, 1997); Jacques; Manesse, *L'aménagement du Territoire* (Paris: LGDJ, 1998).

ties did expand in economic development, professional training, and regional transportation policy areas and they were given the leadership for the coordination of all EU policies. Although this will obviously strengthen the position of regional council presidents in all negotiations with regional prefects, the planned reduction of all structural and social funds by 2007 will minimize the impact of this transfer of authority. Hence, regions have not emerged as key mediators of central-municipal relations.

Prefects were also affected by new reforms (act 2000-374, April 29, 2004) related to the new constitutional amendment that affected the functions and organization of central government. Their impact on regional prefects was interesting, if only to underline that the central government reform included a further de-concentration of services that strengthened the regional coordination of all de-concentrated services. Initiated in 1992 and further reformed with the April 29, 2004, government decision, Act 2000-374 stipulated that prefects and government field offices were to be reorganized under the prefects' strengthened coordinating roles. The five traditional ministries that were not affected by prefectural rule – justice, health, education, finance, and labour – must work with the regional prefects, who are now the exclusive coordinating central-government representative and the only authority able to sign all agreements and contracts. In effect, these prefects became the “gatekeepers” for all interactions with all local governments and the only authority able to engage the central government on contracts and conventions. Another function held by regional prefects is to uphold national coherence in all programs. No government activity can take place without consulting them, including the activities of nationalized private-sector corporations. They chair all service committees, including the “regional action” and “chiefs of staff” committees, and may organize all de-concentrated services according to regional priorities or to competency pools. Finally, they have the authority to nominate project leaders that coordinate specific policy actions¹⁴³. These reforms attested to the need to strengthen the coordination of all central-government field offices, particularly at the level of regions. They

¹⁴³ Tronquoy, “Décentralisation, Etat, Et Territoires”.

not only mark the emergence of prominent regional prefects but also highlight the fact that the minority position held by central-government officials in all regional negotiations is no longer protected by legal or financial authority or by the traditional prestige of their functions. Rather, it results from negotiations among varied points of views, where the primary role of prefects is to maintain national coherence, while other local government officials assert what is best for their communities¹⁴⁴.

It is interesting to note that when the central government de-concentrated further resources and reasserted the authority of the regional prefects, the regions did not see an increase in either their responsibilities or their authority. These two concurrent trends support the contention that it is primarily at the regional level that European central and regional governments and public and private-sector organizations converge to organize the governance of France. It is clear, however, that no one government is emerging as the key mediating authority; neither the prefects and central-state field officials nor regional elected officials and their regional governments are able to dominate the regional policy game. In these interactions, cities may actually be at the heart of the regional political system and, by extension, the mayors of regional governments. The examples of Pierre Mauroy, when he was mayor of Lille, of Martine Aubry, his political “protégée” and successor at Lille city hall, of George Frêche, the mayor of Montpellier, of Jacques Chirac, when he was mayor of Paris, or of Alain Juppe, then mayor of Bordeaux, and their extensive networks of influence and control over regional political networks attest that they are *primus inter pares*.

Thus, there is a political dimension to regional heads but it is recent and evolving. Also, it has not transformed into making regional governments essential to local-central relations. In France, the regional scale has become the territorial level where negotiations between most government

¹⁴⁴ Daniel Béhar, “L’agglomération : entre Gouvernement et Gouvernance”, *Habitat et Société*, 19, no. Septembre (2000); Daniel Béhar and Philippe Estèbe, “Aménagement du Territoire : la Solution Locale”, in *L’Etat de la France, 1999–2000* (Paris: La Découverte, 1999); Béhar and Estèbe, “Etat et Politique Territoriales: de la Discrimination Positive à la Dérogation”; Béhar, Daniel and Estèbe; Philippe, “Aménagement du Territoire : une Mise en Perspective”, in *L’Etat des Régions Françaises* (Paris: La Découverte, 2004).

tiers are taking place; the regional government is only one government among many others. In Spain and Italy, regional governments also became the power base of the opposition always inhibiting re-centralizing projects, but also strengthening the reach of regionalist views into national politics. As central government have progressively lost their ability to control spatial redistribution and economic activity, the focus turned onto regions for increasingly differentiated and multifaceted policy answers to global and economic competition.

2.2.6. The Fiscal Position of Regional Heads in France

The literature on tax systems and regional executives underlines one important lesson: once a certain number of functions and size of budget and staff are reached, local/regional governments should not be appointed or simply managed by public officials but should be elected. David McMillan suggests that functional regional organizations that are accountable to lower-tier governments form, that, in a variety of ways, are the most efficient and necessary institutions of all urban regions. Indeed, McMillan asserts that all large regional governance systems struggle with this very issue and that some of them are directly elected, rather than indirectly or not at all. Hence, functional accountability to lower-level governments might not be enough once those larger regional governing institutions reach a certain budgetary size, which points to the need to have direct elections for the larger regions.

The French local-government tax system consists of grants and tax-sharing mechanisms. The first pillar of this tax system is a system of conditional grants that are usually attached to a new transfer of responsibilities. These grants have been criticized for not addressing the issue of the level of public service and concurrent cost. Despite indexation on inflation and on GDP growth, the central government often does not devolve adequate funding to guarantee standard public service quality. A traditional example of such an imbalance in revenues is the transfer of high schools to regional governments; over time, this transfer has cost regions four times as much as while central government funding did not increase.

The second pillar is a mechanism of tax sharing whereby the central government procures either a specific portion or all of the revenues of a tax instrument for local governments. A key issue is that downloading

certain types of taxes is contrary to European law. For instance, the transfer of the Value Added Tax could lead to a multiplicity of local rates that are contrary to European law¹⁴⁵: The transfer of the “petrol product interior tax” (TIPP), which is paid and monitored at the regional level on gas-production sites, would not allow for effective territorially varied rates. De Courson, for instance, argues that there is only one type of tax that could be transferred to local governments: the traditional income tax and the newer general social contribution. Income tax rates are already deemed very high and only about 51% of all French families pay any income tax. De Courson suggests that the general social contribution is possibly the best transferable tax to local governments because it involves 90% of the population and because varied rates would be compatible with European law.

In 2001, municipalities raised about 41.71 billion euros, *Départements*, 17.91 billion euros, and regions, 4.54 billion euros. Yet, out of these 64.16 billion euros, only 8.19 billion were tax revenues based on economic activities, whereas over 80%, or 55.36 billion, came from various property taxes. Also between 1997 and 2001, the fiscal autonomy of local governments shifted from 52.8% to 45.4% – municipalities, *Départements*, and regions lost 7.2%, 5.7%, and 16.1%, respectively, of their financial autonomy as central government departments substituted specific local-government tax revenues for conditional grants¹⁴⁶.

From 1982 onward, local/regional elected officials were frustrated by the central government’s inability to “keep its word.” A Senate report, chaired by Patrice Gélard, stressed how the central government’s failure in the 1980s and 1990s to transfer resources, along with its extensive downloading, had frustrated local elected officials¹⁴⁷. For instance, the

¹⁴⁵ De Courson, Charles (2002), “Autonomie financière des collectivités locales: la voie étroite” in *Commentaires*, no. 10. Winter 2002–3. pp. 885–887.

¹⁴⁶ Direction Générale des Collectivités Locales, “Fiscalité Locale: Structure, Autonomie”, review of Reviewed Item, Structure de la fiscalité locale; Autonomie de la fiscalité locale, no. (2005), http://www.dgcl.interieur.gouv.fr/donneeschiffrees/accueil_donnees_chiffrees.html.

¹⁴⁷ Patrice Gélard. “Projet de Loi Constitutionnelle Modifiant le Titre Xv de la Constitution”. (Place Published: Senat, 2004), <http://www.senat.fr/rap/104-180/104-180.html> (ac-

Constitutional Council's reluctance to oppose the central government's "re-centralization" of local resources resulted in further constraints on local financial prerogatives, including equalization transfers¹⁴⁸, local taxes, and the regulatory capacity of local tax rates. Contrary to the view of local government officials, the central government administration understood "free local administration" as a principle that de facto suggested the minimal financial autonomy of local governments.

According to Didier Migaud, the member of Parliament for the Département of Isère, the underlying central government ideology that justified this financial disengagement and de-centralization is fuelled by views that deficits and balanced budget issues can be addressed by transferring expenditures and responsibilities to local governments. Such transfers should secure balanced budgets and limit the overall deficits under the 3% of GDP threshold required by the European Union. Also, local governments are perceived as smaller, inexpensive, and efficient policy actors. Migaud argued, for instance, that the transfer of the TIPP¹⁴⁹ was particularly interesting. Its revenues accounted for about 1.94% of GDP in 1994, but were down to 1.6% of GDP in 2001 and, due to the signature of the Kyoto agreement and further increases in gas prices, are expected to reach new lows by 2012, hence affecting again and again local government revenues. He also asserts that such downloading has led to local tax increases and further constraints on the implementation of territorial solidarity and equity¹⁵⁰.

cessed June 25, 2005). See the so called Defferre law, 82–123 regarding the freedoms and rights of Regions, Départements and Communes (JORF 03 March, 1982, p.730) and particularly, article 102, which states that "resources should be transferred along with all net increases in charges resulting from state downloading to local collectivities or the Region".

¹⁴⁸ The central government in 1993 cancelled the Region and Département tax on "no built properties," the finance law of 2000 cancelled the regional share of the "habitation tax", and the finance law of 2001 cancelled the tax on car number plates (so called vignette automobile).

¹⁴⁹ TIPP translates into Petroleum Products Interior Tax.

¹⁵⁰ Didier Migaud, "Un Transfert du Déficit de l'état sur le Dos du Contribuable Local", *Pouvoirs Locaux* 59, no. 4 (2003).

Beginning in June 2000, Senate president and president of the Association of French Departements Christian Poncelet, the president of the Association of Mayors of France Jean Pierre Delevoye, the president of the local finance committees Jean Pierre Fourcade, and the president of the Association of French Regions Jean Pierre Raffarin worked on a constitutional reform proposal. Similarly, the Social and Economic Council consultation produced a white paper in June 2001, and the Mauroy Commission published its views in October 2000. The overall debate on further decentralization acknowledged that it had to include greater local fiscal capacity and autonomy.

In November 2003, at the annual meeting of the Association of French Mayors, Christian Poncelet explained that the local government tax system was “obsolete, unfair, and archaic”¹⁵¹. In 2003, the consensus was that local governments should finally gain constitutional financial guarantees of autonomy¹⁵². The March 28, 2003, constitutional reform led to full powers being transferred to municipalities and, as of August 13, 2004, constitutional principles included local liberty and responsibility, experimentation, referendum, and financial autonomy and resources¹⁵³. The suggestion that all local governments and municipalities are gaining greater financial autonomy, however, is still a matter of debate because a large part of local resources remain centralized.

This reform, specifically article 72.2, strengthened the financial autonomy of local governments by ensuring that local governments have their “own” resources and those resources are to be the “determining” part of “all” their revenues. Both new rules are designed to protect local collectivities from the propensity of the central government to re-centralize and control all local-government resources. According to article 72.2.2, local government resources are made up of loans negotiated with financial institutions, fees for services set by their elected council,

¹⁵¹ Fabrice; Robert, “Vers une Fiscalité Décentralisée”, Cahiers Français – La documentation française 318 (2004).

¹⁵² Charles DE Courson, “Autonomie Financière des Collectivités Locales : la Voie Étroite”, Commentaire, Hiver (2003); Didier Migaud, “Un Transfert du Déficit de l'état sur le Dos du Contribuable Local”.

¹⁵³ Alain; Guengart and Jean-Michel Josselin, “La Constitution Fournit-Elle une Garantie Déterminante d'Autonomie Financière ?”, Pouvoirs Locaux 59, no. 4 (2003).

local taxes, tax basis, tax rates, and evaluation mechanisms. Sauvageot¹⁵⁴, however, notes that this aspect of the reform does not constitute “real innovations,” as local government councils were already empowered to set the tax rate and basis on built and not-built properties, real-estate ownership, and specific professions. In the end, these considerations were likely included in the reforms because the Senate committee insisted on them.

The real innovation, however, is found in article 72.2.3, which affirms that fiscal revenues and other resources form a determining part of all local-government resources. It states that specific grants should be reduced and limited, that substituting any resources by specific grants is also to be limited, and that no “limit” to the free local administration of local governments is acceptable. The implementation of such rules also leads to specific difficulties. For instance, what local governments are to be included? A restrictive understanding would limit the application to metropolitan local government and exclude all others (French Polynesia, French Mayotte Islands in the Pacific ocean, and Saint Pierre and Miquelon in the North Atlantic off of the Canadian coast). How is the principle of majority to be understood? Is it exactly 50% of all resources, or should this be a significant amount as long as no local government’s action is restricted? The spirit of the law seems to indicate that local elected officials are protected from having to agree with the decisions of central-state officials when the administration of their constituency is concerned.

Thus, in France the non-specific nature of the constitutional text seems to imply that the substantive meaning of these constitutional reforms will primarily rely on future interpretations of the Constitutional Council¹⁵⁵. Regarding expenditures, the new texts forbid any download-

¹⁵⁴ Frederic Sauvageot (2003), “Les Nouvelles Garanties Financières des Collectivités”, in Edmond Maestri (2003), *Décentralisation, Histoire, bilan, évolutions*. Paris, France; l’Harmattan.

¹⁵⁵ Key texts on the past and present scholarly views on local public finances: Bouvier, M., Esclassan M.C., and Lassale J.P. (2002) *Finances Publiques*, Paris: L.G.D.J. Darnanville H. M. (2002) *L’Autonomie Financiere et fiscales de collectivités locales passe par une reforme de leur fiscalite*, *Actualite juridique de droit administratif*. Guillaume, D. (2002) *La necessaire consecration constitutionnelle d’un pouvoir fiscal des collectivites territoriales*, Paris: Economica. Robert, H., (2003) *L’ambigue constitutionalisation des finances locales*, *Actualite Juridique de droit administrative*,

ing and any new expenditures not entirely funded by parallel transfers of resources or fiscal instruments. The Constitution also grants freedom of expenditures, but vagueness in the wording left commentators without a clear interpretation. The general principle, however, is that a dual interpretation is possible: the Constitution grants freedom but French legislators inherit the right to organize its exercise. The current debate suggests that any attempts to formulate an explanation could be waived by a decision of the Constitutional Council in the near future. In this matter of interpretation, commentators suggest that Constitutional Council jurisprudence might resemble what was in force prior to the 2003 reform¹⁵⁶, while legislators might be able to specify mandatory expenditures and both government and parliament might be able to cap expenditures, if only to keep all local government expenditures in line with the overall budgetary obligation set by the European Monetary Union. In the end, it seems that the traditional financial control that central-state officials have had over public finances does not seem to be challenged. This is an important finding because it demonstrates that the central government is not only able to force regional governments to work as open and democratic governments but can also control their activities using the power of the purse whenever necessary.

Fiscal intergovernmental relations have also changed drastically in Spain and Italy; After the 1970s period of heavy borrowing and local taxation, Italian municipalities and regions lost the power to borrow and reduced drastically their taxing powers. Today Italian regions and municipalities cannot borrow, and are largely dependent on central government grants and have limited taxing authority. Most of those grants, however, are block grants, which do not interfere with local politics and pol-

11/2003, pp. 548–558. Pierre Mouzet, “Le Conseil d’état et le Contrôle Budgétaire des Collectivités Territoriales”, *Revue Française de Droit Administratif* Juillet-Août (2003); Sylvie (entretien avec) Trosa, “La Lolf Est une Révolution, Mais pas une Réforme de l’état...” *Pouvoirs Locaux* 55, no. 4 (2002).

¹⁵⁶ See for instance, Hertzog, Robert, *L’ambigüe constitutionnalisation des finances locales*, *Actualité juridique de droit administrative*, 11/2003, Mars 2003, pp. 548–558. Ricci, Jean Claude, *Les nouvelles garanties constitutionnelles en matière de ressources des collectivités*, in *Acte u Colloque des 31 Mars et 1 Avril 2003*, *Revue Juridique de L’Ocean Indien*, Saint Denis de la Reunion, 3–2003.

icy choices. Spanish regions raise their revenues from three main sources; central government grants, tax sharing arrangements and regional taxes. The fiscal system that was highly centralized in the 1970s is now akin to a typical federal country. Clearly, despite a strong intergovernmental nature central government is still downloading responsibilities while attempting to control the general orientations of each Autonomous Community.

2.2.7. Conclusion: Merits and Weaknesses of Appointed Executives and Mixed Systems

Contrary to what could be found fifty years ago, appointed regional executives are not in charge of large, multifunctional regional governments any more. In each country, the form, size, efficiency, and democracy of regional governments vary according to tradition and history, although currently some very clear trends are transforming the articulation of local priorities into the global economy. In each constituency, specific functions are left for large, multifunctional government-like bodies that elected officials will manage with their staff under stringent democratic and policy constraints. Other specific functions are managed by experts and technocrats in highly specialized uni-functional governments, which often are not accountable to the public but only to their functional constituents (their consumers). In such case, market forces regulate their activities.

Furthermore, large multifunctional governments are not only to perform efficiently but also to remain democratically accountable, because central governments rely on both efficiency and democratic principles to control their policy activities. Performance measures and regular regional electoral competitions are two modes of control that in France are progressively replacing tutelage, through the nomination in specific functions of centrally trained officials and the control of some substantial amounts of local-regional resources. Overall, it is clear that current trends are keeping regional executives at the core of a tug-of-war between the form and size and the efficiency and democracy of each regional government, all of which organizes the articulation of local choices in the global economy.

Today, regional executives are elected officials that are tightly accountable to their electorate and dependent on market forces for resources. These are increasingly under managerial and democratic pressure, and also responsible for larger number of functions. Central government attempt, however, to monitor their performance and regulate their activities by increasing their accountability to their electorate. Re-centralizing tendencies are politically difficult because such reforms are not administrative but political matters.

Table 2.6

Comparative Analysis of Advantages and Disadvantages of Appointed or Elected Governors of Regional Governments

	Elected	Appointed
Advantages	<ul style="list-style-type: none"> • Greater Democratic Accountability • Greater Political Representation • Greater Competition Among Constituencies/Regions • Market forces regulate resources • Local Coalitions & Political Entrepreneurship • Greater Number of Regional/Local Governments Likely • Regional/Local Government Fragmented Likely • Greater Competition Among Local/Regional Governments • Greater Market Efficiencies in Service Delivery • Better Articulations of Local Priorities with Global Economic Growth • Better Community Based Consultation (likely) 	<ul style="list-style-type: none"> • Distributive Justice • Greater Equity • Greater Tax Base • Greater Central Policy Capacity • Greater Reform Impetus • Greater Economies of Scales • Greater Policy Capacity • Greater New Public Management/Measurement • Greater Policy Transparency • Measures serve central government policy goals • Regional Uni-functional government likely (limited number of function) • Regional Budget Limited • Amalgamation more likely
Disadvantages	<ul style="list-style-type: none"> • Reforms Slow • Weaker Policy Capacity • Market forces regulate resources • Competition regulates resources and services • Variable geometry of services • Variable geometry of capacity 	<ul style="list-style-type: none"> • One Size Fit All Policy • Policies less likely to address specific regional issues • Top own accountability • Weaker regional/local policy capacity • Measurement do not serve Regional Policy goals

The implications of these findings for the Russian regional system of government are:

- On the short-term modernizing reforms are easiest under a bureaucratic system of regional government.
- The short-term advantages of the current Russian system of appointed regional executives are a greater capacity for equity, distributive justice, central policy control, all together leading to a generally greater capacity for further reforms and modernization of the Russian state/regional/local bureaucracies, particularly with regard to planning and economic development objectives.
- The short-term disadvantages include weaker government accountability, and weaker local and regional capacity to articulate local/regional issues with global competition and market priorities.
- In the long-term as Russia democratizes, it may indeed need to further decentralize and democratize its regional government system, reverting again to a system of elected executives. Re-centralizing trend then, however, may become more difficult as local and regional political movements may become central to the articulation of the social construction of each region into the global economy.
- The long-term implications of such changes may then lead to greater government efficiencies, and also greater territorial inequity, greater territorial competition, and variable geometry of public services and policy capacity across the Russian state.

2.3. Reform of the Regional Elections in the Russian Federation

2.3.1. Background. Stages in development of the regional governments leadership in post-socialist Russia¹⁵⁷

The status of the Head of Regional Administration (hereinafter – Governor) appeared in Russia at the beginning of the 1990-s as a result of global revolutionary reform of government structure.

¹⁵⁷ This extract is prepared by A. Zolotareva.

One could not find an exact prototype of that position in the Soviet period due to several reasons:

- As far as the principle of separation of powers was neglected in the USSR, the executive power did not exist in common sense. Formerly, according to the RSFSR constitution of 1978, the complete government power was held by Council of People's Deputies, and all other government authorities were accountable and responsible to that body. Executive and administrative bodies of the regional level were Executive Committees, elected by the Council of People's Deputies.

- Executive Committees of local Soviets, which in a way could be regarded as a prototype of modern regional administrations, were collegial bodies, and their Chairmen had no independent power.

- Basing on the effective Article 6 of the Constitution "On the leading and guiding role of the Communist Party of the Soviet Union", the real power in the regions was in the hands of relevant CPSU Committees, rather than the Councils and Executive Committees thereof.

- Despite the existence of autonomous entities within the RSFSR (for example, the autonomous republic was defined in the 1978 Constitution as "a Soviet Socialist State within the Russian Soviet Federal Socialist Republic"), these entities had no authority of their own. Therefore, in fact, RSFSR (as well as the Soviet Union) was a model of a unitary state.

As per the Law N 1329-1 as of May 24, 1991 the amendments were made to the RSFSR Constitution, introducing in the range of government positions the post of the RSFSR President and the Heads of Regional Administrations. Herewith, the regional administrations had equal authorities with administrations of Kray, Oblast, Autonomous Oblast and Autonomous District. It is remarkable, that the position of Head of executive power (of the Council of Ministers) was not foreseen in the autonomous republics.

Unlike previous Executive Committees, Local administration power was based on the principles of the undivided authority. Its structure had to be approved by the Council of People's Deputies upon presentation of the Head of local administration, and the leaders of the structural units of local government were to be appointed or dismissed directly by the Head of local administration and be accountable to him in all their activities. At

the same time, by the RSFSR legislation, there was set out a list positions range of liabilities for the local administration, which were to be filled and approved by the Council of People's Deputies. Moreover, the local Council of People's Deputies had the right to make a decision on impeachment to the Head and other officials of local administration. However, the Law did not set out the procedure for replacement of the Head of local administration.

On June 12, 1991 the RSFSR President elections were held. Several regional leaders in the absence of legal regulations on replacement of the Head of regional administration, decided to hold those elections simultaneously. The first elected Heads of the executive power were the G. Popov, Mayor of Moscow, A. Sobchak, the Mayor of Leningrad and M. Shaimiev, the President of the Republic of Tatarstan

Later the procedure for replacement of the Head of the local administration has been legally formalized¹⁵⁸. The law of the RSFSR as of November 1, 1991 has introduced in the Constitution the post of the Head of Executive Power (the President) of the Republic within the Russian Federation. The authorities and the procedure of election of the Heads of the executive power (Presidents) of the Republics of the Russian Federation should have been stipulated by the Constitution and legislation of the Republic.

After the coup attempt in August 1991, the Communist Party was dissolved. The Decree of B.N. Yeltsin's No. 78 as of August 23, 1991 has released some executive Chairmen of the Regional Councils of People's Deputies "for providing the support to the so-called State Committee for Emergency Situation in the USSR, failure to execute the provisions of Decrees of the RSFSR President, aimed at curbing the coup"¹⁵⁹.

In those circumstances, the Decree No. 1975 of the President of the RSFSR as of August 22, 1991 "On some issues of executive power in Russia" has introduced the so-called "vertical system of executive power". Under this decree, the Head of regional administration Kray,

¹⁵⁸ The RSFSR Law No. 1803-I as of October 24, 1991 "On Election of the Heads of Local Administrations".

¹⁵⁹ The RSFSR President's Decree No. 78 as of August 23, 1991 "On Dismissal of Chairmen of Executive Committees of the Deputies of Local Councils".

Autonomous Region, Autonomous Okrug, upon approval of relevant Council of People's Deputies was appointed by the President of the RSFSR and was accountable to him. The Head of administration could be dismissed on the initiative of the President of Russia, in response to the Council of People's Deputies request, or at discretion of the Head of administration.

During the period of 1991–1993, at the federal level there was observed a growing confrontation between the executive power and the Supreme Council, which was actively resisting the socio-economic reforms and eventually has taken an attempt to seize power by force. In response to those actions, the President has dissolved the Russian Congress of People's Deputies and the Supreme Soviet of the RSFSR by the Decree No. 1400 as of September 21, 1993. The elections to the State Duma and the referendum on the new constitution draft were appointed for December 12, 1993. During the transition period, the local Councils of People's Deputies were barred from taking part in the appointment of Heads of the Presidential Administration. It was established by the President's Decree¹⁶⁰ that the Heads of Administrations of Kray, Autonomous Okrug, City of regional level should be appointed and released from his responsibilities by the RF President under request of the Chairman of the Council of Ministers, i.e., the RF Government.

The new Constitution of the Russian Federation, adopted on December 12, 1993, has referred establishment of common principles of the organization of the RF subjects to the common competence of the Federation and its Subjects. Establishment of the system of government power of the RF subjects within general principles of the federal law is left within the competence of the RF subjects.

The Order No. 951 as of September 17, 1995 “On elections to the Governments of the Subjects of the Russian Federation and to the local self-government bodies” has established, that the election of local self-government of the RF Subjects, appointed by the President of the Russian Federation, to be held in December 1996. As an exception, the election of

¹⁶⁰ The RF President's Decree No. 1597 as of October 7, 2003 “On the Order of Appointment and Dismissal of the Heads of Administrations of Kray, Oblast, Autonomous Oblast, Cities of Federal Level”.

the Heads of Administrations of Novgorod, Moscow and Omsk regions were appointed to December 17, 1995. Those and other measures, specified by the Decree, were taken, as stated in the Decree, in order to create conditions for the implementation of the principles of democracy, specified in Article 3, Part 2 of the Constitution of the Russian Federation, as well as for the purpose of formation of the Federal Council of the Federal Assembly in 1995, given the incomplete process of formation of legislative base in a number of the RF subjects, necessary for the elections and the functioning of the public authorities of government power and the regional governments, until the federal laws on the general principles of representative and executive bodies of the RF government power are adopted and the financial and material resources of local government are formed.

However, the Federal Law No. 184-FZ "On the general principles of organizing legislative (representation) and executive bodies of state power of the Russian Federation " was adopted only on October 6, 1999. In the absence of relevant federal regulations, some regional legislations in 1994–1995 made attempts to expand their executive powers. Those attempts have been practically ineffective. An important political impact on the separation of legislative from executive power branches at the regional level in Russia was provided by resolutions of the RF Constitutional Court upon verification of constitutionality of some provisions of the Charters (Constitutions) of Altai and the Chita regions (although legally those regulations related only to the Subjects of the Russian Federation). In both cases the motive for the case review was the application to the Constitutional Court of the Administration of the RF Subject, which found the powers of Legislation Assembly too expanded.

The Charter of the Altai Region envisaged, in particular, the election of the Governor by the Regional Legislation Assembly, which was commented by the Constitutional Court as follows:

"...Due to such approach, the Legislative Assembly is turned into a kind of electoral board, which substitutes free elections by voting. That type of election is not consistent with the Constitution and effective legislation of the Russian Federation. The Governor, elected in that order, can not be considered a legitimate independent member of the executive

power, since neither the legislative, nor the executive branch has the right to appoint the representatives of each other, including federal power bodies. Those requirements, based on the independence of executive and legislative powers and justifying the independent formation of their bodies, are reflected in Article 95 (Part 2) of the Constitution of the Russian Federation. In accordance with those provisions, the Federation Council is composed of two representatives from each Subject of the Russian Federation: one from the legislative and one from executive bodies of the state power. Such separate representation would become pointless, if both representatives, the Chairmen of the Legislative Assembly and the Head of Regional Administration were elected by the same government body”.

The regulations of the Charter, which provide the right to the Legislative Assembly to establish the structure of the Administration Council and appoint its leaders, express mistrust or approve their dismissal¹⁶¹, were found to be inconsistent with the Constitution, as well as the provisions, empowering the Chairman of the Legislative Assembly with the right to adopt the regional laws.

In another case, in verification of the constitutionality of some provisions of the Charter of Chita region, the Constitutional Court also found a violation of the balance between legislative and executive powers. In particular, it was stated that: “...the disputed provision of the Charter on accountability of Administration, reviewed in context with other regulations..... demonstrate that the regional law can unlimitedly expand Duma powers, including definition of forms and methods of its control authorities, creates the possibility of actually transferring the Administration from the independent executive body into Duma subordinate body. This is incompatible with the principle of separation of powers and the principle of independence of legislative and executive bodies, stipulated in Article 10 of the Constitution of the Russian Federation”¹⁶².

¹⁶¹ The Decision of Constitutional Court of the Russian Federation No. 2-P dated January 18, 1996 on verification of constitutionality of several provisions of the Charter (Basic Law) of Altai Region.

¹⁶² The Resolution of Constitutional Court of the Russian Federation No. 3-P dated February 1, 1996 on a verification of constitutionality of the Charter – Basic Law of Chita Region.

The Federal law No. 192-FZ as of December 5, 1995 “On the formation of the Federation Council of the Federal Assembly of the Russian Federation” stipulates, that the Federation Council is composed of two representatives from each Subject of the Russian Federation: The Head of legislative (representative) body and the Head of executive government power. The same Law has established the deadline for completion of regional Governors elections for December 1996.

By early 1997 the Governors’ elections were completed almost everywhere. The election procedure for replacement of the Chief Executive Officer (Head of the Supreme Executive body of government power) of the Subject of the Russian Federation) was established in the first edition of the Federal Law “On general principles of formation of legislative (representative) and executive bodies of government power of the Russian Federation”, dated October 6, 1999. An exception to the general rule of direct elections of the Governors of the RF Subjects was admitted in cases, when on the day of entry into force of that Federal Law, the RF Constitution (or the Charter of the RF Subject) envisages that the Chief Executive Officer (Head of the Supreme Executive power of the Subject of the Russian Federation) should be elected by a special representation meeting¹⁶³.

In 2000 the newly elected President of Russia V.V. Putin launched the reform of government administration. There were formed seven federal regions, and a representative of the President was appointed to each of those regions. The procedure of formation of the Federation Council was changed. According to the new “On the procedure of formation the Federation Council of the Federal Assembly of the Russian Federation”¹⁶⁴, a member of the Federation Council form the legislative body of a the Subject of the Russian Federation is elected by that body for the term of its powers, and in case of formation the legislative body of the RF Subject by rotation – for the duration of powers of non-repeatedly elected mem-

¹⁶³ Article 18 of the Federal Law No. 184-FZ “On general principles of formation of legislative (representative) and executive bodies of government power of the Subjects of the Russian Federation ”dated October 6, 1999.

¹⁶⁴ Federal Law No. 113-FZ ”On the formation of the Federation Council of the Federal Assembly of the Russian Federation” dated August 5, 2000.

bers of this body (Art. 2). The representative of the Federation Council from executive body of the Subject of the Russian Federation is appointed by the Governor of the RF Subject (Head of the top executive body of the Subject of the Russian Federation) for the term of his powers (Article 4).

*2.3.2. An Analysis of Constitutionality
of the New Procedure of Appointment
and Dismissal of the Regional Governors*

In December 2004, there were adopted amendments to the Federal Law “On general principles of formation of legislative (representative) and executive bodies of government power of the Russian Federation”¹⁶⁵ which have fundamentally changed the procedure of replacement of the Head of the Subject of the Russian Federation.

If, as noted above, the Heads of the Subjects of the Russian Federation, as a rule, were elected directly by the population of the RF Subjects, according to the new wording of the Law 184-FZ, they should be appointed by legislative bodies of the RF Subjects upon presentation of the RF President for the term of up to 5 years. In the case of the nominated candidate is rejected twice, the President is entitled to “submit a new proposal on the candidate of the Executive Officer of the Subject of the Russian Federation”, or to dissolve the legislative body of the Russian Federation. At the same time, the dismissal of Head of the Subject of the Russian Federation by the President of the Russian Federation is foreseen, including such grounds as “the loss of confidence” from the RF President.

The constitutionality of these provisions of No. 184-FZ was disputed in the Constitutional Court of Russia. In the opinion of the persons, who initiated the court proceedings, the provisions of that Law unduly restrict the right of citizens to participate in government power and violate their

¹⁶⁵ Federal Law “On amendments to the federal law on the general principles of formation of legislative (representative) and executive bodies of government power of the Subjects of the Russian Federation and to the Federal Law “On the basic guarantees of electoral rights and rights to participate in the referendum to the citizens of the Russian Federation” dated December 11, 2004 No. 159-FZ.

electoral law, as well as the constitutional principles of separation of powers, separation of jurisdiction and powers between the Russian Federation and its Subjects and they are incompatible with the constitutional provisions on the powers of the President of the Russian Federation. By the Order No. 13-P, dated December 21, 2005, the Constitutional Court declared that there are contradictions in the new procedure for filling the post of Head of a Subject of the Russian Federation as to the RF Constitution. The review of constitutionality of other provisions of the Law was rejected on formal grounds. However, two judges of the Constitutional Court, A.L. Kononov and V.G. Shchelkanov did not agree with that decision, basing their position on the so-called “dissent opinion”¹⁶⁶. Let us consider the main arguments, given in the dispute on the constitutionality of the new appointment procedure of the Head of the RF region.

The main argument of the Constitutional Court was that the Constitution does not directly regulate the formation of government bodies of the Subjects of the Russian Federation. However, as noted above, before the Constitutional Court has found the provisions in the Constitution, which were inconsistent with the exemption of the population of the RF Subject from the election of the Head of the RF Subject (when the situation in Altay Region was under consideration).

Then the Constitutional Court argued that the meaning of Articles 3 and 32 of the Constitution imply that the top-rank official of the Subject of the Russian Federation, forming the bodies of executive power, acquires his credentials directly from the population and is responsible to the electorate. The Head of Administration, elected by the Legislative Assembly, can not be considered a legitimate independent representative of the executive power¹⁶⁷. Thus, the Constitutional Court argument that there was no provisions in the Constitution as to formation of the government bodies of the Subjects of the Russian Federation, is refuted by the earlier decision of the Constitutional Court.

¹⁶⁶ Law on the Constitutional Court envisages mandatory publication of the views of the judges of the Constitutional Court, who disagree with its decision.

¹⁶⁷ The decision of Constitutional Court as of January 18, 1996 on review of constitutionality of some provisions of the Charter (Basic Law) of Altai Territory.

Considering the issue of compliance of the Law No. 184-FZ to the Constitution principle of differentiation of governments between the Federation and its Subjects, the Constitutional Court stated, that the establishment of common principles of formation of government bodies of the Subjects of the Russian Federation, the Constitution relates them to the issues of joint competence of the Russian Federation and its Subjects, basing on which Federal laws and related laws and other legal regulations of the RF Subjects are adopted. However, we can't argue the opinion of Judge Kononov that the procedure of appointment and dismissal of Heads of executive power in the regions, regulated by the Federal law in detail, can be hardly attributed to the "general principles of organization of government power in the RF Subjects", because it leaves no freedom to the regions in development their own legal regulations. Thus, the constitutional principles of differentiation of powers between the Federation and its Subjects were violated by the provisions of that Law.

Participation of the President of Russia in the appointment of Heads of the executive power of the RF Subjects was substantiated by the Constitutional Court by the fact that "the Head of the RF Subject is a link in the common system of executive power in the Russian Federation and, as such, is in direct subordination to the President of the Russian Federation". Article 77 of the Constitution really refers to the "common system of executive power", but Federal executive authorities and the executive bodies of the Subjects of Federation enter that common system only "within the competence and responsibilities of the Russian Federation in regard to the issues of joint jurisdiction". Thus, according to the Constitution, in addition to a unified vertical system of the RF executive power, in the framework of which one can speak of subordination, there exists a system of executive power of the RF Subjects, independent from the centre and accountable directly to their population.

In our view, to ensure the unity of executive power of the Federation governments and its common responsibilities with its Subjects, participation of the Federation in the formation of regional executive bodies is not required in fact. Already at the time of the Law adoption, the legislation has provided to the federal bodies rather strong means of influencing the regional executive power. Thus, according to the Constitution, the Acts of

the President and the government of Russia are mandatory for execution throughout the territory of the Russian Federation. The RF President has the right to suspend the acts of the executive power of the RF Subjects in the event of their contravention to the RF Constitution, Federal laws, international obligations of Russia, as well as those related to the issue of human rights and freedoms (prior to the court decision on this issue). Moreover, according to the federal law “On general principles of organization of the legislative (representative) and executive bodies of state power of the Subjects of the Russian Federation” in the version, effective at the time of approval of amendments under review, the federal executive authorities, in some cases, have the right to perform temporarily certain responsibilities of a Subject of the Russian Federation, including the event of financial insolvency of the Region, or in case of violations of the Federal regulations, committed by regional governments, funded from the Federal budget. In these circumstances, empowering the President with an authority in the formation of the executive bodies of the regions looked as unjustified measure.

However, the law under review not only envisages participation of the President, but provides him the leading role in the procedure of the appointment the Heads of Regional executive power. The President chooses the candidate, and according to the Law, the President has the right to offer again the same candidate, who has previously been rejected by the regional parliament. It is unlikely, however, that the regional Parliament will be very persistent in voting in view of a threat of its dissolution or appointment of “temporary acting” Regional Head. Thus, the role of regional legislation bodies in the appointment of the Heads of the RF Subjects looks rather figurative.

As noted above, the Constitutional Court refused to consider the constitutionality of the legal provisions, not directly related to the procedure of appointing the Heads of the RF Subjects. Meanwhile, the institution of Head of the RF Subject presumes not only the appointment, but also the dismissal, and without relevant regulations, it is incorrect to consider the constitutionality of the Law, in our view.

With such procedure of appointment and dismissal of the Heads of regions the isolation of the interests and needs of the region and the indif-

ference to their performance on the part of the population is inevitable, which is hardly consistent with the principles of constitutional democracy

Judge A.L. Kononov also draws attention to the fact: “The persistent denial of the Constitutional Court to recognize the right of each individual to vote and be elected as the Head of executive power of the Region [...] is in striking contradiction with the norms and principles of the Constitution of the Russian Federation, which is claimed as the democratic federal state with a republican form of government power (Article 1) and recognizes the multinational population as the only source of power, exercising this power either directly, or through government bodies and local self-government authorities(Article 3)”.

Initiators of proceedings in the Constitutional Court substantiated their position by the fact that there is no power to appoint and dismiss the heads of regions in the President’s responsibilities, outlined by the Constitution. However, the Constitutional Court has stated, that “this fact alone does not prevent the Federal legislator [.....] to empower the President of the Russian Federation [...] with certain functions on delegation to a Russian Citizen an authority of the Head of the Subject of the Russian Federation”.

Commenting the opinion of his colleagues, Judge A.L. Kononov highlights the importance of the fact, that the Constitution provides comments on the powers of the President in federal relations in a comprehensive list: to use the procedures for the settlement of disputes (Article 85, part 1) and the right to suspend the Acts of the executive power of the Subjects of the Russian Federation in certain situations (Article 85, Part 2). Judge A.L. Kononov also comments: “Assuming, as the Constitutional Court did, that the constitutional powers of the President can be extended by federal law without any limits because he is the representative of the nation, then why is the Constitution needed at all?”

Judge Kononov supports his position with the references to the views of international organizations, protecting human rights, on the norms of the reviewed Law No. 184-FZ. For example, the European Commission (Venice) “Democracy through Law” draws attention to its impact on the Federation Council. The main objectives of the Federation Council, comments the Commission, according to the Articles 101 and 102 of the

Constitution of the Russian Federation, are the supervision of the activities of the Federal government and especially the President.

Nevertheless, a half of the members of the Federation Council is appointed by senior officials of the Subjects of the Russian Federation, and if these officials are appointed by the President and can be dismissed any time in case of loss of confidence, the members of the Federation Council, appointed by the executive power, can not be regarded as sufficiently independent for effective monitoring and control of the federal government and the President. In this case the question arises on consistency of the Federal Council with the principle of differentiation of powers, stipulated in Article 10 of the Russian Constitution.

In our view, the arguments of Judge A.L. Kononov are far more convincing than the position of the Constitutional Court. The diversity of arguments, expressed by the parties of the legal dispute, creates the impression of the complexity of the issue of the constitutionality of the new procedure of appointment and dismissal of the Heads of the Subjects of the Russian Federation. However, in our view, the arguments of Judge A.L. Kononov are more convincing than the position of the Constitutional Court. Furthermore, the Constitution contains an explicit answer to that question, independent on the subjective opinions on such philosophical, rather than legal categories as “democracy”, “federalism” and the “differentiation of powers”. Part 2 of Article 11 of the Constitution reads: “The government power in the Subjects of the Russian Federation is executed by the power authorities, formed by the RF Subjects”.

Obviously, the President of the Russian Federation will not be regarded as a person, representing the Subject of the Russian Federation in the process of formation of governments of the latter. The Subject of the Russian Federation can be represented either directly by its population, or the power authorities of the Subjects of the Russian Federation, elected by its population.

Thus, in our opinion, the Constitution of the Russian Federation excludes the participation of Federal power authorities in the process of formation of power authorities of the RF Subjects.

3. Modeling Financial Behavior of the Regional Governments under Changes of the Political Structure of Russian Federation

Given the peculiarities described in the previous section, main effects from changes in the political structure of RF might comprise a modification of mechanisms of formation of the regional governments' preferences. That in turn should entail modifications of their financial behavior. To analyze the modifications, in this section we present theoretical models of the system of elections of heads of the executive power of the Russian Federation and its Subjects, which, along with the above conducted analysis of the literature, should enable us to formulate some hypotheses of possible modifications of the regional governments' post-2004 financial policies.

The principal objective of the present analysis is to model effects from the transition from election of governors in Russia to their appointment. Accordingly, the key role in the models is granted to the comparison of situations when heads of the executive power of the RF Subjects are elected by the population in a given region with situations when they are appointed by President and approved by the legislative body of the Subject. Meanwhile, all the models suggest that, in compliance with the RF Constitution, the candidature of the RF President is chosen on the basis of election.

3.1. Main Assumptions and Structure of the Model

While building the model, let us consider a two-tier structure of government as a starting prerequisite. In a country with the federative structure, citizens inhabit a preset number of regions, in each of which there operates a government body that collects regional taxes and delivers public goods¹⁶⁸. We assume that the regional governments' preferences are

¹⁶⁸ The framework of the theoretical analysis conducted in this section does not imply singling out the legislative power. Rather, our research focuses on the executive power as the one that exercises the strongest influence on the financial policy in a given region.

determined differently in the two cases under consideration: (1) an elected body of the regional executive power whose preferences are formed by virtue of aggregating those of the local population (the aggregation mechanism is discussed below) and (2) an appointed body of the regional executive power whose preferences are formed by the federal center. At the level of the federation, there exists a central body of power that collects federal taxes and delivers federal public goods, and its preferences are formed by means of aggregation of those of the whole population of the country.

Let us assume that the population's preferences are formed according to the ideology of a simple model of choice between private and public goods: the volume of consumption of private goods decreases under the rise of taxes that are channeled to finance public goods. Accordingly, every citizen has a preferred volume of consumption of public goods whose delivery is financed out of the taxes collected. The difference between this particular situation and a standard simple model of the public choice of the volume of financing is that in this case the population has preferences with respect to the volume of the federal, as well as the regional, public goods. Following the classical model, we will assume that under any preset volume of the federal public goods the preferences of the volume of the regional public goods are single-peak ones and, vice versa, under a preset volume of the regional public goods, the preferences of the volume of the federal public goods are likewise single-peak ones.

Aggregation of such preferences on the federal and regional (in the event a ballot is employed as a mechanism of formation of the public choice) levels is made in the following fashion. The selection of the victor among all candidates that take part in the federal and regional elections (we assume their number is infinite and they all put forward all possible financial policy options) is made by means of a pairwise comparison of the existing (various) options by each voter in the case of ballot and following the simple majority rule. Meanwhile, every voter makes his choice on his own and picks an alternative that maximizes his utility function¹⁶⁹.

¹⁶⁹ See, for instance, Persson, Tabellini (2000). Whereas preferences are assumed to be single-peak, the identification of the victor at elections can be based on comparisons of

Under each considered variant of spending the tax system is assumed to be fixed, i.e. every volume of public goods at the federal and regional level is matched by a volume of the federal and regional taxes that ensures their funding. Voters identify most preferable volumes of public goods at the federal and regional levels, and the identification is made on the basis of a comprehensive information of a given tax system. Given that the voters pay federal and regional taxes from their individual single budgets and assuming federal taxes and the volume of the federal public goods preset, the voter may opt for a preferable volume of regional public goods which would depend on the said preset volume of the federal public goods as a parameter. And, vice versa, under a preset volume of the regional public goods and regional taxes the voter's choice with regard to the volume of the federal public goods would likewise correlate with the volume of public goods set at the regional level.

So while evaluating a financial policy of the **elected** regional administration, we assume that the federal and regional elections outcomes constitute results of a strategic interaction between federal and regional voters who, while voting for candidates they prefer, elect President and governors, respectively. In other words, casting their ballot, voters influence the public choice (according to the simple majority rule) of a value of the federal public goods delivered, depending on their choice of the volume of the regional public goods delivered, and vice versa, while electing a governor, they identify the volume of the regional public goods depending on their opting for a volume of the federal public goods delivered.

The above interaction can occur simultaneously – while selecting a governor, the voters consider their preferences and those of other voters with regard to choice of the President and, vice versa, while picking the President, they consider their preferences with respect to the governor elections. In order not to complicate the below theoretical models and focus on the analysis of effects from the transition from elections of governors towards their appointment, we will not consider in a general form consequences of such an interaction, but will assume, for the sake of simplicity, that elections at each level take place under preset elections out-

neighboring pairs of candidates between each other, and such pairs can be regulated, for example, by increase in the offered volume of public goods.

comes at the other level, i.e. once the President is being elected, the results of governor elections are already known and vice versa¹⁷⁰.

Should the preferences appear smooth and one-peak, and regular simultaneously with regard to the regional and federal public goods (see *Fig. 3.1*), the result of the aforementioned election pattern will become Nash equilibrium, which is determined by the median voter's preferences in terms of the federal public goods at the federal elections and those of the median voters in terms of regional elections in every region¹⁷¹. Furthermore it can be suggested that the regularity of preferences with regard to the volume of public goods may be related to the regularity of voters by incomes. In the Russian conditions of the regressive taxation of individual incomes with personal income tax and social tax it can be assumed that the preferred volume of public goods rises along with the growth in the voters' incomes. In a general case, the existence of such a correlation is determined by the structure of the taxation system¹⁷².

Hence, in the case of elected regional governments their preferences mirror those of the median voter in the region (this suggests that, once elected, the governor pursues a regional policy that is in line with his pre-election promises). In other words, with no assumptions of influences by red tape or particular vested interests on the public choice, it can be asserted that the regional governments' preferences are determined by those of the regional median voter. Thus, for the purpose of analysis in this case

¹⁷⁰ In practice, such a situation may become possible in the following cases: the federal and regional elections (at both levels the elections take place, for instance, once in four years) can be split in time and they can take place subsequently (with a 2-year shift), rather than simultaneously. Accordingly, while casting a ballot, voters cannot take into account results of the other election, for instance, due to a short (not more than 2 years) horizon of planning ("near-sightedness"). In addition, the iterations of the concurrence of the selected decision to the equilibrium one can take place conditionally in the course of debating programs announced by this or that potential candidates for presidency or governorship. Such a prerequisite appears analogous to the assumption of the permanency of the duopolist's strategy, as per Curnau's model.

¹⁷¹ Black (*Black, 1948*) demonstrated in the one-dimensional case that under the one-peak preferences the Condorcet victor always exists and coincides with a median voter.

¹⁷² Persson, T and G. Tabellini (2000), *Political Economics: Explaining Economic Policy*, MIT Press, Cambridge and London.

the local residents' preferences can be characterized using those of the median voter.

Similarly, in the case of two-tier elections, the federal governments' preferences reflect those of the median nationwide voter with regard to the federal public goods. In the general case, the situation that involves the two-tier elections appears unsolvable due to the impossibility to compare alternative variants in the two-dimensional space. None the less, we would assume that all voters can be regulated along a negatively sloped line by preferred sets of regional and federal public goods. In this case, the conclusions regarding the median voter's selection of preferences retain their force (see *Fig. 3.1*).

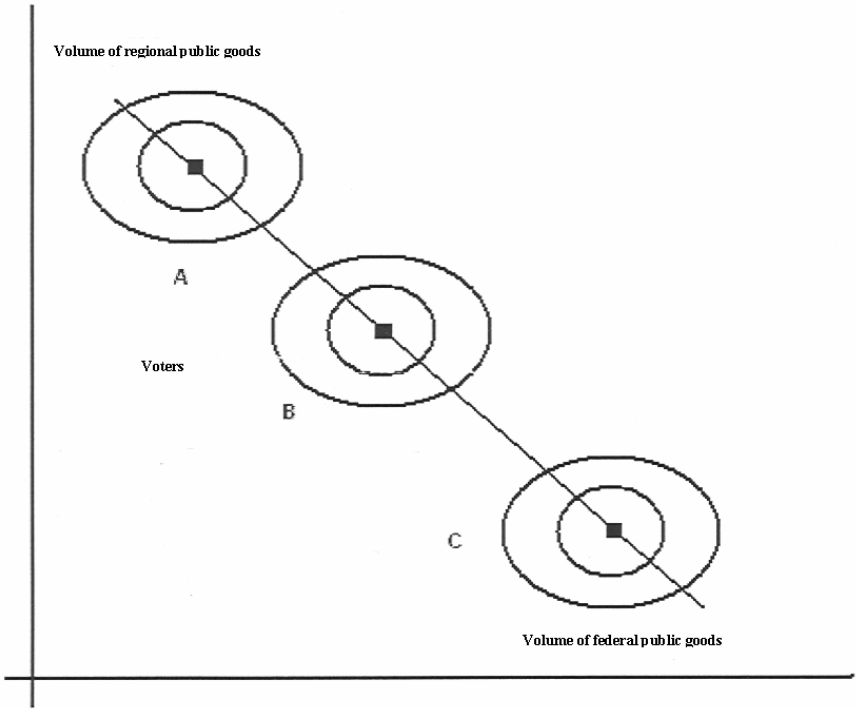


Fig. 3.1

Note: the discussion can be found in Mueller (1997) ch. 8 "Majority Rule".

The final equilibrium that emerges in such a model of interaction between the federal governments' preferences and the regional governments' ones constitutes Nash's equilibrium, whereat the delivered volumes of the federal and regional public goods would be set depending on a variant of formation of the elected governors and the federal center's preferences (the median voter's preferences with respect to the federal and regional goods, as per the basic model).

In the case of elected regional governments, let us assume for them the possibility to bias from the median voter's preferences post-elections, i.e. the possibility for a post-election behavior which differs from the one declared prior to the elections.

One of variants of such a post-election behavior by regional governments is bureaucratic behavior¹⁷³. So far as the federal governments are concerned, we would admit a possibility for the behavior under which, post-election, the federal center does not directly mirror the voters' preferences. Rather, it maximizes public welfare by redistributing revenues between regions. Plus, while seeking an optimal degree of the financing of federal goods and financial assistance, the federal center can take into account externalities from the regional public goods delivery, which should also lead to a rise in public welfare.

In the event of the transition towards **appointed** regional governments, it is the federal center's preferences with regard to volumes of regional public goods that matter. It is so, because it is assumed that the federal center transmits its own preferences with regard to the regional public goods to a regional governor through the mechanism of appointment. Accordingly, in the case governors are appointed, we suggest that in the event of election of a federal center one considers both the volumes of the federal public goods offered by candidates and volumes of provision of the regional public goods they put forward in their programs. After the elections and once governors have been appointed, their prefer-

¹⁷³ The bureaucratic behavior can also be noticed at the stage holding elections, when bureaucrats manipulate the ballot by offering for comparison certain variants in a certain sequence (this case is omitted for the sake of simplicity). In order not to complicate the model, we will not suggest the possibility for the bureaucratic behavior at the federal level.

ences are formed by those of the federal center with regard to the regional goods, which reflect the respective preferences of the voter who appears the median nationwide one.

In the case of appointment of governors, one has to accentuate an additional peculiarity, which is associated with the fact that a given presidential candidate that enjoys the federal median voter's preferences with regard to the federal public goods (the one who offers a given financial policy option that implies a respective volume of the federal public goods), given governors are appointed, would also become subject to the voters' additional assessment with respect to the regional public goods (the volume of the regional public goods they would suggest), which can be either uniform for all the regions, or region-specific. Accordingly, with account of regional preferences, such a candidate can be elected, by means of casting ballot, by the simple majority method in the event he has preferences with respect to the regional public goods at the level of the median voter in every region (i.e. he lines up majority of votes in every region), or at the level of the median voter with regard to the regional public goods throughout Russia on the whole (i.e. he wins in the race nationwide, rather than in every given region). To avoid complicating the model, we will not consider below the variant with different candidates offering different volumes of public goods to different regions, but will opine that, as noted above, post-election, in pursuance of maximization of public welfare, the federal center can bias from the financial policy it offered prior to the elections.

So, whilst considering below different variants of models, we will be comparing the models with elected and appointed regional governments under different additional conditions:

- the elected regional governments reflect either the regional median voter's preferences, or the red tape's ones;
- the elected federal government reflects the federal median voter's preferences, or they maximize the public welfare by redistributing revenues between regions by means of a transfers system, or by considering externalities while opting for a financial policy.

For the sake of simplification, we consider in the models the interaction between the federal government and an administration of one of the

regions. Accordingly, we do not analyze effects from equalization of volumes of provision of public goods between several regions. Such premises allow one to structure the models considered in the present section in the form of the table below. In every model, we will analyze a replacement of elected regional governments with appointed ones in an assumption of the substitution for the regional governments' preferences (the regional median voter's preferences) with the federal center's preferences with regard to the regional public goods.

Table 3.1

Structure of Interaction between the Federal and Regional Governments

		Regional governments reflect preferences of	
		Regional median voter	Bureaucracy
Federal center	Reflects the federal median voter's utility	Model A1	Model A2
	Maximizes public welfare by equalizing revenues between regions	Model B1	Model B2
	Maximizes public welfare by equalizing revenues between regions with a due account of externalities from regional public goods	Model C1	Model C2

In the Table above, it is only model A1 under which in the case of elected regional governments their and the federal governments' preferences match those of the respective median voters. In all other cases it is assumed that the federal and regional governments' post-election behavior differs from the federal or regional voter's preferences. More specifically, in models B1 and C1 the regional governments' preferences match those of the regional median voter, while the federal center maximizes the welfare by allocating financial assistance (redistributing revenues between regions) and with account of externalities from the delivery of the regional public goods.

In model A2, the federal center's preferences match those of the federal median voter, while the regional governments' preferences reflect those of bureaucracy. In models B2 and C2, both the federal center and

the regional governments bias from preferences of the respective median voters, with the federal center maximizing public welfare and the regional governments mirroring the median voter's preferences. Models C1 and C2 employ the same premises as models B1 and B2, respectively, and they additionally suggest a greater utility from financing the regional public goods, due to the presence of externalities from their provision.

The above pattern of the public selection of the financial policy parameters is of course a great simplification of the system of elections of the federal and regional governments in Russia prior to 2005, but we believe it would allow us to depict, with a certain degree of conditionality, the impact the abolition of the regional governments elections in Russia has on the regional financial policies and to formulate respective hypotheses for their empiric testing.

3.2. The Regional and Federal Governments' Preferences

The regional governments' preferences. Let us assume at the first stage, while modeling the elected regional governments, that their preferences match those of the regional median voter. Meanwhile, we assume that greater expenditures on financing public goods and lower tax withdrawals lead to growth in the utility of the median voter in a given region. More specifically, the utility function of the median voter (elected regional governments) in i region (i changes from I to N)¹⁷⁴ over some period of time (for instance, a year) takes the following form (to analyze effects from the transition from elections of governors to their appointment, we employed as a basic model the one of the choice between financing private and public goods, which, by its general structure, appears analogous to models used in *Kadochnikov P., Sinelnikov-Mourylev S., Trunin I., Chetverikov S., Vigno M., 2005*¹⁷⁵).

¹⁷⁴ To allow the consideration in the model of several regions, we keep the index of the region i and consider below the interaction between the federal center and one, i , region.

¹⁷⁵ See: *Kadochnikov P., Sinelnikov-Mourylev S., Trunin I., Chetverikov S., Vigno M. (2005) "Reforma fiskalnogo federalizma v Rossiii: problema myagkikh budgetnykh ogranicheniy regionalnykh vlastey"*. CEPRA, M., IEPP, 2005.

$$u_i = u_i^{MV} \left(\begin{array}{c} E_i, \underbrace{Y_i - \overline{T}_F - T_i}_{+} \\ + \end{array} \right) \rightarrow \max_{E_i, T_i}, \quad (22)$$

where u_i^{MV} – utility function of regional governments in i region that reflects the median voter (MV's) preferences; it is assumed to be convex upwards by its arguments:

E_i – volume of budgetary expenditures in i region per capita (of the local population),

Y_i – income of the median voter in i region per capita (of the local population),

\overline{T}_F – volume of tax revenues to the federal budget on average per capita (the line over the variable means that while opting for a volume of regional taxes and regional public goods, the volume of federal taxes is set exogenously by the federal government),

T_i – volume of tax revenues to the federal budget in i region per capita.

The elected governor determines regional expenditures levels and taxes, thus maximizing the median voter's utility under a preset budget constraint:

$$\begin{aligned} E_i &\leq T_i + G_i \\ E_i &\geq 0, T_i \geq 0, D_i \geq 0, G_i \geq 0, \end{aligned} \quad (23)$$

where G_i – volume of the aggregate federal financial assistance per capita in i region (in this particular case it is assumed that the volume of the federal financial assistance is preset exogenously); for models A1 and A2, under which no financial assistance (a post-election redistribution of resources between regions) is assumed, it is suggested that $G_i=0$.

The overall amount of the regional budget expenditures should meet the budgetary constraint and it may not exceed the budget revenues (the

amount of its own tax revenues and financial assistance in models that allow its allocation)¹⁷⁶.

Under usual assumptions for the utility function¹⁷⁷ the following correlation is valid for optimal in the problem in question expenditure and tax revenue values (the marginal utility in the region from an increase in the regional expenditures equals the marginal utility from an increase in the median voter's disposable income):

$$\frac{\partial u_i^{MV}(E_i, Y_i - \bar{T}_F - T_i)}{\partial E_i} = - \frac{\partial u_i^{MV}(E_i, Y_i - \bar{T}_F - T_i)}{\partial T_i}$$

for $\forall i = 1..N$ (24)

Optimal values of volumes of regional taxes and expenditures of the regional budget (regional public goods) depend on the regional governments' preferences. In the event due to various reasons (the regional bureaucracy's own interests, corruption, a high concentration of individual industries, which may result in special interest groups' lobbyist efforts), the preferences in question differ from those of the median voter, the optimal values of the regional expenditures and taxes can also differ from those for the median voter.

In addition to the preferences, the values of regional taxes and regional budget expenditures that result from the above correlation also appear dependent on tax revenues collectable to the federal budget and volumes of the allocated federal financial aid.

Preferences of the federal government. While building a problem of the central government, we assume that it collects the federal taxes and

¹⁷⁶ The model framework does not suggest the existence of non-tax revenues or other ways of financing expenditures, such as, for instance, borrowings.

¹⁷⁷ While conducting the analysis and finding equilibrium values of expenditures, tax revenues and financial assistance (in the models that allow it), we will suggest that all the utility functions under consideration are concave and have continuous second derivatives by the arguments, and the budgetary constraint is effective as an equilibrium (otherwise the utility value could be increased by boosting up expenditures), while constraints on non-negativity do not appear correlating, i.e. the first-order conditions are, at the same time, sufficient conditions for the optimum.

finance the federal expenditures¹⁷⁸. Its preferences match those of the federal median voter who receives utility from the federal public goods delivery (increase in the federal expenditures) or lower federal taxes (growth in consumption of private goods):

$$U = U^F \left(\underset{+}{E_F}, \underset{+}{E_1}, \dots, \underset{+}{E_n}, \underset{+}{Y_F} - \underset{+}{T_F} - T_R, \underset{+}{Y_1} - \underset{+}{T_F} - T_1, \dots, \underset{+}{Y_N} - \underset{+}{T_F} - T_N \right) \quad (25)$$

$\xrightarrow{E_F, T_F, G_1, \dots, G_N} \max$

where $U^F (E_F, E_1, \dots, E_n, Y_F - T_F - T_R, Y_1 - T_F - T_1, \dots, Y_N - T_F - T_N)$ – the utility function of the federal governments;

- E_F – the federal government expenditures on provision of the federal public goods per capita;
- E_R – expenditures of the government of the region of residence of the federal median voter;
- E_i – the regional government expenditures on provision of the regional public goods per capita;
- T_F – the federal government ax revenues per capita;
- T_R – tax revenues of the government of the region of residence of the federal median voter;
- T_i – tax revenues per capita in i -region;
- Y_F – per capita incomes of the voter who is median for the federation on the whole;
- Y_i – incomes of the median voter in i -region per capita;
- G_i – volume of financial aid to i -region¹⁷⁹ per capita.

¹⁷⁸ See: *Kadochnikov P., Sinelnikov-Mourylev S., Trunin I., Chetverikov S., Vigno M. (2005) "Reforma fiskalnogo federalizma v Rossiii: problema myagkikh budgetnykh ogranicheniy regionalnykh vlastey". CEPRA, M., IEPP, 2005.*

¹⁷⁹ Theoretically, there may arise a situation when the considered below equilibrium and optimal values of expenditures and tax revenues would become attainable under zero

The given kind of the utility function constitutes a general one for all the models in question. As to the models in which post-election the federal center reflects preferences of the federal median voter under fixed regional taxes, the respective utility function of the federal center appears substantially simplified and it can be put down as follows:

$$U = U^{FMV} \left(\underbrace{E_F, Y_F - T_F - \bar{T}_R}_{+} \right) \xrightarrow{E_F, T_F} \max \quad (26)$$

The utility function of the federal center is used at the elections of the center; and in the event the federal center consequently pursues its post-election behavior that maximizes public welfare, the maximization is carried out for the more general function presented above.

The general problem of maximization of the regional governments' utility function is solved under a budget constraint when expenditures on the federal public goods delivery may not exceed its revenues (or revenues less the federal financial assistance, in the case the latter has been allocated):

$$E_F = T_F - \sum_{i=1}^N G_i, \quad E_F, T_F, G_i \geq 0 \quad (27)$$

where

T_F – tax revenues to the federal budget per capita;

G_i – volume of financial assistance to i region per capita (as above, we suggest that the financial assistance allocated to regions is positive, particularly in the equilibriums below) for models A1 and A2 is $G_i=0$, due to the assumption of the absence of financial assistance.

values of the federal financial assistance, but while conducting our analysis below, we suggest such situations do not arise.

3.3. Modeling the Financial Behavior of the Regional Governments after the Changes of the Political Structure of the Russian Federation

In the case of elected regional governments in model A1 (the absence of biases from preferences of the median voter after elections) the final values of the federal and regional expenditures, as noted above, will form an equilibrium as a result of the strategic interaction, with both the federal center and regional governors reflecting preferences of the federal and regional median voters, respectively.

Meanwhile, in the equilibrium the choice of the federal center and regional governments should be determined proceeding from the condition of optimality of federal expenditures for the federal center under preset regional expenditures, while for the regional governments – under preset federal expenditures (according to the assumption, there is no federal financial assistance in this model). The respective conditions for the equilibrium with the **elected governor** can be put down as follows (model A1):

FOC of the federal median voter:

$$\frac{\partial u_F^{MV}(E_F, \overline{E_R}, Y_F - T_F - \overline{T_R})}{\partial E_F} = - \frac{\partial u_F^{MV}(E_F, \overline{E_R}, Y_F - T_F - \overline{T_R})}{\partial T_F}.$$

FOC of the regional median voter:

$$\frac{\partial u_i^{MV}(\overline{E_F}, E_i, Y_i - \overline{T_F} - T_i)}{\partial E_i} = - \frac{\partial u_i^{MV}(\overline{E_F}, E_i, Y_i - \overline{T_F} - T_i)}{\partial T_i}.$$

The above conditions, with account of budgetary constraints, allow one to find functions of the federal and regional governments' responses to elections of each other. Then, by solving the respective system of equations, one can arrive at equilibrium expenditure values on each level of government which are attained at the point of intersection of the response curves which are set by the following functions of the mutual cor-

relation between the federal center’s expenditures and those of the regional governments and vice versa:

$$\begin{cases} E_F^* = E_F(E_R^*, Y_F) \\ E_R^* = E_R(E_F^*, Y_i) \end{cases}$$

The federal center sets levels of federal expenditures and taxes in such a manner so that the marginal utility of the federal median voter from an increase in the federal expenditures would equal the marginal utility from a reduction in the federal taxes. Meanwhile, in every region the governor picks levels of expenditures and taxes in such a way so that the marginal utility from an increase of the expenditures equals the marginal utility from the tax cuts for their median voter.

Transition to appointment of the regional governments. To have the model reflect modifications in the system of the political structure, let us assume that in the event regional governors are appointed, they reflect the federal center’s preferences. At this point, it should be specified that reflecting the center’s preferences in this case means that once appointed, governors would opt for the same volumes of regional taxes and regional expenditures as the federal center (the federal median voter) does under given expenditures of the region.

If the regions’ revenues are the same¹⁸⁰, in the event the federal government appoints governors in all the regions, they set in all of them the same level of expenditures and taxes that reflects the median voter’s preferences with regard to regional goods by the Federation on the whole.

Accordingly, the optimal volumes of federal and regional public goods with the **appointed governor** in place can be gotten from the fulfillment of conditions of equality between the respective marginal utilities. Whereas in this particular case the federal government’s preferences with respect to the federal and regional goods match preferences of the same federal median voter, the decision is made simultaneously, i.e. to

¹⁸⁰ This prerequisite is also permissible for regions with different revenues, providing one makes an additional assumption that *ad interim* the regions’ revenues have been equalized as a result of introduction of non-targeted equalization grants.

match conditions of maximization of the federal center's (federal median voter) utility, one equals marginal utilities from taxes with the regional and federal public goods delivery:

$$\begin{aligned} \frac{\partial u_F^{MV}(E_F, E_R, Y_F - (T_F + T_R))}{\partial E_F} &= - \frac{\partial u_F^{MV}(E_F, E_R, Y_F - (T_F + T_R))}{\partial (T_F + T_R)} = \\ &= \frac{\partial u_F^{MV}(E_F, E_R, Y_F - (T_F + T_R))}{\partial E_R}; \end{aligned} \tag{28}$$

Let us consider modifications of the presented model with the respective modifications of the federal center's utility function (4):

Maximization of public welfare (models B1-C1). Let us assume that post-election, keen to boost up public welfare, the federal center biases from the federal median voter's preferences; that is, despite the fact that as a result of the elections its utility function is formed according to the federal median voter's preferences, its post-election financial policy is pursued proceeding from a solution of the problem of maximization of public welfare, i.e. maximization of the utility function of the following form (problem B1):

$$\begin{aligned} U &= U(u_F^{MV}(E_F, E_R, Y_F - T_F - T_R), u_1^{reg}(E_F, E_1, Y_1 - T_F - T_1), \dots, u_N^{reg}(E_F, E_N, Y_N - T_F - T_N)) \\ &\rightarrow \max_{E_F, T_F, G_1, \dots, G_N} \\ \text{s.t. } E_F &= T_F - \sum_{i=1}^N G_i \end{aligned} \tag{29}$$

In this case expenditure volumes on the federal and regional levels are identified proceeding from the solution of the problem of the federal center, which identifies the said expenditure volumes proceeding from conditions of optimality while solving the given problem and equalizing utilities of the provision of private goods (disutility of collection of regional taxes) and expenditures within each region. The possibility for equalization of the utility between expenditures (taxes) on the regional and federal

levels in this case depends on whether given regional governments are elected or appointed.

In the event the regional governments are **elected**, having formed its preferences according to the elections outcomes, post-election, the federal center organizes a system of grants, which is aimed at increasing public welfare (but which does not necessarily guarantee that the federal center will be elected, should it be included in the election agenda). Meanwhile, having received respective (non-targeted) grants, the elected regional governments pick regional tax revenues and expenditures according to the regional median voter's preferences, which ultimately may not necessarily match the values calculated by the federal center as a result of maximization, in the event their preferences differ from the ones the federal center suggests. The respective expenditure values are calculated proceeding from the following conditions of equality of marginal utilities at each level (by each of them individually)¹⁸¹:

$$\begin{aligned} \frac{\partial u_F^{MV}(E_F, \bar{E}_R, Y_F - T_F - \bar{T}_R)}{\partial E_F} &= - \frac{\partial u_F^{MV}(E_F, \bar{E}_R, Y_F - T_F - \bar{T}_R)}{\partial T_F} = \\ &= \frac{\partial u_i^{reg}(E_F, \bar{E}_i, Y_i - \bar{T}_F - T_i)}{\partial E_i}; \\ \frac{\partial u_i^{MV}(\bar{E}_F, E_i, Y_i - \bar{T}_F - T_i)}{\partial E_i} &= - \frac{\partial u_i^{MV}(\bar{E}_F, E_i, Y_i - \bar{T}_F - T_i)}{\partial T_i}. \end{aligned} \quad (30)$$

Once governors are no longer elected but **appointed**, opting for respective levels of the federal assistance, the federal government set expenditures and taxes in every region at a publicly optimal level. In this case, after elections, the marginal utilities from the financing of expenditures and tax collection are simultaneously equalized at all the levels. Ac-

¹⁸¹ A similar by its structure model was considered in: *Kadochnikov P., Sinelnikov-Murylev S., Trunin I., Chetverikov S., Vigno M. (2005), "Reforma fiskalnogo federalizma v Rossiii: problema myagkikh budgetnykh ogranicheniy regionalnykh vlastey.*

cordingly, the final expenditure values can be calculated proceeding from the following conditions:

$$\begin{aligned} \frac{\partial u_F^{MV}(E_F, \overline{E_R}, Y_F - T_F - \overline{T_R})}{\partial E_F} &= - \frac{\partial u_F^{MV}(E_F, \overline{E_R}, Y_F - T_F - \overline{T_R})}{\partial T_F} = \\ &= \frac{\partial u_i^{reg}(E_F, E_i, Y_i - \overline{T_F} - T_i)}{\partial E_i} = - \frac{\partial u_i^{reg}(E_F, E_i, Y_i - \overline{T_F} - T_i)}{\partial T_i}, \end{aligned} \quad (31)$$

In the frame of the model in question it is suggested that the given conditions secure the attainment of the public optimum (providing that the utility function of the federal center is the public welfare function), while an increase of the efficiency is secured by equalization of marginal utilities from the financing of expenditures on the federal and regional levels by virtue of redistribution. It can be noted that in this case the transition to the appointments system does not result in any decline in the welfare, but at best leads to its increase. Meanwhile, it should be taken into account that an erratic identification of volumes of the federal and regional taxes and financial assistance would result in a failure to reach the optimum and, under certain conditions, may contribute to a decline in welfare vis-à-vis the original level (welfare in the conditions of elections).

With externalities from provision of public goods at the regional level in place, the respective public welfare function maximized by the federal center can be put down as follows:

$$U = U(v_F^{Ext}(E_F, E_R, Y_F - T_F - T_R, E_1, \dots, E_n), u_1^{reg}(E_F, E_1, Y_1 - T_F - T_1), \dots, u_N^{reg}(E_F, E_N, Y_N - T_F - T_N)) \rightarrow \max_{E_F, T_F, G_1, \dots, G_N}$$

$$\frac{\partial v_F^{Ext}}{\partial E_F} = \frac{\partial u_F^{MV}}{\partial E_F}, \quad \frac{\partial v_F^{Ext}}{\partial E_i} > 0 \quad \text{для } i = 1..N \quad (32)$$

As for the rest, this problem (C1) appears analogous to the problem of maximization of public welfare (B1) – the federal center identifies the volume of financial assistance which in this case should be greater, given the regional externalities are positive; the elected governors identify the volume of regional expenditures proceeding from the regional median voter’s preferences. The transition to appointed governors in this case means that publicly optimal (with account of externalities) expenditure volumes will be set at the regional level.

The post-election behavior of regional governments: red tape’s preferences.

Let us consider the modification of the presented model which suggests that the regional governments’ post-election preferences do not reflect those of the regional median voter, but red tape’s preferences which, according to Niskanen’s hypothesis¹⁸², are characterized with a greater marginal utility of regional expenditures:

$$u_i = v_i^B (E_i, Y_i - \overline{T}_F - T_i) \rightarrow \max_{E_i, T_i}, \frac{\partial v_i^B}{\partial E_i} > \frac{\partial u_i^{MV}}{\partial E_i} \text{ under} \tag{33}$$

the unchanged E_i and T_i

The result of the strategic interaction between the federal government with such a governor (in model A2) or identification of regional expenditures proceeding from the allocated financial relief (models B2 and C2) will be greater regional budget expenditures, because of a greater marginal utility of expenditures.

Clearly, the transition to the practice of appointing governors in this case will be characterized by convergence between the volume of regional expenditures and the federal median voter’s preferences or a public optimum, provided the federal center has tackled the respective problem of maximization.

The final results of the analysis and a comparison between theoretical models are presented in *Table 3.2*.

¹⁸² See: *Niskanen, 1968*.

Table 3.2

Changes in the Level of Welfare as a Result of the Switchover from Election to Appointment of Heads of Executive Authority in Regions

	1. Switchover from election of regional governments, reflecting preferences of (regional) median voter, to their appointment from center	2. Switchover from election of regional governments, reflecting preferences of bureaucracy, to their appointment from center
A. Federal center reflects utility of federal median voter	<p>In case of one region: the same situation remains in face of changed method of interaction (in situation of appointment there is no strategic interaction, which in situation of election does, however, occur)</p> <p>In case of several regions: diminished advantages that were achieved through decentralized decision-making in each region, except in region where federal median voter resides, decline of aggregate well-being in society</p>	<p>Growth of well-being resulting from switchover to appointment, due to smaller decreases resulting from overestimation of regional budget by governors.</p> <p>Lowering of public well-being due to equalization of volumes of regional benefits between regions</p>
B. Federal center maximizes public well-being with redistributions of funds between regions	Growth of public well-being due to (possibility) of choice of socially optimal levels of federal and regional expenditures and taxes and through redistributions of funds between regions	Growth of public well-being due to choice of socially optimal levels of expenditure and taxes, redistributions of regions' revenues and through imposing limits on overestimation of expenditure by bureaucracy
C. Federal center maximizes public well-being by taking into account external factors with redistributions of funds between regions	Growth of public well-being due to choice of socially optimal levels of expenditure and taxes, redistributions of funds between regions, as well as to taking into account external factors when choice of centralized.	Growth of public well-being due to choice of socially optimal levels of expenditure and taxes, redistributions of regions' revenues with taking into account external factors, and restricted overestimation of expenditure by bureaucracy

Our theoretical analysis has led to several conclusions. In a situation when federal and regional governments reflect the preferences of federal and regional median voters, respectively, the switchover from election to appointment has the following two peculiar features. Firstly, it is the changed character of interaction between the federal center and regional

governments – there occurs a transition from a strategic interaction between federal and regional governments acting in their own interests to an optimization of the choice of financial policy in accordance with the preferences of federal government. Such a transition may improve the efficiency of the allocation of resources, if prior to reform the elective regional governments used to reflect the preferences of the bureaucracy.

Besides, the switchover to governor appointment makes it possible to raise the level of public well-being through providing opportunities for taking external factors into account when implementing a financial policy, as well as for redistributing resources between regions in order to maximize public well-being. And the growth of public well-being will be higher to the same degree as the regional governments will lower the degree to which they reflect the preferences of median voter, e.g., because of the fact of the bureaucracy having their own interests. In other words, as a result of the switchover from election to appointment of governors, the change in the level of public well-being will depend on whether the decline in well-being becomes more marked due to centralized decision-making, or its growth is due to a decreased influence of the interests of the bureaucracy or to the approximation of public well-being to the optimum level through the redistribution of resources between regions and to taking into account the external factors given rise to by the provision of regional public benefits.

Of course, such conclusions can only be justified when several preconditions for such theoretical analysis are complied with. The first one is that the federal center reflects the preferences of median federal voter or makes decisions while maximizing the function of public well-being, that is, the preferences of the federal center are formed as a result of the existence of a certain sufficiently well-developed procedure for aggregating the individual preferences of citizens. The second one is that an appointed governor should have the same preferences as the federal center, while the center may efficiently control a governor's activities and correct them if the policy being implemented is not compatible with the center's preferences. And the third one is that the function itself of public well-being does not depend on the presence or absence of the procedure for a democratic election of regional governments.

4. An Empirical Analysis of the Reform Results

4.1. The Main Hypotheses for the Changes in the Financial Behavior of Regional Governments

The theoretical analysis, presented in the previous section, of the changes that took place within Russia's political establishment in 2005 has made it possible to describe certain potential changes in the financial policies of the regions that could have resulted from the completed reform of the Russian Federation's political system, and to formulate certain hypotheses to be tested empirically. In this section these hypotheses are presented in a structured form and are worded more precisely, for purposes of subsequent empirical testing with due regard for the specific features of the available statistics, including the actual financial indices of regional budgets established for the Russian regions. As has been noted earlier, the year 2005, alongside certain changes in the political system, also saw the redistribution of powers between federal and regional governments. Therefore, while discussing the changes in the financial behavior of regional governments produced by reform, we are going to assess the general consequences of the changes that have been made.

One of the most important prerequisites of our theoretical analysis is the fulfillment of the hypothesis that the behavior of elective federal and regional governments, in absence of any discord between the policy being actually implemented and the declared electoral programs, does, in fact, reflect the preferences of federal and regional median voters, respectively. The results of preliminary estimations and the comparison of models applying, instead of the income of a region's average citizen (as described by average income per capita, gross regional product per capita or tax revenues per capita), the income of a median voter per capita have demonstrated that the application of median voter's revenues yields slightly better results, which, however, show no statistically significant

difference from the results yielded by the model incorporating average incomes.

In this connection, considering that the coefficients applied to such variables demonstrate no statistically significant changes, either, while the by-region correlation between average incomes and the median voter's incomes amounts to more than 90 % (depending on a given year), we finally applied average incomes (per capita), in order to avoid making the empirical models too complex. We also assume that the achieved results do not contradict the hypothesis that the preferences of elective regional governments conform with the preferences of the median voter.

From the theoretical considerations discussed in our overview of literature on the subject and in the theoretical analysis in the previous section it follows that when regional governments are elective, the necessity to demonstrate that the policy being implemented conforms to the preferences of voters (including instances when the bureaucracy also have their own preferences) may give rise to certain political cycles in the dynamics of expenditures: in order to win voters' support, the key expenditure items in regional budgets most relevant for voters (public health care, education, etc.) begin to grow as the date of an election is approaching. Thus, the hypothesis can be formulated as follows: **as the time of the governor election becomes nearer, certain expenditure items and aggregate expenditure in regional budgets grow (that is, there exists a negative dependence of expenditure on the timespans before the next election of a regional governor).**

When describing the activity of the bureaucracy resulting from the switchover from election to appointment of regional governments, it is also necessary to take into consideration those indices that are characteristic of a governor's tenure of office. For this purpose the model incorporated the variable of a governor's tenure of office (number of months). In this connection we assume that, in accordance with Niskanen's hypothesis, all other conditions being equal, the longer a governor's tenure of office, the higher the expenditure of a regional budget¹⁸³.

¹⁸³ The other facet of the bureaucratic preferences of regional authorities can be represented by their acting in favor of groups with specific interests. In this case it can be assumed that the presence of such groups, e.g., a high share of a certain branch in total re-

One more hypothesis following from the theoretical analysis states that there has occurred an equalization of certain expenditure items in regional budgets between regions as a result of the switchover from election to appointment of regional governments. Such an equalization in a theoretical model of similar regions implies equalized expenditure levels. In actual practice, considering the differentiation of Russian regions, we are going to assume that there occurs an equalization of the financing of expenditures with due regard for the differences between regions produced by their different objective parameters (the demographic structure of population, availability of appropriate infrastructure, the number of those employed in the budget-funded sector, etc.).

Such an equalization implies that, resulting from the switchover from election to appointment of regional governments, **the regional expenditures allocated to certain budget items will, as before, depend on the parameters characterizing regional differences, while at the same time their dependence on their revenue proper and financial assistance will be diminishing.** In other words, the appointed governors, in order to not to lose their post and to receive the support of the federal center, will allocate priority funds to those expenditure items that are most relevant for the federal center, primarily public education, health care, housing and utilities, which, in fact, overlap the areas covered by the currently adopted national projects, no matter what the revenues proper of regional budgets may be. This means that it can be assumed that these expenditure items will become less dependent on tax revenues proper as a result of reform.

In this connection, two circumstances must be pointed out. Firstly, in a situation of economic growth the revenues proper of regional budgets (in real terms) grow, and accordingly grow the opportunities for funding various items of expenditure and becomes more narrow the gap between the actual and basically sufficient level of financing. Therefore, in respect of the dependence of regional budget expenditure on tax revenues, the

gional output, will result in allocating increased expenditures to certain items for the benefit of a given group. After the switchover to appointment this effect should diminish, because the support from such groups becomes less relevant than the support from the federal center.

saturation effect may be observed, i.e., a situation when, as revenues grow, an increasingly diminishing part of this increment is being used for financing the expenditures on certain items. In other words, in a situation of growing budget revenues there may be observed a gradual decline in the dependence of certain expenditure items on tax revenues, resulting from the financing of other areas of expenditure (including capital expenditures). Thus, we believe that as time passes such a decline may indeed occur. At the same time, resulting from reform of the political system in 2004–2005, a substantial additional reduction in the dependence on tax revenues of those expenditures items that are relevant for the federal center items (health care, public education, housing and utilities) may also take place, due to a one-time shift in the priorities of expenditure allocation.

Secondly, in order to secure the achievement of the federal center's priorities, and national projects in particular, the federal center may provide additional financial support by increasing the amounts of allocated financing. Accordingly, in a situation when regions are striving to implement the priorities of the federal center, this will result in funding being spent on the implementation of national projects. That is, in this case it can be expected that **as a result of the implementation of reform of the political system the expenditures on health care, public education, and housing and utilities will become more and more dependent on federal financial support.**

As noted earlier, in order to reveal the existence of the equalization of certain socially significant expenditures, it not enough simply to compare the level and dispersion of expenditure between different items across regions. In our expenditure model the indices are broken into those describing the budgetary network, as well as those characterizing the conditions of granting public benefits, and secondly, the indices describing a region's endowment with its own revenues and financial assistance. The differences in the parameters of the budgetary network and the levels of demand for public benefits result in a situation when even those regions that are equally endowed with revenues will have different indices of expenditures. As a result, the estimation of the degree of diminished dependence of expenditures on regions' own revenues requires that an

econometric model should be specified according to all the listed factors, with a by-year analysis of changes in the coefficients applied to tax revenues and financial assistance. It should be noted once again that the considerations discussed here are not contradictory to budget identity, because the overall changes in the coefficients applied to tax revenues and financial assistance earmarked for those expenditure items for which it was possible to build models (among which there are nearly all the expenditure items of priority significance for the federal center), imply changes in the opposite direction of all those other expenditure items for which no models with satisfactory explanatory properties could be built. Consequently, as before, a single coefficient must be applied to aggregate expenditures when demonstrating their dependence on tax revenues and financial assistance (with due regard for potential differences in identity arising from the financing of deficit or surplus).

The hypotheses described above concerning the diminishing dependence (or coefficient) of those expenditure items that are of priority significance for the federal center (public health care, public education, the housing and utilities sector) on tax revenues, and their increasing dependence (or growing coefficient) on federal financial assistance, actually imply that changes in the political system produced a change in regional governments' priorities regarding the financing of expenditures. If in a situation of elective regional governments priorities used to be determined individually for each governor (it can be assumed that priority financing of state administration expenditures was a general trend characterizing all elective governors), after the switchover to the appointment procedure they have begun to regard as priority those expenditure items that are of priority significance for the center, and in particular those addressed by federal national projects, – public health care, public education, and the housing and utilities sector. Consequently, it can be expected that resulting from the reforming of the political system the financing of these expenditure items will be organized as a priority procedure – firstly, independently of regional revenues proper, and secondly, by allocating to these items a higher portion of federal financial assistance than prior to reform.

In addition to the theoretical models based on our overview, coupled with our theoretical analysis of the hypotheses that the dynamic of expenditure becomes less cyclic in nature and that those expenditure items that have priority significance for the federal center become equalized across regions after the switchover to the appointment of governors, we can also present several hypotheses based on the actual peculiarities of the interaction between governors and federal government. Among the factors shaping the financial policy of a region, we may point to a governor's alliance with a pro-government party. In this connection, we assume that, in order to secure support for a pro-government party or the president during a federal election, the governors belonging to the same party were increasing the expenditure of regional budgets. In other words, **a governor's membership in a pro-government party may induce an increase of regional budget expenditure.** In order to test this hypothesis, we inserted into models for each year a dummy variable equal to 1 if governors belonged to a pro-government party, which was then excluded in those instances where the corresponding coefficient was found to be insignificant. In this connection it was assumed that the noted effect of expenditure growth was most prominent in those years when federal elections took place, or in the immediately preceding years.

It is also necessary to single out one more group of factors influencing the behavior of regional governments. The switchover from election to appointment of governors resulted in the priorities of the federal center becoming those of regional governments, namely (beside the equalization of expenditures) the stability of the social and political situation, a decreased number of instances of civil disobedience, the coordination of decisions being made by regional governments with the federal center's policy (as demonstrated, for example, by the number of acts adopted by regional governments and abolished by the procuracy), the implementation of certain, sometimes unpopular, reforms, etc. Regretfully, the non-financial character of certain behaviors, as well as the insufficiently long period of observation, made it impossible to obtain adequate empirical results within the framework of the specific models applied in our study. Accordingly, no such hypotheses have been tested within the framework of this study.

It should also be taken into consideration that the switchover to the procedure of governor appointment took place in the second half of the year 2004, while the first governors were actually appointed only as late as 2005. This means that the first regional budgets approved by appointed governors and reflecting their financial policies appeared in 2006. As of the moment of the preparation of this study, the statistical data on the execution of regional budgets, with final turnover indices, was not yet available, and so the period of assessment is limited by the year 2005. Therefore, in order to assess the financial consequences of the switchover from election to appointment of governors we applied the assumption that the adopted changes in the political establishment were implemented by regions immediately after the declaration that reform should be carried out, that is, during the preparation, adoption and execution of the 2005 budgets.

The financial indices of regions tested in the course of empirical analysis were also influenced by many other factors, e.g., economic growth and growth of regions' revenues, legislative changes¹⁸⁴, etc. Nevertheless, we believe that it is the switchover from election to appointment of regional governments that largely influenced both the variables applies in our estimations and those changes in the financial behavior that could actually be observed.

4.2. The Specification of Econometric Models and the Data Description

For purposes of testing the discussed hypotheses we are going to apply, wherever possible, the systems of equations describing the interconnections between the specific expenditure of regional budgets and the volumes of public benefits actually provided to the population. Besides,

¹⁸⁴ Resulting from the coming into force, from 1 January 2005, of Federal Law No. 122-FZ, changes were introduced into more than 150 legislative acts addressing the issues of social policy, remuneration of labor, public education and science, public health care, physical culture and sport, culture and the mass media; the use of natural resources and environment protection, the protection of population from emergency situations; national defense and security; development of infrastructure and support to certain branches of the national economy, etc.

when building expenditure models, the characteristics of the volumes of provided public benefits may in some instances be approximated by indices describing results or the demands for such benefits (population morbidity, crime level, etc.)¹⁸⁵. Similarly to the methodology applied in our previous works, for expenditure modeling we are going to use the estimations of systems of equations that look as follows:

$$\begin{cases} E_{ij} = e_j(G_{ij}, T_i, Tr_i, \bar{X}_i, \bar{Z}_i) + \varepsilon_{ij}^E \\ G_{ij} = g_j(E_{ij}, \bar{X}_i) + \varepsilon_{ij}^G \end{cases}, i = 1, \dots, n; j = 1, \dots, m;$$

where

I – a region’s number;

J – number of expenditure item (or public benefit);

E_{ij} – cash expenditures;

G_{ij} – volume of a public benefit provided;

T_i – tax revenues of a regional budget;

Tr_i – financial assistance;

\bar{X}_i – factors characterizing the differentiation of regions by the indices of budget network sufficiency, demographic peculiarities, etc.;

\bar{Z}_i – political and economic factors influencing expenditure volume.

The corresponding estimations were made for the following expenditure items of the budgets of the Federation’s subjects:

- expenditures on public health care;
- expenditures on public education;
- expenditures on general state issues;
- expenditures on law-enforcement activity;
- expenditures on housing and utilities;
- expenditures on social policy.

These expenditure items in regional budgets correspond to the new budget classification, introduced from the year 2005 onward. For purposes of accounting, in according with the new classification, and also in

¹⁸⁵ See *Kadochnikov, Sinelnikov, Trutin, 2002*.

order to bring the data recorded under the old budget classification in conformity with the new one, we applied the compatibility table based on the data published by the RF Ministry of Finance (see Annex). For purposes of compatibility, each subsection of the old classification was correlated with the corresponding subsection of the new one, and then all the subsections of the new classification were aggregated into sections in accordance with the new classification¹⁸⁶.

The estimations in respect of expenditures on public health care and public education, as well as expenditures on culture, cinematography and the mass media, were done in the form of the system of equations presented above. No such systems of simultaneous equations could be built for other expenditure items (expenditures on general state issues, expenditures on national security and law-enforcement activity, expenditures on the housing and utilities sector, or on social policy), or for aggregate expenditure, and so a single econometric equation was estimated (the first equation of the dependence of expenditures on tax revenues, financial assistance and other factors).

Cost variables, designed to eliminate interregional differences for each region, were applied in values per capita and adjusted for differences in prices on the basis of a fixed basket of goods and services, by year and by region, which made it possible to eliminate the interregional differentia-

¹⁸⁶ It should also be noted that the subsection "Operation of executive bodies of state authority", which prior to 2005 was included only in the section "State administration and local self-government", from the beginning of 2005 has become part of every section of the new functional classification. The subsection "Development of prospective technologies and priority areas of scientific and technological progress" prior to 2005 was included only in the section "Fundamental research and promotion of scientific and technological progress", while from 2005 onward it has also been incorporated into each section. The subsection "International cooperation" prior to 2005 was included only in the section "International activity", while from 2005 onward it is no more part of "International relations and international cooperation" (into which a whole section has been transformed), but is incorporated into the majority of the other sections. In such instances, when one and the same subsection from the old classification has become part of several sections of the new one, and no statistics was available on the basis of which the expenditures from a subsection of the old classification could be distributed among the sections of the new one, we distributed that subsection in equal shares among all those sections of the new classification which, according to the compatibility table, incorporate that subsection.

tion in prices, as well as to make adjustments for their overall growth every year.

Our computations were based on panel data for the years 1999–2005 on 88 regions of the Russian Federation (with the exception of Chechen Republic), as well as on the data on the aggregate financial assistance received from the federal budget derived from the reports of the Ministry of Finance of the Russian Federation on the execution of regional budgets, while the other statistical information was taken from open publications of the Federal Statistics Service of the Russian Federation and the annual collection “Regiony Rossii” (“The Regions of Russia”).

When building the expenditure models, it was assumed that the main factors incorporated in the models built for each of specific expenditure items comprised the following groups of indices. Firstly, these were the factors characterizing the development of the budgetary network: the numbers of schools, hospitals, pre-school institutions, libraries, the numbers of their personnel, etc. Secondly, expenditures are influenced by demographic factors and the population spread factors – the share of urban populations, as well as the share of population older or younger than the employment age. Thirdly, budget expenditures are influenced by budget revenues, including tax revenues proper and federal financial assistance. Fourthly, the volume of budget expenditure is influenced by political factors – the period of time remaining until the next election/appointment of a governor, a governor’s tenure of office, or a governor’s membership in a pro-government party.

As explanatory, in the equation of the volume of public benefits provided to the population in regions, the following variables were applied:

Variables describing the education levels in regions (higher values of these indices produce higher values of expenditure indices in a given region):

- Number of public daytime comprehensive educational establishments, per 1000 residents of a region.
- Number of children in pre-school institutions, per 1000 residents of a region.
- Number of students at educational establishments for primary vocational training, per 1000 residents of a region.

- Number of students at state secondary specialized educational establishments per one resident of a region.
- Number of students at public daytime comprehensive educational establishments, per 1000 residents of a region.
- Number of pre-school institutions, per 1000 residents of a region.
- Number of educational establishments for primary vocational training, per 1000 residents of a region.
- Number of state secondary specialized educational establishments, per 1000 residents of a region.
- Number of daytime comprehensive educational establishments, per 1000 residents of a region.

Variables describing the level of providing public health care services in regions (higher values of these indices produce higher values of expenditure indices in a given region):

- Number of hospital beds, per 1000 residents of a region.
- Number of physicians of all specialties, per 1000 residents of a region.
- Number of nursing staff, per 1000 residents of a region.

Variables describing the culture development level in regions (higher values of these indices produce higher values of expenditure indices in a given region):

- Number of publicly available book copies in libraries, per 1000 residents of a region.

Variables describing the level of transport services (higher values of these indices produce higher values of expenditure indices in a given region):

- Number of public buses, per 100,000 population.
- Number of passenger operations by public buses, per one resident of a region (in thousands of passenger operations).

The population's demographic structure was described by applying the following variables:

- The percentage of persons aged older than the employment age in a region's overall population number (it can be expected that this variable will have a positive effect on regional budget expenditures, be-

cause pensioners enjoy numerous privileges. For example, an increased number of senior persons who use free-of-charge transport services results in transport expenditure growth, to be compensated from the regional budget¹⁸⁷).

- The percentage of urban population in a region's overall population number (the introduction of this variable into an expenditure model makes it possible to explain the differences between the levels of budget expenditures in those regions where rural population prevails and those with the prevalence of urban population; in this connection, it can be expected that an increased share of urban population in a region's overall population results, in a majority of cases, in diminished average per capita regional expenditures due to the effect of scale: however, considering that rural residents consume certain services (housing and utilities, transport) to a lesser degree than urban residents, a positive dependence can be expected between the share of urban population and these types of expenditures).

The model also incorporated indices reflecting a region's endowment with revenues (the higher is the revenue level in a region, the higher are the expenditures under separate items (public education, public health care, housing and utilities), with due regard for the hypothesis stating that this type of influence should diminish with the switchover from election to appointment of governors:

- Regional budget tax revenues per capita.
- Aggregate federal financial assistance, including transfers, subsidies, subventions and funding received by way of setoffs, per one resident of a region.

Besides, the model incorporated indices reflecting *political factors* (these hypotheses have been discussed earlier):

- Period of time remaining until the next election/appointment of a governor, in months elapsed from a year's beginning (the shorter is the period until the next election/appointment, the higher are expenditures if a governor is elected).

¹⁸⁷ Such considerations are not applicable to a later period, when in 2005 the monetization of privileges was introduced.

- A governor's tenure of office (a longer period corresponds to a more concentrated increase of those expenditure items that help to win the highest support).
- A governor's membership in a pro-government party – dummy variable (for those regions whose governors belong to the pro-government party, the relevant expenditure items of regional budgets tend to increase in those years when federal election is held and the immediately preceding years).

The expenditure model also incorporated the variable reflecting the number of population in a region. It can be expected that, as the population grows, the per capita expenditures of a regional budget should decline due to the effect of scale.

The data applied are structured as panels, and consequently, in the study's first phase, after the pooling of all the regions and all years into a general panel, the tests for revealing the significance of individual and fixed effects were performed, the results of which pointed to the necessity of their separation. The assessments of the models presented below for the whole period of 1999–2005, based on panel data with single angular coefficients and individual fixed and time effects, have demonstrated the models' unsatisfactory explanatory properties of for all expenditure items, where the majority of coefficients have been found to be insignificant.

With due regard for the existing structural shifts and other changes in the financial policies of regional governments and the federal center relating to the rules for the allocation of financial assistance and the consolidation of the main taxes, tests were performed in order to view the possibility of uniting into a panel the data relating to separate years (general F-test for equality of angular coefficients between neighboring years, where time effects could be different). On the basis of the tests' results (which are shown below for all the expenditure items discussed here), it was noted that nearly in all the models for the majority of years the hypothesis concerning the equality of angular coefficient between neighboring years was rejected, and only in some instances the pairs of neighboring years could be pooled into panels.

Considering the obtained results of the testing of the equality of coefficients between years, with break-up of the panel into separate years, the resulting systems of equations were assessed separately for each year¹⁸⁸. In those instances when the results of tests pointed to the possibility of pooling neighboring years into a panel, the models were assessed on the basis of panel data for the related 2 or 3 years, with the separation of time effects and individual fixed effects and the pooling of angular coefficients in accordance with the results of testing.

4.3. Results of the Econometric Estimation of Regional Budget Expenditure Models

4.3.1. Expenditures on Public Health Care

When modeling the expenditures on public health care (the item's full title is "Expenditures on Public Health Care and Sport") in the form of a system of simultaneous equations, the number of nursing staff (per capita) was applied as the variable describing the volume of public benefits being provided to the population.

In the equation for expenditures on public health care the tax revenues of a regional budget, financial assistance and the availability of nursing staff were applied as explanatory variables (it is assumed that all these variable have a positive effect on the expenditures on public health care). In addition to these indices, in the preliminary estimations some other variables describing the development level of the budgetary network were also applied: the capacity of outpatient medical institutions, the number of hospital beds, the number of visits to outpatient clinics, as well as the indices describing the demographic situation in a region – the share of population aged younger and older than the employment age, birth rate, mortality, etc. Besides, some indices describing political factors were applied.

¹⁸⁸ The assessment of such systems (or equations) in econometric packages is also hindered by a number of technical problems, arising not only from the panel structure of the data, but also from the necessity to apply dummy variables, whose overall number in this case varies from approximately 25 to 60.

In the second equation, as the explanatory variables for the number of nursing staff in addition to the constant, the expenditures of a regional budget on public health care, morbidity rate (in regions where the morbidity rate is higher the demand for nursing staff is greater), as well as the average wage level in a region, were applied as indices describing the benefits associated with employment in the private sector.

In the model of expenditures on public health care, on the basis of the results of preliminary estimations and the testing of the equality of coefficients between years (the hypothesis concerning the equality of all angular coefficients, where time effects could be different), the years 2001–2002 and 2003–2004 were pooled. The hypothesis as to the equality of coefficients between other pairs of years was rejected (see the table).

Table 4.1

**Results of Wald Test Applied to the Equality of Coefficients
between Years for Expenditures on Public
Health Care and Sport**

	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05
F-statistic	2.465	3.018	0.250	1.855	1.556	40.218
Probability	0.021	0.006	0.972	0.082	0.154	0.000
Chi-square	17.257	21.125	1.748	12.988	10.893	281.528
Probability	0.016	0.004	0.973	0.072	0.143	0.000

According to the results of preliminary estimations, in the model of expenditures on public health care and sport, in addition to the tax revenues proper of a regional budget and financial assistance, the following insides were found to be significant: the availability of nursing staff, morbidity, average wage level, the share of urban population, the number of months before election/appointment, the governor’s tenure of office, and a dummy variable equal to 1 if the governor is a member of a pro-government party.

Table 4.2

Results of Testing the Public Health Care Expenditure Model

Equation for expenditures on public health care					
Assessment period	1999	2000	2001-2002	2003-2004	2005
Constant	-0.309 (0.021) ¹⁸⁹	-0.118 (0.363)	-0.094 (0.187)	-0.146 (0.048)	-0.853 (0.013)
Tax revenues of regional budget	0.090 (0.000)	0.121 (0.000)	0.102 (0.000)	0.107 (0.000)	0.028 (0.000)
Financial assistance	0.080 (0.000)	0.094 (0.000)	0.111 (0.000)	0.100 (0.000)	0.150 (0.000)
Availability of nursing staff	0.062 (0.000)	0.056 (0.000)	0.043 (0.000)	0.045 (0.000)	0.010 (0.004)
Share of urban population		-0.004 (0.003)			0.070 (0.004)
Number of months before election/appointment			-0.0003 (0.003)		
Governor's tenure of office (in months)				-0.001 (0.008)	
Governor's membership in pro-government party			0.051 (0.088)	0.059 (0.009)	
R², adjusted	0.754	0.927	0.909	0.889	0.980
Equation for availability of nursing staff					
Assessment period	1999	2000	2001-2002	2003-2004	2005
Constant	7.486 (0.000)	8.60405 (0.000)	7.692 (0.000)	7.338 (0.000)	8.722 (0.000)
Expenditures on public health care	3.591 (0.000)	1.718 (0.000)	2.684 (0.000)	2.313 (0.000)	0.003 (0.000)
Morbidity	0.0023 (0.003)	0.0019 (0.016)	0.0018 (0.016)	0.0027 (0.000)	0.0001 (0.058)
Average wage level	-0.0005 (0.029)		-0.0002 (0.026)		
R², adjusted	0.231	0.218	0.221	0.280	0.157

Note. Hereinafter the absence of estimations in a table implies that the corresponding variables have been excluded from the model because of their insignificance.

¹⁸⁹ Hereinafter in brackets, under the coefficient value, the probability (*P*-value) of *t*-statistics of a significant difference of the coefficient's value from zero is shown.

The results of assessment demonstrate a decrease in the value of the coefficient applied to the tax revenues of a regional budget in 2005. While in 1999–2004 an excess in the amount of every 100 roubles of budget revenues in one region, by comparison with another one, corresponded to an excess in the amount of 9–12 roubles of the expenditures on public health care, in 2005 that coefficient corresponded only to an increase in the amount of 3 roubles. As regards financial assistance, on the contrary, a rise in the coefficient value from 8–11 % in 1999–2004 to 15 % in 2005 was noted. The dependencies correspond to the hypotheses described above – since public health care is one of the priority items relating to the implementation of federal national projects, regional governments finance such expenditures in the priority procedure, independently of regional revenues proper, financial assistance being earmarked for the corresponding purposes.

Higher availability of nursing staff also corresponds to higher expenditures on public health care. In the second equation, in accordance with the formulated hypotheses, a positive dependence of the availability of nursing staff on the expenditures on public health care and morbidity can be seen, as well as a negative dependence on a region's average wage level as an index of the attractiveness of alternative employment.

Concerning political factors it can be noted that the period of time remaining before appointment was found to be significant in 2001–2002 and insignificant in the subsequent years. In 2003–2004 the dummy variable describing a governor's membership in a pro-government party was also significant, higher expenditures on public health care being observed in the corresponding regions (in 2001–2002 this variable had a lower level of significance).

4.3.2. Expenditures on Public Education

When modeling the expenditures on public education as part of a system of simultaneous equations, the variable applied to describe the volume of public education services in a region represented the number of public daytime comprehensive educational establishments (schools) per capita. Accordingly, the existence of a positive influence on public education expenditures of a region's tax revenues proper and financial assistance is assumed, as well as a negative effect of the share of urban popu-

lation (due to scale effect). The first equation also incorporated political factors. The second equation for the availability of schools, in addition to the expenditures on public education, incorporated the share of urban population, as well as demographic indices, including the share of population aged younger than the employment age.

In the model of expenditures on public education, on the basis of the results of preliminary estimations and the testing of the equality of coefficients between years (*F*-test applied to reveal the equality of angular coefficients between years; time effects were also pooled on the basis of the test's results), the years 2001–2003 were represented as one panel. The hypothesis as to the equality of coefficients between other pairs of years was rejected (see the table below).

Table 4.3

**Results of Wald Test Applied to the Equality of Coefficients
between Years for the Expenditures
on Public Education**

	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05
<i>F</i>-statistic	2.193	2.038	1.742	1.575	4.247	12.547
Probability	0.038	0.054	0.103	0.147	0.000	0.000
Chi-square	15.352	14.263	12.196	11.022	29.728	87.828
Probability	0.032	0.047	0.094	0.138	0.000	0.000

According to the results of preliminary estimations, the following indices were found to be significant in the model of expenditures on public education, in addition to tax revenues proper of a regional budget and financial assistance: the share of urban population, the number of schools per capita, and the number of months before election/appointment. The estimations' results are presented in the table below.

Table 4.4

Results of Testing the Public Education Expenditure Model

Equation for expenditures on public education					
Assessment period	1999	2000	2001–2003	2004	2005
Constant	0.203 (0.009)	0.223 (0.076)	0.129 (0.001)	0.131 (0.135)	–1.635 (0.000)
Tax revenues of re- gional budget	0.154 (0.000)	0.159 (0.000)	0.185 (0.000)	0.124 (0.000)	0.049 (0.000)
Financial assistance	0.167 (0.000)	0.132 (0.000)	0.160 (0.000)	0.092 (0.000)	0.237 (0.000)
Number of schools per capita	0.611 (0.000)	0.937 (0.000)	0.867 (0.000)	1.811 (0.000)	3.647 (0.000)
Share of urban popula- tion		–0.003 (0.099)			0.017 (0.000)
Number of months before elec- tion/appointment		0.00033 (0.019)			
R², adjusted	0.844	0.948	0.935	0.883	0.988
Equation for availability of schools (number of schools per capita)					
Assessment period	1999	2000	2001–2003	2004	2005
Constant	0.649 (0.000)	0.536 (0.000)	0.565 (0.000)	0.404 (0.000)	0.526 (0.000)
Expenditures on public education	0.114 (0.000)	0.159 (0.000)	0.089 (0.000)	0.127 (0.000)	0.017 (0.000)
Share of urban popula- tion	–0.005 (0.000)	–0.005 (0.000)	–0.005 (0.000)	–0.003 (0.000)	–0.003 (0.004)
R², adjusted	0.314	0.451	0.381	0.532	0.339

The results of estimations of the first equation of expenditures on public education, in accordance with the formulated hypothesis, point to a diminishing value of the coefficient applied to the tax revenues of a regional budget. While an increase by 100 roubles in the amount of re-

gional tax revenues in 1999–2003 implied an increase by 15–18 roubles of the expenditures on public education, in 2004 the corresponding difference was estimated as being equal to approximately 12 roubles, and in 2005 – to approximately 5 roubles (a statistically significant difference from the previous level). The coefficient applied to financial assistance in 2005 demonstrated a dramatic rise up to approximately 0.24, which also is compatible with the formulated hypothesis.

In the first equation the availability of schools was also found to be significant (the higher the availability of schools, the higher the expenditures on public health care). No definite conclusions concerning the dependence of expenditure under this item on political indices can be drawn. In the second equation the availability of schools is positively influenced by the expenditures on public education and negatively – by the share of urban population (in regions with a higher share of urban population the number of schools is lower due to their larger size and higher number of students in each class).

4.3.3. Expenditures on General State Issues

Under the new budget classification the expenditures on general state issues include the costs of the functioning of the top officials of a subject of the Russian Federation and local self-government, the functioning of legislative (representative) bodies of state authority and local self-government, the functioning of the top officials of the bodies of executive authority of subjects of the Russian Federation, local administrations, etc.

Based on the results of the testing, during preliminary estimations, of angular coefficients for equality between years in the model of expenditures on general state issues, the angular coefficients of variables for years 1999–2000 and 2001–2002 were pooled. The hypothesis of the equality of coefficients between other pairs of years was rejected (see the table below). Time effects were found to be significant and were estimated as being different for all the years.

Table 4.5

Results of Wald Test Applied to the Equality of Coefficients between Years for Expenditures on General State Issues

	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05
F-statistic	1.379	5.792	1.375	6.190	5.350	13.542
Probability	0.218	0.000	0.220	0.000	0.000	0.000
Chi-square	9.654	40.546	9.625	43.328	37.447	94.797
Probability	0.209	0.000	0.211	0.000	0.000	0.000

Unfortunately, no system of simultaneous equations of the type “expenditures – volume of public benefits provided” could be built for the expenditures on general state issues (or for other expenditure items discussed later in the text), largely because of the absence of a suitable index to describe the volumes of the corresponding public benefits being provided to the population. Accordingly, the models of the other expenditures items were estimated in the form of a single equation for the dependence of expenditures on revenues and other factors in accordance with the hypotheses of the dependence of expenditures on the revenues proper of a regional budget and a region’s various parameters (demographic indices, the budgetary network’s level of development, etc.).

As seen by the results of preliminary estimations, in the model of expenditures on general state issues the following indices were found to be significant, in addition to tax revenues proper of a regional budget and financial assistance: the share of urban population, the number of civil servants per capita, the share of the biggest branch of industry in a region’s output, the number of enterprises and organizations per capita, and the number of months before election/appointment.

Table 4.6

Results of Testing the Model of Expenditures on General State Issues

Assessment period	Expenditures on general state issues						
	1999–00	2001–02	2003	2004	2005		
Time effect	-1.90	-2.09	-2.72	-3.06	-2.534	-3.885	-3.193
Tax revenues of regional budget	0.166 (0.000)	0.264 (0.000)	0.052 (0.097)		0.089 (0.000)		0.032 (0.000)
Financial assistance	0.572 (0.000)	0.408 (0.000)			0.593 (0.000)		0.383 (0.000)
Share of urban population	0.018 (0.000)				0.038 (0.000)		0.033 (0.000)
Number of civil servants per capita	0.074 (0.0012)	0.365 (0.000)	0.429 (0.000)		0.136 (0.008)		0.099 (0.000)
Share of biggest branch of industry in region's output	-0.007 (0.010)	-0.025 (0.009)					
Number of enterprises and organizations per capita		0.046 (0.000)	0.034 (0.000)				
Number of months before election/appointment		-0.004 (0.000)	-0.002 (0.007)				
Governor's tenure of office (in months)							0.002 (0.108)
R², adjusted	0.933	0.821	0.865		0.926		0.968

The results of estimations have demonstrated a general trend toward a diminishing dependence of the expenditures on general state issues on the tax revenues of a regional budget and financial assistance by 2005, as compared to 1999–2000: while in 1999–2000 an increase in the tax revenues of regional budgets by 100 roubles corresponded to an increase in the expenditures on general state issues by 17 roubles, by 2005 this difference amounted to only 3 roubles. By comparison with the previously discussed models of expenditures on public health care and public education, it can be noted that the dependence of the expenditures on general state issues on tax revenues was characterized (over the whole period under consideration) by the coefficient's value declining without any sharp

falls throughout 2004–2005, which may reflect the general dynamics of expenditure saturation under this item, where the main bulk is spent on wages, alongside growth in revenues. At the same time, no definite trend could be separated for federal financial assistance regarding the dependence of expenditures on it.

This result on the whole also fits within the hypothesis as to the priority character of certain items of expenditure. As the expenditures on general state issues do not belong directly to the priority directions of the federal center’s policy, the signs of their being financed in the priority procedure, including with the attraction of the resources of financial assistance, are either not visible at all or are visible to a lesser degree.

Besides, in this equation the share of urban population and the number of enterprises and organizations per capita were found to be significant for a greater number of years. A higher share of urban population and a higher number of enterprises per capita correspond to higher expenditures on general state issues, this phenomenon being due, most probably, to a higher degree of complexity of the organization of state administration and the provision of public benefits in urban areas and in regions with higher concentration of enterprises.

The index of time before the next election/appointment was significant and negative (the nearer an election, the higher the expenditures on general state issues), which is compatible with the formulated hypothesis as to the existence of a political cycle in the dynamics of expenditures in 2001–2003. At the same time, this variable was found to be insignificant in 2004–2005, which points to the disappearance of this trend after the switchover to the appointment of governors was completed.

4.3.4. Expenditures on Law-Enforcement Activity

This item of expenditure in regional budgets (its full title being “Expenditures on National Security and Law-Enforcement Activity”) includes primarily the expenditures on law-enforcement activity, on the prevention and the liquidation of consequences of emergency situations and natural disasters, civil defense, anti-fire safety measures, etc.

When modeling expenditures under this item, as explanatory variables, in addition to tax revenues proper and financial assistance, the following variables describing both the general situation in a region and the

crime level were applied: crime incidence and the number of registered crimes of various types. Besides, some indirect indices influencing the volume of expenditure were also incorporated in the model – the share of population aged younger than the employment age, the share of urban population, unemployment level, the indices of the population’s living standards, education level, etc. In addition, the indices describing the effect of political factors were applied.

By the results of tests for the equality of angular coefficients, the years 1999 and 2000 (with different time effects) were pooled in one panel. The hypothesis as to the equality of coefficients between other pairs of years was rejected (see the table).

Table 4.7

Results of Wald Test Applied to the Equality of Coefficients between Years for Expenditures on Law-Enforcement Activity

	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05
F-statistic	0.782	5.928	2.544	6.322	3.799	40.703
Probability	0.603	0.000	0.017	0.000	0.001	0.000
Chi-square	5.475	41.496	17.809	44.257	26.593	284.922
Probability	0.602	0.000	0.013	0.000	0.000	0.000

By the results of preliminary estimations, in the model of expenditures on national security and law-enforcement activity, in addition to the tax revenues proper of a regional budget and financial assistance, the following indices were found to be significant: the share of urban population, the share of population aged younger than the employment age, the number of months before election/appointment, a governor’s tenure of office, and a dummy variable, which was equal to 1 if a governor belonged to a pro-government party.

Table 4.8

**Results of Testing the Model of Expenditures
on Law-Enforcement Activity**

Assessment pe- riod	Expenditures on law enforcement activity					
	1999– 00	2001	2002	2003	2004	2005
Time effect	0.1 0.1 7 3	0.05	0.040	0.074	0.088	–0.717
Tax revenues of regional budget	0.027 (0.000)	0.021 (0.000)	0.023 (0.000)	0.048 (0.000)	0.033 (0.000)	0.004 (0.000)
Financial assis- tance	0.014 (0.000)	0.036 (0.000)	0.015 (0.001)	0.040 (0.000)	0.069 (0.000)	–0.078 (0.000)
Number of months before elec- tion/appointment	– 0.0001 (0.106)	–0.0002 (0.012)	–0.0001 (0.063)		0.0003 (0.001)	0.0005 (0.000)
Share of urban population	–0.001 (0.001)					0.007 (0.000)
Share of popula- tion aged younger than employment age			0.006 (0.026)			0.035 (0.000)
Governor's tenure of office (in months)			–0.0004 (0.045)			
Governor's mem- bership in pro- government party			0.034 (0.029)			
R², adjusted	0.692	0.644	0.794	0.794	0.967	0.913

The results of estimations have demonstrated that an increase in the tax revenues of a regional budget by 100 roubles corresponds to an increase in the expenditures on law-enforcement activity of 2 to 5 roubles in 1999–2004, depending on a particular year. In 2005 this coefficient yields a value of only 0.4 roubles approximately.

As regards financial assistance, in 1999–2004 a higher by 100 roubles volume of assistance corresponded to a higher by 1.4–6.9 roubles level of expenditures on law-enforcement activity. Just as for the expenditures on

general state issues, no trend of an increasing coefficient of financial assistance can be noted. Moreover, in 2005 the results of estimations demonstrated a negative coefficient of financial assistance, which, most probably, was due to the fact that the regions receiving small volumes of financial assistance were allocating more financing to the expenditures under this item; and vice versa, the regions receiving substantial financial assistance were allocating it to other items of expenditures, while spending less on law-enforcement activity¹⁹⁰.

Among the other variables it should be noted that, in accordance with the formulated hypothesis, the share of population aged younger than the employment age had a positive effect on the amount of expenditures on law-enforcement activity. The time before election/appointment had a negative effect on regional budget expenditures on law-enforcement activity in 1999–2002, that is, as an election was getting nearer, the expenditures under this item were growing. In 2003 this index was found to be insignificant, while in 2004–2005 – both significant and positive, which may point to the efforts of newly elected or appointed governors aimed at imposing order in a region’s territory immediately after the election or appointment, when there was no need for gaining voters’ support for a future reelection.

4.3.5. Expenditures on Housing and Utilities

When modeling the expenditures on housing and utilities, as explanatory variables were applied the indices describing the overall number of consumers of services (number of enterprises per capita, the property

¹⁹⁰ In respect of financial assistance, the basic hypothesis states that, all other conditions being equal, a higher amount of financial assistance should correspond to higher expenditures - that is, for the dynamics of the main expenditure items the logic of budget constraint becomes true (the higher revenues, the higher expenditures). In this connection it may be assumed that in regions with low budget sufficiency the expenditures are lower, while simultaneously financial assistance is higher. As the dependence of expenditures on tax revenues diminished, it can be expected that the dependence corresponding to the logic of budget constraint (when expenditure grow alongside growth of revenue, including in the form of financial assistance), becomes weaker, and therefore the dependence may change because the effect of negative correlation between expenditures and financial assistance becomes dominating (in poorer regions financial assistance is higher, while expenditures are lower, and vice versa).

structure of the municipal fund, the share of urban population, the availability of housing, etc.). In this connection it was assumed that an increase in the share of urban population or the number of enterprises per capita produces a need for more financing to be allocated to the housing and utilities sector and, accordingly, to higher expenditures on the housing and utilities sector.

Similarly, the testing of the equality of coefficients between years (a single hypothesis as to the equality of all angular coefficients except the constant) did not make it possible to pool neighboring years into a panel. The results of tests are shown in the table.

Table 4.9

Results of Wald Test Applied to the Equality of Coefficients between Years for Expenditures on the Housing and Utilities Sector

	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05
F-statistic	3.068	3.578	13.388	2.282	1.972	6.344
Probability	0.005	0.001	0.000	0.031	0.063	0.000
Chi-square	21.478	25.049	93.716	15.972	13.802	44.408
Probability	0.003	0.001	0.000	0.025	0.055	0.000

By the results of preliminary estimations, in the model of expenditures on housing and utilities, in addition to the tax revenues proper of a regional budget and financial assistance, the following indices were found to be significant: the share of urban population, the number of enterprises and organizations per capita, the number of civil servants per capita and the number of months before the election/appointment of a governor.

The results of the estimations of the dependence of expenditures on housing and utilities on the tax revenues proper of a regional budget have demonstrated that, while in 1999–2003 an increase by 100 roubles in the amount of tax revenues corresponded to an increase by 12–19 roubles in the amount of expenditures on housing and utilities (depending on a particular year), in 2004 the corresponding difference would have amounted to approximately 9 roubles, and in 2005 – to approximately 5.6 roubles. No uniform downward trend was seen in the value of the coefficient applied to financial assistance, its values varying between 7.7 and 18.8 %.

In accordance with the formulated hypotheses, a higher share of urban population or a higher number of enterprises and organizations per capita would also result in higher expenditures on housing and utilities.

Table 4.10

Results of Testing the Model of Expenditures on Housing and Utilities

Assessment period	Expenditures on housing and utilities						
	1999	2000	2001	2002	2003	2004	2005
Time effect	0.13	-1.09	-0.762	-0.895	-0.787	-0.008	-1.502
Tax revenues of a regional budget	0.129 (0.000)	0.181 (0.000)	0.120 (0.000)	0.194 (0.000)	0.151 (0.000)	0.087 (0.000)	0.056 (0.000)
Financial assistance	0.077 (0.000)	0.182 (0.000)	0.079 (0.000)	0.176 (0.000)	0.145 (0.000)	-0.079 (0.004)	0.188 (0.000)
Share of urban population	0.016 (0.000)	0.019 (0.001)	0.014 (0.000)		0.007 (0.100)		0.022 (0.000)
Number of enterprises and organizations per capita			0.010 (0.025)	0.036 (0.000)	0.015 (0.000)	0.008 (0.012)	0.009 (0.072)
Number of civil servants per capita						0.061 (0.004)	
Number of months before election/appointment				-0.002 (0.008)	-0.001 (0.053)		
R², adjusted	0.669	0.736	0.843	0.810	0.781	0.931	0.993

From these estimations it also follows that for the expenditures on housing and utilities in 2002–2003 the coefficient applied to the time before election/appointment turns out to be significant and negative, that is, in accordance with the formulated hypothesis, the nearer an elections, the higher are the expenditures on housing and utilities, all other conditions being equal. As reform of the political system in the RF was progressing, with the switchover from election to appointment of governors, the corre-

sponding coefficients applied to the variable of the time remaining to election/appointment in 2004–2005 were found to be insignificant.

4.3.6. Expenditures on Social Policy

For the expenditures on social policy, as explanatory variables, in addition to the revenues of a regional budget, also the variables of the share of urban population (scale effect and the need for implementing social policy) were applied, as well as the variables describing the demographic structure of a region’s population. By the results of testing the equality of angular coefficients between years, 1999–2000 and 2002–2003 were pooled into panels (see the table below).

Table 4.11

Results of Wald Test Applied to the Equality of Coefficients between Years for Expenditures on Social Policy

	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05
<i>F</i> -statistic	0.497	3.658	2.267	1.715	2.813	3.124
Probability	0.778	0.004	0.051	0.135	0.019	0.011
Chi-square	2.485	18.290	11.334	8.574	14.065	15.621
Probability	0.779	0.003	0.045	0.127	0.015	0.008

By the results of preliminary estimations, in the model of expenditures on social policy, in addition to the tax revenues proper of a regional budget and financial assistance, the following indices were found to be significant: the share of urban population, the number of months before election/appointment and the dummy variable of a governor’s membership in the pro-government party.

In accordance with the estimation’s results, higher tax revenues of a regional budget correspond to higher expenditures on social policy. While in 1999–2003 the value of this coefficient was 5.4–5.9%, in 2004 it went down to 3.2%, and in 2005 was only approximately 1.8 %. No definite conclusion can be drawn as to a diminishing value of the coefficient applied to federal financial assistance.

Table 4.12

The results of Testing the Model of Expenditures on Social Policy

Assessment period	Expenditures on social policy						
	1999–2000		2001	2002–2003		2004	2005
Time effect	0.33	0.33	0.57	0.46	0.37	0.322	–0.007
Tax revenues of regional budget	0.059 (0.000)		0.056 (0.000)		0.054 (0.000)	0.032 (0.000)	0.018 (0.000)
Financial assistance	0.021 (0.000)		0.008 (0.2802)		0.012 (0.065)		0.035 (0.0034)
Share of urban population	–0.004 (0.000)		–0.004 (0.0029)		–0.002 (0.0248)		0.008 (0.0018)
Number of months before election/appointment	–0.0001 (0.068)					0.0003 (0.0478)	
Governor’s membership in pro-government party	–0.032 (0.0969)						
R², adjusted	0.681		0.797		0.651	0.632	0.973

Among the political variables, a significant negative sign applied to the time before reelection in 1999–2000 can be noted, which implies that the expenditures on social policy increased as an election grew nearer, while no such dependence was observed in the subsequent years.

* * *

In order to assess on the whole the results of our analysis, we present here summary tables of the coefficients applied to the dependence of the expenditure items studied on the tax revenues of regional budgets and federal financial assistance (see the table below).

Table 4.13

**Coefficients at the Tax Revenues and the Federal
Financial Aid in the Expenditure Items Models**

%	1999	2000	2001	2002	2003	2004	2005
tax revenues							
Public health care	9.0	12.1	10.2	10.2	10.7	10.7	2.8
Public education	15.4	15.9	18.5	18.5	18.5	12.4	4.9
General state issues	16.6	16.6	26.4	26.4	5.2	8.9	3.2
Law-enforcement activity	2.7	2.7	2.1	2.3	4.8	3.3	0.4
Housing and utilities sector	12.9	18.1	12.0	19.4	15.1	8.7	5.6
Social policy	5.9	5.9	5.6	5.4	5.4	3.2	1.8
Total	62.5	71.3	74.8	82.2	59.7	47.2	18.7
federal financial aid							
Public health care	8.0	9.4	11.1	11.1	10.0	10.0	15.0
Public education	16.7	13.2	16.0	16.0	16.0	9.2	23.7
General state issues	57.2	57.2	40.8	40.8	40.8	59.3	38.3
Law-enforcement activity	1.4	1.4	3.6	1.5	4.0	6.9	-7.8
Housing and utilities sector	7.7	18.2	7.9	17.6	14.5	-7.9	18.8
Social policy	2.1	2.1	0.8	1.2	1.2	1.2	3.5
Total	93.1	101.5	80.2	88.2	86.5	78.7	91.5
<i>Reference: ratio of amount of expenditures under these 6 items to general expenditures of regional budgets</i>	78.3	66.8	68.9	71.0	72.6	75.6	77.2

The results cited here speak in favor of the hypothesis formulated above as to a possible shift in the priorities of regional governments as a result of reform in the political system of the Russian Federation. The characteristic feature of the dependence of certain expenditure items on the tax revenues of regional budgets is the decline in the values of the

corresponding coefficients. As noted earlier, one of the reasons could be expenditure saturation under conditions of economic growth and increasing budget revenue (this is indirectly demonstrated by the decreasing sum of coefficients).

However, in view of the dramatic fall in the coefficients applied in 2005 to the expenditures on public health care and public education (two areas where federal national projects are being implemented), it can be assumed that the obtained results are largely due to the changes in the financial behavior of regional governments, who are more inclined to finance those expenditure items that have priority significance for the federal center in order to receive political support in a situation when governors are appointed.

Similarly, one can note a dramatic increase in the values of coefficients applied to federal financial assistance allocated to the items covering the areas where national projects are being implemented, – public health care, public education, and the housing and utilities sector. This is also compatible with the formulated hypothesis that in a situation of governors being appointed, in order to provide good reports to the center, governors allocate the financial assistance they receive (a significant part of which is not specifically earmarked) in the priority procedure to finance those expenditure items that are significant in the eyes of the federal center. Since the total sum of coefficients does not decrease (and even somewhat increases in 2005), the obtained results point to the redistribution of priorities in the sphere of the use of financial assistance from other items of expenditure to the target ones.

Below we present summary results of our estimation of the dependence of certain expenditure items on the time remaining before the next election/appointment of a governor.

In order to estimate the dependence of expenditures on the variable describing the period of time remaining until the next election/appointment, it can be noted that the overall result is represented by the significance of this variable in the expenditure models for 1999–2003; that is, as the election of a governor grew nearer, the amount of expenditures under the studied items of regional budgets was increasing. As noted earlier, the existence of this political cycle in the dynamics of expenditures can be estimated from various points of view. On one hand,

such expenditures are not always justified, being predominantly aimed at “acquiring” votes. On the other, the financing of these items in order to gain voters’ support may in some instances approximate the structure of regional budget expenditure to that preferred by voters. In this sense the existence of such a cycle is a positive phenomenon. In 2004–2005 no significant facts confirming the existence of an influence of the period of time before election/appointment on the amount of expenditures were registered. This, in its turn, means that, in course of a switchover from election to appointment of governors, it becomes no more necessary to gain voters’ support through increasing expenditures under certain items, while the factor of support from the federal center grows in importance.

Table 4.14

Time before Election/Appointment Coefficient

	1999	2000	2001	2002	2003	2004	2005
Public health care				■	■	■	
Public education		■					
General state issues			■	■	■	■	
Law-enforcement activity	■	■	■	■	■		
Housing and utilities sector				■	■	■	
Social policy	■	■	■				

Note: grey squares reflect a significant negative sign in a corresponding equation (as an election grows nearer the corresponding items of expenditure also grow).

Thus, on the whole the results of our empirical analysis support the formulated hypotheses that, resulting from reform in Russia’s political system and a switchover from the election to the appointment of governors, there occurred a shift in the financial policy of regional governments in favor of priority financing of those items of expenditure in regional budgets that are important for the federal center (in particular, in areas where national projects are being implemented). At the same time, in accordance with the formulated hypothesis, the political cycle of expenditure growth before elections can no more be observed in the overall dynamic of expenditure.

Conclusions

Our study has led to the following conclusions:

1. In a situation when governors were elected the opportunities for the federal center to ensure control over the financial policy of regional governments were quite limited. Within a model's framework, the only instrument available to the federal center for influencing the policy of elective regional governments is represented by non-targeted grants, which make it possible, whenever necessary, to increase the utility of regional governments (or regional voters), but do not guarantee that surplus financial assistance is going to be allocated in full to the provision of regional public benefits¹⁹¹. In actual practice, the federal center has a sufficiently large arsenal of instruments for influencing the regions, but due to information asymmetry and the impossibility to directly interfere with the financial policy being implemented by regional governments the desirable distribution of resources cannot always be achieved, in particular the growth of public well-being through the redistribution of resources between regions, as well as by taking into account the external factors resulting from the production of regional public benefits.

2. The situation of incompatibility of the policies pursued by regions with the preferences of the federal center becomes more visible in those instances when the preferences of the bureaucracy produce a serious impact on the shaping of financial policy at the regional level. In this connection, a formal overestimation of expenditure at the regional level under conditions of governors being elective within a model's framework means that such a governor initially should not have been elected by a region's population.

In actual practice the incompatibility of the financial policy being implemented by a governor with the preferences of a region's population does, indeed, formally diminish the support for such a governor during a second election, this support, however, quite often being earned by allo-

¹⁹¹ See also the results of the study by *Kadochnikov P., Sinelnikov – Murylev S., Trunin I., Chatverikov S., Vignio M., 2005 "Reform of fiscal federalism in Russia: the problem of soft budget constraints on regional authorities"*.

cating additional expenditures to the financing of socially significant public benefits (raising the salaries of employees in the budget-funded sphere, improving towns and settlements, etc.). This means (see also the overview) that the bureaucracy can gain regular support by applying various mechanisms for manipulating public opinion and certain groups of voters.

Within the framework of the system of relationships existing between the federal center and elective heads of regions this creates opportunities for an inefficient distribution of resources, which cannot be corrected by applying the existing instruments of interbudgetary relations. In actual practice, such a situation may give rise to the emergence of political – business cycles in the flow of regional budget expenditure. The elimination of such cycles after the switchover to governor appointment, on one hand, reflects a lesser degree of regional governments' ability to manipulate public opinion through varying the amount of expenditure. On the other, it is indicative of a lack of necessity for regional governments to win voter support, which diminishes the compatibility between the volume and structure of regional expenditures and the population's preferences, and results in lower public well-being.

3. In a situation when federal and regional governments reflect the preferences of median voters (federal and regional, respectively), the switchover from election to appointment of governors eliminated one important feature of the federal political system: the strategic interaction between the interests of federal and regional governments (or voters) disappears, which, on one hand, prevents possible manipulation of the process of decision-making at one level of state authority by the other level of authority. On the other, at the same time the advantages of fiscal decentralization are lost, because the equalization, between regions, of the volumes of public benefits being actually provided may result in lower efficiency and losses of public well-being.

Such equalization of expenditures between regions ensures a more just redistribution of resources between regions from the point of view of inequality. However, at the same time the efficiency of the distribution of resources becomes lower because of the resulting disregard for the specific preferences displayed by voters in different regions and lowered in-

centives for the efficient development of both the donor regions and the regions - recipients of financial assistance.

4. The appointment of governors under conditions of compatibility between the preferences of governors and those of federal governments, coupled with efficient control of their activity by the center, makes it possible to ensure the implementation of financial policy which can, at least in its general features, conform to federal priorities. Within a model's framework this is expressed by growing public well-being due to the switchover from the situation when regional financial policy was being shaped by the preferences of bureaucracy to that when financial policy becomes compatible with the preferences of a non-bureaucratic (as preconditioned in the model) federal center. If the center is interested in implementing an efficient budget policy, while the population in regions enjoys only limited opportunities for controlling the justified character of regional revenues, after the switchover from election to appointment the center obtains greater opportunities for influencing the financial behavior of governors (in absence of the situation of asymmetric distribution of information between the center and the governors).

The appointment of governors makes it possible to relatively easier implement in regions certain administratively uncomplicated measures aimed at achieving the priorities of federal policy, which are justified from the point of view of the federal center (the implementation of national projects alongside the directions of regional policies, which gives rise to positive long-term external factors). This would have been more difficult to achieve in a situation of elective regional governments forced to reflect the preferences of their own voters. It should, however, be noted that under conditions of fiscal federalism such issues, relating to the coordination of the priorities of federal and regional policies, can be resolved not by imposing the center's preferences on regional governments, but by a more careful distribution of powers and areas of jurisdiction between the center and regions, when the center ensures the achievement of its own priority goals by applying those financial instruments that belong to its own sphere of competence, and not to that of regional governments.

5. The striving (as preconditioned in the model) of the federal center to achieve a social optimum is theoretically compatible with the situation

when there exists an omniscient benevolent dictator. Unfortunately, in actual practice the situation is more complex because of information asymmetry, as well as the presence of the bureaucracy and groups with specific interests. In reality the federal center, even if it can be regarded as benevolent, is not equipped with an adequate potential for controlling the behaviors of appointed heads of regions. This means that the center is able to ensure the compatibility between the financial policy implemented by regions and its own preferences only in respect of some most important controllable items, which cannot be guaranteed for all the items of budget expenditure.

On one hand, such a situation means that even appointed regional governments would have opportunities for ensuring their own interests, that is, bureaucratization. At the same time, the high degree of concentration of powers in the hands of regional administration increases the risk of consolidating certain funds that can be spent on lobbying decisions that would be advantageous for specific groups but inefficient from the point of view of public well-being. On the other, this still leaves to regional governments some opportunities for improving well-being through increasing the compatibility between the policy being implemented and the interests of the residents of a given region or municipality.

6. The results of testing the empirical hypotheses point to a diminished dependence of main expenditure items (which have priority significance for the federal center) on tax revenues, which we have interpreted not only as the result of the saturation of the population's need for those items due to general growth of resources available to regional governments under conditions of economic growth, but also as a result of the financing allocated to public health care, public education and the housing and utilities sector being given priority to over all the other expenditure items in a regional budget. This is confirmed by an increasing dependence of these items on financial assistance in the situation of a switchover to the appointment of governors: in order to improve the indices being reported to the center, governors earmark the financial assistance for those items that have priority significance for the federal center.

7. The results of estimations have also demonstrated that in 1999–2003, as the time of governor reelections was growing nearer, the expen-

ditures allocated to the main items of regional budgets were increasing, whereas in 2004–2005 no significant evidence of any effect of the time remaining to election/appointment on the size of expenditure items was observed. This may be interpreted as follows: resulting from the switch-over from election to the appointment of governors, it has become no more necessary to earn additional voter support through increasing expenditures. Such a situation can be estimated as a positive outcome of the completed reform, considering that the pre-election rise in expenditure had for most part little effect. However, the observed disappearance of the political-business cycle also points to a decreased regard for the interests of voters when determining the financial policy of regional governments.

The increased degree of centralization in Russia does not correspond to the general trends in the development of the relations between regions and the center in federal states. International experience has demonstrated that, with time, regional governments obtain a continually increasing range of powers and functions, simultaneously being more and more often headed by elective leaders. These processes are to a substantial degree conditioned by the need to regulate the activity of regional governments by applying market-based and democratic mechanisms, by the necessity to execute the control over their activity through democratic procedures and by procedures based on competition during elections, with the efficiency of the operation of regional governments being assessed by the population. Such a system does not exclude the application of administrative and controlling mechanisms on the part of the federal center, while the majority of such mechanisms are designed to monitor the performance of regional governments by increasing transparency and the accountability to an electorate capable of exercising comprehensive control within a given region.

On the whole, judging by the results of our analysis, a controversial character of the results of reform can be noted. On one hand, such reform in a situation of a less than perfect division of areas of responsibility between the federal center and regions makes it possible to ensure a more efficient implementation of federal priorities at the regional level, reduce the dependence of financial policy on the electoral cycle and potential

corruption (if federal officials are assumed to be impervious to it), provide opportunities for taking into account interregional external factors and solve the problem of an optimal distribution of resources between regions. However, the overall increase of public well-being and the opportunities for an efficient implementation of the potentially positive results of reform are significantly dependent on how adequate are the actions of the federal center and how successful is the control over the vertical of the execution, at the regional level, of the decisions made by the federal center. This is coupled with the actual inability of citizens to ensure the direct expression of their will at the regional level and, accordingly, with no regard for their interests when decisions are made and the financial policy is being implemented in a region. One more important moment is that the participation of citizens in the democratic elections of authorities of all levels represents an absolute value that cannot be reduced to an analysis of its economic consequences.

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