

Chapter 1. The record of interbudgetary relations development in Russia

The evolution of the budgetary system and interbudgetary relations in the Russian federation for the period of 1992 - 1993

The contemporary system of interbudgetary financial flows started developing as early as in 1991. By that time before the formation of the independent Russian State the budgetary system of the former RFSR existed as part of the Soviet Union centralized budgetary system. By 1991 the USSR budgetary system presented the totality of all the budgets of the country integrated into the USSR state budget which fell into the union budget, the union republics' state budgets, and that of state social insurance. The state budgets of the union republics embraced, in their turn, a union Republic's republican budget, the state budgets of the autonomous republics belonging to the union republic, and local budgets. The latter compressed three groups: the budgets of regions and "krays", those of the cities subordinate to republics, and those of districts (for the republics with no regional subdivision). Besides, the budgets of the regions included regional and krays' budgets (by the analogy with the union republics' state budget structure), the budgets of the autonomous regions (okrugs), the budgets of the region-subordinate (kray-subordinate) cities, and also district budgets. The budgets of districts (inclusive of those regional ones) embraced, in their turn, district budgets, the budgets of the district-subordinate towns, the budgets of settlements and village budgets.

On the whole the revenue distribution between the budgets of different levels was as follows¹. The union budget was replenished by turnover tax (with a subtraction of the part remitted to the budgets of the union republics), by profit tax on the enterprises and state-subordinate organizations, by personal income tax, also by payments for state social insurance, customs duties.

The budgets of the union republics compressed part of the profit tax on the enterprises and utility organisations under republican and local subordination, the forest income, the income tax on collective farms, co-operative and social enterprises, the agricultural tax, the allocations from the turnover tax and other coun-

¹ For detailed discussion see S.Sinelnikov "Budgetny krizis v Rossii: 1985 – 1995 gody", Eurazia, Moscow, 1995.

try-wide kinds of income measured in accordance with the state budget Law for the respective year, and also some other payments.

The budgets of the Autonomous Republics, districts and regions received subtractions from the subordinate enterprises' profit and also part of the payments from the profit of the enterprises and institutions, transmitted to these budgets, the state duty, the revenues gained by showing movies, the local taxes and fees.

The revenues of the local budgets were constituted by the subtractions from the profit of the enterprises under local subordination and by the transfers received from higher level budgets.

It is obvious, that the revenue distribution came to reflect the specificity of the Soviet tax system, which doesn't leave open to discussion the questions of delegating income authorities with different levels of power, as the majority of the exponents was subject to approval to be made by the higher echelones.

The adoption of budgets for administrative-territorial institutions was a process consisting in their spending and revenue exponents to be affirmed by the state authorities of a higher level, and the regional budgets themselves were further liable to consolidation into the united state budget. Due to the lack of any universal norms for assignment of income sources and spending responsibilities, each administrative unit had got individual proportions of tax and non-tax incomes distribution which funded the expenditures agreed on in advance. The interbudgetary equalization in Russia of the USSR times was also achieved by means of rendering subsidies for financing these or those spending articles by the budget of a higher level, besides the subsidy amounts were determined as a result of conforming the demands for resources based on the natural rates.

It's natural, that the introduction of real principles of federalism into the sphere of the state establishment required serious reforming of the budget system and the interbudgetary relations in Russia. At the end of 1991 the Supreme Council of RSFSR adopted the laws "On the bases of the budget process and budget establishment in RSFSR" and "On the bases of the RFSR tax system", which outlined the basic principles of budget federalism. During the two succeeding years the theses of the normative acts listed gained development with the laws like "On the subventions to the republics within the body of the Russian Federation, to the autonomous okrugs, to the city of Moscow and Saint Petersburg" and "On the bases of budget rights and the rights to form and use the extra-budgetary funds of representative and executive state power authorities of the Republics

within the body of the Russian Federation, autonomous regions, okrugs, krais and oblasts, the city of Moscow and Saint Petersburg, also self-governance bodies².

These attempts of realization of the basic principles of federalism in the context of building up a budget system faced real difficulties when implemented. The regional authorities of the subsidized regions had a habit taken after the Soviet times which was to wage wars for the redistribution of budget resources by means of concluding individual agreements with the federal power organs, whereas financially strong regions alongside with the evolving economic crisis sought to precipitate the payment of tax revenues into the federal budget, for instance, some of the national republics (that of Sacha, Tatarstan, Bashkortostan) stopped paying taxes into the federal budget, aspiring to gain the right to accumulate all the tax incomes coming from the region's territory within their own budget by means of regular transferring the only payment into the Federal Budget, the amount of which was to be negotiated with the Federal government.

Under the conditions of the increasing spending pressure upon the Federal budget and the considerable shortage of tax revenues the federal organs of power initiated a process of passing part of federal budget expenditure responsibilities over to the regional level (the subsidies for selling foodstuffs and other goods at regulated prices, free medication, subsidies for public transport and utility services, the expenditures for social protection of the population and some kinds of communal expenditures), which caused an increase of the spending share of the Federation Members' budgets within the consolidated RF budget (see Table 1).

TABLE 1. THE SHARE TAKEN BY SOME BUDGET EXPONENTS OF THE FEDERATION MEMBERS IN THE CONSOLIDATED RF BUDGET (%).

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000* |
|--------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Tax revenues | 44,2% | 53,1% | 53,4% | 47,6% | 49,5% | 53,1% | 54,0% | 48,9% | 45,9% |
| Total revenues | 44,0% | 58,0% | 53,9% | 52,6% | 53,8% | 57,5% | 56,6% | 49,2% | 41,4% |
| Total expenditures | 34,0% | 40,3% | 37,7% | 43,4% | 45,4% | 48,1% | 48,4% | 46,9% | 46,1% |

* for the first half-year

Source: federal Ministry of Finance

The extent of budget independence gained by regional authorities remained rather limited, since the only exponent they could exert a real influence upon was

² For detailed discussion of the first stage of interbudgetary relations in Russia see: Christine I. Wallich "Intergovernmental fiscal relations: setting the stage" in Christine I. Wallich, ed. "Russia and the Challenge of Fiscal Federalism", The World Bank, Washington, D.C., 1994, pp. 19-63, X. Мартинес, Дж. Бокс "Децентрализация бюджетной системы в Российской Федерации: тенденции, проблемы и рекомендации", Georgia State University, M., 1998

the regional budgets' expenditures. At the same time the regions didn't get any rights to independently raise revenues into the budget, and finance departments of regional administrations were placed under the double subordination of the regional authorities and the Federal Ministry of Finance. The federal authorities alongside with that retained the right to apply a differentiated manner of regulating the tax sharing rates into the regional budgets from the basic federal taxes which determined the amount of tax revenues of the state budget system. In 1992 - 1993 financial assistance was delivered to regional budgets coming as subsidies in case the revenues from their own and regulating (shared) taxes proved insufficient to cover the minimal necessary budget, the size of which was agreed on by federal and regional authorities.

The regional level reproduced the same principles for interbudgetary relations' realization as those applied at the federal level, the only difference being the fact that both tax revenues disbursed on a shared basis and subsidies didn't come from the federal budget, but were transferred from the regional one. It's notable that a scheme like that enabled a regional level to gain greater efficiency in reallocating the resources from rich municipalities in favour of those poorer ones; such a manner of procedure, however marked by the lack of any legitimate rules of relations between regional and local budgets imparts local authorities a negative incentives to raising their own incomes and to developing a tax base of their own. Thus higher authorities got capable of diminishing the sharing rate of the regulating taxes for the municipality or of diminishing the subsidy size in case the previous budget period displayed the growth of its incomes.

The pressure the regional authorities exerted upon the federal ones resulted also in the growth of regional financial aid³ share in the Federal budget expenditures from 6,9% to 14,9% for the period of 1992 - 1994.

The interbudgetary relations' reform of 1994 and their development for the period of 1994 - 1997.

The new Constitution of 1993 and federal authorities' strengthened positions made it possible to make a reform of interbudgetary relations in 1994, the main purpose of which being to formalize the aspects of revenue allocation between

³ Under federal financial aid to regional budgets we shall understand the sum of all non-earmarked federal grants (flows) to regional budgets: subsidies (dotations), subventions, transfers from the FFSR (including those financed through the off-set against federal share of VAT), mutual settlements, federal budgetary loans less repayments.

federal and regional budgets and to provide financial aid for lower level budgets⁴. With articles 71 and 72 in place, the new Constitution formalized the basic aspects of competence for federal, regional and local authorities. Besides, a number of treaties were signed to differentiate the objects of competence between the Centre and the Federation members known as the main abusers in paying no taxes to the federal budget and, thus a tax payments to the federal budget was made possible, although in smaller shares compared to the rest of the regions (implying Tatarstan, Sacha, Bashkortostan).

As regards interbudgetary relations, the main result of the reform undertaken was primarily the formation of a Fund of Financial Support to the Regions within the framework of the Federal Budget, that was to disburse its resources between the subjects of the Russian Federation according to an all-unified methodology regarding both regional budgets' revenue capacity and spending needs, and secondarily, it was an attempt to set out universal rates for the allocation of federal tax revenues between the centre and the regions. The 1994 federal budget law contained the common rates for tax income distribution between the federal and the regional budgets for basic federal taxes. Set in 1994, the tax income distribution proportions for the three basic federal taxes remained practically unchanged till 1998 (see Tables 3–5 for the currently operating proportions of tax income distribution and also for those of tax authorities and spending responsibilities). The tax sharing rates between the Federal budget and the budgets of Federation members made: for VAT – 25% of tax revenues collected on the region's territory, for corporate profit tax – at the rate of 25% to 22% for different years, for personal income tax – 90%-100% (taking account of a particular the year) of the tax revenues originating from the region's territory. Regional authorities also got a right to change the regional corporate profit tax rate, and also a right to introduce regional and local taxes of their own (the latter right was abolished in 1996)⁵.

The ideas on gaining greater objectiveness in interbudgetary relations were however implemented inappropriately, especially in the sense of interbudgetary relations formalisation and imparting them transparency. So the regional shares in FFSR calculated according to a universal method, were subject to approval to be made by the State Duma as part of the Federal Budget Law, which precondi-

⁴ For discussion see A.M.Lavrov "Interbudgetary relations in Russia: problems of reforming", mimeo, 1997.

⁵ See presidential decree "On the formation of the republican budget of the Russian Federation and relations with budgets of the constituent entities of the Russian Federation in 1994"

tioned numerous current amendments in the calculations presented by the Ministry of Finance when drafting the bill. Sticking to universal rates for the distribution of federal tax revenues between the federal and the regional budgets wasn't actually carried out either: first, as a result of the non-cash off-sets the shared taxes might be paid only in the share, that assigned to the region's budget, and second, setting the federal taxes' sharing rates in the case the budgets of a number of national republics was a procedure regulated by special instructions of the Ministry of Finance, i.e. it could be made on the individual basis.

One should lay a special emphasis upon the agreements on division of authorities and objects of competence between the federal centre and the regions which came to characterise the relations between the federal and regional authorities, since 1994. Alongside with the transition made to replace individual agreement-based management of interbudgetary relations with the introduction of common principles, there was however an opposite tendency displaying itself as making agreements on competence division with certain Federation Members. Thus there were several agreements with the republics of Tatarstan and Bashkortostan signed in 1994 to preserve the whole-hearted unity of the Russian Federation, implying not only the 100% assignment of some federal taxes (mainly VAT) into the budgets of the republics but also setting proportions for the distributing the rest of the taxes on agreement basis.

Later on during the period of 1995 - 1996 the agreement made between the republic of Sakha (Yakutia) and the city of Saint-Petersburg confirmed the latter condition. The same kind of agreements reached for the period of 1995-1997 with a number of other Federation members (the republic of Udmurtia and Komi, the Krasnodarsky and Khabarovsk krais, the Sverdlovsky, Irkutsky, the Nizhny Novgorod, Rostov, Vologda, Murmansk and Chelyabinsk regions) also implied a considerable extension of the budget rights with regional authorities. First and foremost, this means providing an opportunity for a region to finance the federal budget expenditures on the region's territory at the expense of the federal tax revenues, originating from the territory, then about the right to effect individual off-sets with the federal budget, to use exponents individually agreed on when calculating the transfers from FFSR, to finance regional spending programs at the expense of the resources from the Federal budget, then about obtaining a right to control the resources of the regional departments of federal non-budget funds and also to appoint administration for these departments etc. As becomes obvious from the above-described⁶, some of the regions were delegated too wide authori-

⁶ See "OECD Economic Surveys: Russian Federation", OECD, March 2000, pp.113-149

ties in comparison with the majority of other federation members – the budget statistics suggests that the agreements made enabled Tatarstan, Bashkortostan and Yakutia to control considerable revenue amounts, additional spending responsibilities being thereby incumbent upon them, which implied a greater extent of independence for these regions compared to other Federation members. It is however notable that the privileges, implied by the agreements, actually operated only for Tatarstan, Bashkortostan and partly the Republic of Sakha, whereas the federal government and the Ministry of Finance gave the other Federation members no chance to implement the agreement-implied privileges. The record of interbudgetary relations development in Russia.

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tax on the enterprises and state-subordinate organizations, by personal income tax, also by payments for state social insurance, customs duties.

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Under the conditions of the increasing spending pressure upon the Federal budget and the considerable shortage of tax revenues the federal organs of power initiated a process of passing part of federal budget expenditure responsibilities over to the regional level (the subsidies for selling foodstuffs and other goods at regulated prices, free medication, subsidies for public transport and utility services, the expenditures for social protection of the population and some kinds of communal expenditures), which caused an increase of the spending share of the Federation Members' budgets within the consolidated RF budget (see Table 1).

The extent of budget independence gained by regional authorities remained rather limited, since the only exponent they could exert a real influence upon was the regional budgets' expenditures. At the same time the regions didn't get any rights to independently raise revenues into the budget, and finance departments of regional administrations were placed under the double subordination of the regional authorities and the Federal Ministry of Finance. The federal authorities

⁸ For detailed discussion of the first stage of interbudgetary relations in Russia see: Christine I. Wallich "Intergovernmental fiscal relations: setting the stage" in Christine I. Wallich, ed. *"Russia and the Challenge of Fiscal Federalism"*, The World Bank, Washington, D.C., 1994, pp. 19-63, Х.Мартинес, Дж. Боекс *"Децентрализация бюджетной системы в Российской Федерации: тенденции, проблемы и рекомендации"*, Georgia State University, M., 1998

alongside with that retained the right to apply a differentiated manner of regulating the tax sharing rates into the regional budgets from the basic federal taxes which determined the amount of tax revenues of the state budget system. In 1992 - 1993 financial assistance was delivered to regional budgets coming as subsidies in case the revenues from their own and regulating (shared) taxes proved insufficient to cover the minimal necessary budget, the size of which was agreed on by federal and regional authorities.

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Source: federal Ministry of Finance

The regional level reproduced the same principles for interbudgetary relations' realization as those applied at the federal level, the only difference being the fact that both tax revenues disbursed on a shared basis and subsidies didn't come from the federal budget, but were transferred from the regional one. It's notable that a scheme like that enabled a regional level to gain greater efficiency in reallocating the resources from rich municipalities in favour of those poorer ones; such a manner of procedure, however marked by the lack of any legitimate rules of relations between regional and local budgets imparts local authorities a negative incentives to raising their own incomes and to developing a tax base of their own. Thus higher authorities got capable of diminishing the sharing rate of the regulating taxes for the municipality or of diminishing the subsidy size in case the previous budget period displayed the growth of its incomes.

The pressure the regional authorities exerted upon the federal ones resulted also in the growth of regional financial aid⁹ share in the Federal budget expenditures from 6,9% to 14,9% for the period of 1992 - 1994.

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The new Constitution of 1993 and federal authorities' strengthened positions made it possible to make a reform of interbudgetary relations in 1994, the main purpose of which being to formalize the aspects of revenue allocation between federal and regional budgets and to provide financial aid for lower level budgets¹⁰. With articles 71 and 72 in place, the new Constitution formalized the basic aspects of competence for federal, regional and local authorities. Besides, a number of treaties were signed to differentiate the objects of competence between the Centre and the Federation members known as the main abusers in paying no taxes to the federal budget and, thus a tax payments to the federal budget was made possible, although in smaller shares compared to the rest of the regions (implying Tatarstan, Sacha, Bashkortostan).

As regards interbudgetary relations, the main result of the reform undertaken was primarily the formation of a Fund of Financial Support to the Regions within the framework of the Federal Budget, that was to disburse its resources between the subjects of the Russian Federation according to an all-unified methodology regarding both regional budgets' revenue capacity and spending needs, and secondarily, it was an attempt to set out universal rates for the allocation of federal tax revenues between the centre and the regions. The 1994 federal budget law contained the common rates for tax income distribution between the federal and the regional budgets for basic federal taxes. Set in 1994, the tax income distribution proportions for the three basic federal taxes remained practically unchanged till 1998 (see Tables 3–5 for the currently operating proportions of tax income distribution and also for those of tax authorities and spending responsibilities). The tax sharing rates between the Federal budget and the budgets of Federation members made: for VAT – 25% of tax revenues collected on the region's territory, for corporate profit tax – at the rate of 25% to 22% for different years, for personal income tax – 90%-100% (taking account of a particular the year) of the tax revenues originating from the region's territory. Regional authorities also got a right to change the regional corporate profit tax rate, and also a right to intro-

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duce regional and local taxes of their own (the latter right was abolished in 1996)¹¹.

The ideas on gaining greater objectiveness in interbudgetary relations were however implemented inappropriately, especially in the sense of interbudgetary relations formalisation and imparting them transparency. So the regional shares in FFSR calculated according to a universal method, were subject to approval to be made by the State Duma as part of the Federal Budget Law, which preconditioned numerous current amendments in the calculations presented by the Ministry of Finance when drafting the bill. Sticking to universal rates for the distribution of federal tax revenues between the federal and the regional budgets wasn't actually carried out either: first, as a result of the non-cash off-sets the shared taxes might be payed only in the share, that assigned to the region's budget, and second, setting the federal taxes' sharing rates in the case the budgets of a number of national republics was a procedure regulated by special instructions of the Ministry of Finance, i.e. it could be made on the individual basis.

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Later on during the period of 1995 - 1996 the agreement made between the republic of Sakha (Yakutia) and the city of Saint-Petersburg confirmed the latter condition. The same kind of agreements reached for the period of 1995-1997 with a number of other Federation members (the republic of Udmurtia and Komi, the Krasnodarsky and Khabarovsk krais, the Sverdlovsky, Irkutsky, the Nizhny Novgorod, Rostov, Vologda, Murmansk and Chelyabinsk regions) also implied a considerable extension of the budget rights with regional authorities. First and

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foremost, this means providing an opportunity for a region to finance the federal budget expenditures on the region's territory at the expense of the federal tax revenues, originating from the territory, then about the right to effect individual off-sets with the federal budget, to use exponents individually agreed on when calculating the transfers from FFSR, to finance regional spending programs at the expense of the resources from the Federal budget, then about obtaining a right to control the resources of the regional departments of federal non-budget funds and also to appoint administration for these departments etc. As becomes obvious from the above-described¹², some of the regions were delegated too wide authorities in comparison with the majority of other federation members – the budget statistics suggests that the agreements made enabled Tatarstan, Bashkortostan and Yakutia to control considerable revenue amounts, additional spending responsibilities being thereby incumbent upon them, which implied a greater extent of independence for these regions compared to other Federation members. It is however notable that the privileges, implied by the agreements, actually operated only for Tatarstan, Bashkortostan and partly the Republic of Sakha, whereas the federal government and the Ministry of Finance gave the other Federation members no chance to implement the agreement-implied privileges.

¹² See "OECD Economic Surveys: Russian Federation", OECD, March 2000, pp.113-149

TABLE 2. AMOUNTS AND STRUCTURE OF THE FEDERAL FINANCIAL AID TO THE BUDGETS OF THE RF CONSTITUENT ENTITIES IN 1993 – FIRST HALF OF 2000.

| | 1993 | | 1994 | | 1995 | | 1996 | |
|--|-------|---------------------|-------|---------------------|-------|---------------------|-------|---------------------|
| | % GDP | % of total fin. aid | % GDP | % of total fin. aid | % GDP | % of total fin. aid | % GDP | % of total fin. aid |
| Dotations | 0,02% | 1% | 0,09% | 3% | 0,06% | 3% | 0,09% | 4% |
| Subventions | 0,69% | 26% | 0,42% | 12% | 0,12% | 7% | 0,12% | 5% |
| Total transfers from the FFSR | 0,00% | 0% | 0,36% | 10% | 1,17% | 64% | 1,04% | 44% |
| <i>including:</i> | | | | | | | | |
| Transfers | 0,00% | 0% | 0,36% | 10% | 0,86% | 47% | 0,68% | 29% |
| Transfers at the account of the regional VAT share | 0,00% | 0% | 0,00% | 0% | 0,31% | 17% | 0,36% | 16% |
| Mutual settlements (surplus) | 1,95% | 72% | 2,54% | 74% | 0,42% | 23% | 0,81% | 35% |
| Budgetary loans to the lower levels of the budgetary system less repayments: | 0,03% | 1% | 0,02% | 1% | 0,04% | 2% | 0,23% | 10% |
| Deficiencies in transfers from the regional budgets to the special purpose budgetary funds | 0,00% | 0% | 0,00% | 0% | 0,02% | 1% | 0,05% | 2% |
| Totals: amount given to the lower level budgets | 2,70% | 100% | 3,4% | 100% | 1,8% | 100% | 2,3% | 100% |
| Total federal expenditures | 21,2% | | 23,0% | | 16,6% | | 15,8% | |

* for January-June

Source: RF Ministry of Finance, authors' calculations

| 1997 | | 1998 | | 1999 | | 2000* | | |
|-------|---------------------|--------|---------------------|--------|---------------------|-------|---------------------|--|
| % GDP | % of total fin. aid | % GDP | % of total fin. aid | % GDP | % of total fin. aid | % GDP | % of total fin. aid | |
| 0,13% | 5% | 0,10% | 6% | 0,06% | 4% | 0,18% | 11% | Dotations |
| 0,09% | 4% | 0,02% | 1% | 0,20% | 14% | 0,02% | 1% | Subventions |
| 1,22% | 49% | 1,12% | 70% | 0,99% | 71% | 1,20% | 74% | Total transfers from the FFSR |
| | | | | 0,00% | | 0,00% | | <i>including:</i> |
| 0,86% | 35% | 1,00% | 62% | 0,99% | 71% | 1,20% | 74% | Transfers |
| 0,36% | 14% | 0,12% | 8% | 0,00% | 0% | 0,00% | 0% | Transfers at the account of the regional VAT share |
| 0,43% | 17% | 0,36% | 22% | 0,14% | 10% | 0,20% | 12% | Mutual settlements (surplus) |
| 0,64% | 25% | -0,03% | 0% | -0,28% | 0% | 0,02% | 1% | Budgetary loans to the lower levels of the budgetary system less repayments: |
| 0,00% | 0% | 0,00% | 0% | 0,00% | 0% | 0,00% | 0% | Deficiencies in transfers from the regional budgets to the special purpose budgetary funds |
| 2,5% | 100% | 1,60% | 100% | 1,39% | 100% | 1,61% | 100% | Totals: amount given to the lower level budgets |
| 15,3% | | 14,5% | | 14,8% | | 13,7% | | Total federal expenditures |

As was stated above the next basic component of the interbudgetary relations reform of 1994 was the creation of the Fund for Financial Support to the Regions within the federal budget, the resources of which coming as transfers were calculated according to a single universal formula for the Federation members and were to lay the foundation for the federal financial assistance delivered to regional budgets. It is, however, only in 1994 and 1995, that the FFSR transfers were really calculated by precise sticking to the formula, as the proportion of the FFSR transfers in the total amount of federal financial assistance to the regions was small enough (see Table 2). Later on the regions' shares in the Fund (the law on the federal budget for each year fixed the transfer size as shares of transfer recipient regions in the total amount of the fund) were essentially amended when passing the budget bill in the State Duma.

The mechanism of FFSR disbursement applied for calculating transfers since 1994 till 1998 was based on a balancing procedure compressing two stages. The first stage was to outline the regions where the per capita budget revenues were below average and then a certain amount was calculated to raise their incomes level up to the average. Such regions were named «those requiring financial support». For the reasons of taking into account the country's spending needs interregional differentiation it was decided to split the regions into three groups, individual average exponents of the incomes forecasted being calculated for each, – these are «nothern» regions or those having districts ranked with the Far North, regions contained districts acknowledged equal to Far North and other Federation members. The second stage was to delineate the regions, in which the estimated revenue amount failed to cover the amount of expenditures forecasted for the next financial year – these are named «regions requiring extra financial support». For such regions a certain amount was prescribed to fill the gap. The shares of regions in FFSR were later on calculated in proportion to the region's total demand for resources at the first and the second equalization stages. The right to obtain FFSR transfers was given to app. 70 to 80 Federation Members in all the 89 of them annually.

The total amount of FFSR resources was defined annually on the basis of the federal budget capacity. The source of FFSR forming was set in 1994 as the proportion of VAT on goods and services, produced and rendered on the territory of the Russian Federation estimated as 22% from the federal share of the tax. In 1995 the share of FFRS assignment the was increased to 27% of the VAT federal part. In 1996 and 1997 FFSR was formed by the 15% share of the total amount of tax revenues into the federal budget, supervised by tax organs (i.e. taxes on external operations excluded), this share decreasing to 14 % in 1998.

It's notable that the incomes of the regional budgets used for calculating the transfers were the previous year reported budget incomes in the budgets of the Federation Members diminished for a certain value for the purpose of stimulating regional authorities to mobilize the incomes. The regional budgets' spending exponents involved in the calculations presented data on regional budgets' expenditures for 1991, «brought» to the conditions of the planned year by means of a number of «adjustments» and corrections. For instance, the regions' revenue base for 1998 was calculated with reference to the data of the previous reported year (1996) with a 3 positions decrease and a six positions increase, whereas the expenditures were forecasted by inflating of the 1991 data, 15 spending articles being excluded and 32 new kinds of expenditures added up, the expenditures for housing and utility services being also overviewed.

Using the 1991 data as the basis for transfers calculation is first and foremost accounted for by the regional representatives' demand that the rates of regional budgets spending needs be taken into account when calculating the transfers. However there haven't been any affirmed normatives for budget expenditures with a subject-to-subject ranging, the reason for which being the questionable basic social guarantees for the population of the Russian Federation and the doubtful sources of their funding. Such-like conditions suggested taking the actual expenditures of Russian regions for 1991 as the basis for the federal financial support distribution, since the year was generally recognized as the last one with the budget resources' spending performed according to the natural norms of the Soviet times. It's lucid that the numerous corrections applied to the 1991 data became an aggravating factor for the exponent, groundless as it was, and all in all an approach like that actually happened to fix the budget demands of the Federation Members on the level of 1991. Thereby it appears favorable for some regions, the expenditures of which were at a comparatively high level in 1991, and *visa versa*¹³.

Since the time of the FFSR foundation and the introduction of a new mechanism of interbudgetary equalization the basic spending и revenue exponents of the FFSR distribution methodology were further liable to conforming to the rep-

¹³ For instance, the Altai Republic until 1992 was not the member of the Russian Federation, but as autonomous oblast belonged to the Altaiski krai. That is why the majority of the public organizations at its territory was financed from the krai's budget. The consequences of this was a situation when a region (Altai) with per capita revenue almost equal to the neighboring Tuva but branching of budgetary organizations network is 1.5 times higher receives lower financial support. With the adoption of new principles of financial support distribution the sum of transfers to Altai is 3 times higher that it was earlier.

representatives of regional authorities. However in the course of time the forecasted revenues and especially the Federation Members' expenditures proved to be subject to an largely increasing influence of individual agreements, as the Ministry of Finance was beginning to face greater difficulties in proving the exactness of the data gained by introducing corrections into the 1991 exponents. As a result, by 1998 both basic exponents for transfer calculations and financial support final amounts could be changed arbitrarily by agreements made in the Government or the State Duma, which placed any objectiveness, or transparency, or formalization of the FFSR transfers out of the question.

As a result of the reforms undertaken, the system of federal financial support of the regions became inclusive of several channels to render financial resources, which can be divided into two groups: the regular and irregular kinds of financial support. The regular kinds of financial support embrace, first of all, transfers from the federal fund for financial support to the regions, the «dotations» delivered to the budgets of closed administrative-territorial institutions, the subventions for the city of Moscow, federal financing for shipping goods in advance to the regions of «problematic accessibility» (the so called «Northern shipping»). The irregular kind of financial support mainly consists of expenditures as part of various federal programs' performance, and also financing through budget limits of ministries and other government bodies. One should lay a special emphasis on budget loans and resources passed to regional budgets when carrying out mutual payments: the channels of the resources' allocation, presenting no formal kinds of financial support offered regularly, have actually acquired a status of an extra source for covering the gap between the revenues and expenditures in regional budgets.

The resources passed to the lower level of the budget system within the framework of mutual payments were officially defined as the resources directed to fund the expenditures, related to the implementation of the federal decisions adopted in the course of the fiscal year, i.e. after the Federal budget Law had already come into power. However due to the common shortage of financial resources, insufficient to finance various expenditures set by the acts of Federal legislation, the resources passed through mutual payments happened to serve as a kind of federal financial support, both additional to FFSR transfers and rather substantial in quantity. The resources mentioned contributed to the regions as a compensation for growing their expenditures which resulted from the decisions made on the federal level and was connected with the performance of federal and regional investing programs. Besides the expenditures financed directly in the mutual payments form, there were many other kinds of expenditures added up

hitherto, the volume of which was defined either on a negotiation basis or by a decision taken by a higher authority. Since 1994 and on, the majority of the resources that the regions receive mutual payments fell with financing housing and utility services, the required expenditures for which were set by agreement between federal and regional authorities. It's notable that the expenditures for carrying out mutual payments weren't implied the Federal Budget Law – it's already at the stage of the budget's executions, that they were defined and agreed on. Besides, in different times all the regions of the Russian federation (with no exception) were recipients of such-like resources.

The budget loans offered to regions on a repayable and chargeable basis were often a latent kind of grants, as it's the regions that were the recipients, whereas the loan repayments were often postponed, or the loan debt was cancelled. Along with that, the amounts of federal budget loans, offered similarly to the resources, spent through effecting mutual payments weren't implied by the Federal budget law; as to the order of their financing, it was vague and resulted from individual agreements and decisions of federal authorities. For example, during the 1997 campaign of paying salaries to the budget sphere staff the federal budget paid more than 10 bln. rubles to the budgets of the Federation Members (more than 1,5 % of GDP) which made about 20% of all federal budget resources given to the regions that year. (see Table 2).

The pressure exerted by the regional leaders as well as the reasons of supporting the bill on the federal budget for 1998 in the Federal Council resulted in the decision to envisage 1,5 mlrd. roubles for the financial support of depressive regions and of those being badly in need, in addition to the Fund of Financial support to the regions (the planned amount of FFSR for 1998 was 39 mlrd. roubles). Thereby it was noted, that the order of these facilities' distribution was set to be determined by the Government of the Russian Federation. In the mid-September of 1998 the Government approved of a methodology of extra financial support distribution and affirmed the distribution over the subjects of the Russian Federation¹⁴.

The methodology mentioned actually set out a number of principles to calculate regional shares in the total amount of facilities aimed at extra financial support. It was supposed in particular, that ranking a region among depressive ones is a procedure performed on the basis of «budgetary provision» exponent defined as a ratio of the difference between the regional budget's expected ex-

¹⁴ See resolution of the federal Government of the RF of 19.09.1998 #1112 "On the supplementary financial support of the depressed regions".

penditures and income to the expected expenditures. Besides, it's only socially relevant expenditures of regional budgets, that are taken into consideration (salaries together with payroll taxes, state payments to the families with children, scholarships etc), adjoined by the amount of subsidies for housing and utility services and the creditor debt in socially relevant spending articles.

In accordance with the methodology adopted, a Federation Member is ranked with the category of depressive regions in case it has displayed the dominance of the spending exponents noted over the revenue ones. The financial resources were distributed with depressed (that are highly-subsidized) regions, identified by applying the corresponding method, proportionally to the absolute meaning of the gap between expenditures and revenue in question. In 1998 the right to receive extra financial support facilities was offered to 28 subjects of the Federation.

A new stage of interbudgetary relations reforming: 1998 - 2000.

The relations between the budgets of various levels haven't been left unaffected by the serious changes that have been taking place in the sphere of economic, financial and budget policy since 1998. Despite the reforms performed in 1994, the political trading process together with the struggle of federal authorities to gain support with regional elites have resulted in the fact that the federal budget has been spending huge facilities to fund the budgets of the Federation Members embracing both direct expenditures and revenues undergained. The federal government at the same time had efficient levers of control neither over the compliance of the funds provided with the real demands of regional budgets, nor over the spending directions these funds were given by regional authorities. The financial crisis that came to increase the demand for budget revenues mobilization has as well pushed the Government to search for the ways to increase both the interbudgetary relations efficiency and effectiveness.

Reforming the interbudgetary sphere was already laid foundation to with the adoption of the Law on «Financial bases for local self-governance in the Russian Federation» in 1997 and by the creation of a working group for reforming interbudgetary relations under the Committee for economic reform (the governmental structure). The task to change the system of rendering assistance to the lower level budgets as well as to distribute sources of revenue and spending displayed itself as urgent during the massive campaign of offering federal budget loans to regional budgets which was undertaken in December 1997 for the purpose of paying the salaries in the public sphere. The conditions which induced the federal authorities to resort to an urgent extra funding of regional spending needs (as to

budget loans, these were formerly described as a kind of a grant to the regions badly in need (due to the cancellation capacities and numerous repayment delays) rendered via irregular, non-formalised channels, devoid of transparency) has led the federal authorities to the recognition of a necessity to create a new order of federal transfers distribution supposing it was to be both formalized and transparent and to become the one and only channel of rendering the non-earmarked federal financial support to the regions.

The first steps to direct reforming of the regional financial support system were already undertaken when preparing the federal budget for 1998. The methodological outline for FFSR distribution which was placed with the State Duma as part of the bill suggested reducing the Fund size from 15% to 13% of tax revenues together with relinquishing the former division of the Federation Members into «regions badly in need for financial support» and «those requiring extra financial support» as well as earmarking as much as a 3% tax revenues part of the Fund for financial support of territorial funds of compulsory health insurance. It's no less important to stress the reservation of 10% of the Fund within its whole amount for the purpose of distributing them over regions marked by a most vivid disproportion of expenditures and revenues, and also the combination of offering facilities for financing housing and utility services with fulfilling the conditions the housing reform.

Nonetheless, the draft of the FFSR distribution methodology was never adopted in the course of discussion. According to the existing practice the State Duma has a right to change the shares' values obtained as a result of the calculations conducted by the Ministry of Finance with the help of the respective method. All that has formed a condition under which the regions' actual shares in FFSR, fixed in the 1998 Federal Budget Law are much different from those presented in the bill by the Ministry of Finance. The analysis undertaken helps reveal that the regions' shares in FFSR which were finally approved of by the Federal Council tend to be closer in figures to the true structure of FFSR distribution in 1997 than to the share values calculated with the help of the proposed methodology¹⁵. A situation like that came to nearly reproduce the previous year situation when the transfers for the regions affirmed by the Budget Law were mostly determined by means of agreements rather than with the help of the calculations of the Ministry of Finance.

As soon as the Federal Budget Law came into power in the shape it was adopted by the State Duma, the Ministry of Finance conducted vigorous work on

¹⁵ See *"Russian Economy in 1998: Trends and Prospects"*, IET, Moscow, 1999

preparing a full-scale reform for interbudgetary relations which turned to one of the most important strategies of the new Russian government. This first of all resulted in forming a tripartite working group for modifying interbudgetary relations, engaging representatives from the Government, the President Administration and the Federal Assembly and, secondly, in signing of the President's directive on the interrelations between the federal budget and those of the Federation Members¹⁶.

The directives the President's Directive voiced were basically aimed at normalizing the relations between the federal and regional budgets, cutting out the inappropriate usage of the federal financial support and financing groundless spending obligations at a regional level at the federal budget's expense. The Directive thus suggests that the Government should allow the repayment delays of the formerly offered budget loans as well as to sanction providing financial aid only in case an agreement is reached by the Government of the Russian federation and its subjects' executive power authorities in favour of the state finance recovery granting the same for the financial support providing conditions which were to be rather severe in stopping non-cash settlements, restructuring tax arrears, reforming the housing and utility services sector etc.

The pressure that the Federal Government was exerting upon regional authorities by means of applying conditions onto the repayment delay of federal loans and offering a different kind of financial support assisted undertaking the very first attempt to reform the budget sphere in order to reduce the budget expenditures. As shown by the data on federal budget's execution, the Ministry of Finance kept sticking to the theses of the document under discussion for the rest of 1998 - the amount of budget loans offered was preserved at a low level whereas the repayment amount surpassed the value of the previous years making 0,2 % by the end of the year which is 866 mln. roubles more than the budget loans' total amount. It's right since 1998, that federal budget loans have ceased to be an additional channel of providing federal financial support.

The second one of the governmental strategies in the field of fiscal federalism was working out basic conceptions of an interbudgetary relations reform which was once approved of by the tri-partite working group for interbudgetary relations updating and then affirmed again at the end of July 1998, already shaped as a Concept of reforming the interbudgetary relations in the Russian

¹⁶ See: presidential decree 5.05.1998 №495 "On the supplementary measures regarding payment of salaries to the employers in the public sector and sanitation of public finances"

Federation for 1991 - 2001¹⁷. This document sets out the basic directions for the interbudgetary system reform to take. These are: the differentiation of the spending authorities and the responsibility between the power authorities of various levels, the differentiation of the sources of income between the levels of the Russian Federation's budgetary system, the modification of the formation and distribution methodology for the federal Fund of financial support of the Federation Members and also investment support for the development of territories. The Concept puts forward basic suggestions for each direction, supposing the reform ought to be based thereupon alongside with the set of measures that appear inevitable for carrying out the task.

Thus its spending authority defining part for variously leveled budgets enumerates the basic kinds of expenditures that are to be financed at the expense of budgets of various levels according to the Constitution, and also the expenditures subject to joint financing. In 1998 it was already expected to inventory the spending authorities of the federal, regional and local budgets and to affirm the expenditure rates for housing and utility services, education, health care, state administration, child support, and in 1999 it was expected to set rates for the rest of spending articles in regional budgets while the assessment of the Federation Members' consolidated budgets would be performed on a normative basis beginning with 2000. Besides regional authorities are recommended to undergo transition to a normative-based assessment of municipal institutions' demands before the end of 2001.

As to the sphere of revenue sources distribution, the Concept adduces a closed list of federal, regional and local taxes which is to be approved of by the corresponding normative acts alongside with the list of federal taxes subject to distribution among variously levelled budgets. Besides it is asserted that the distribution of the regulating taxes income between the federal and regional budgets is to be performed on the basis of rates, set for a period no shorter than three years, whereas with regional and municipal budgets it is to be carried out on the basis of the rates set for no shorter period.

The chapter putting forward the methods of forming and distributing the Federal fund of Support to the regions appears to be one of the most important parts of the Concept for interbudgetary relations reforming¹⁸. The document

¹⁷ See resolution of the federal Government of the RF of 30.07.1998 №862 "On the concept of the reforming interbudgetary relations in Russia in 1999-2001"

¹⁸ Discussion on the forms and implementation of the new method of transfers distribution see С.Баткибеков, П.Кадочников, О.Луговой, С.Синельников, И.Трунин "Оценка налогового потенциала регионов и распределение финансовой помощи из

states the financial expenditure rates for state services rendering to be the likeable basis for determining the financial aid from FFSR, then, the total amount of FFSR resources would be defined by the rate of allocations into the federal budget set by the federal law for a period no shorter than three years, and some of the FFSR resources could be offered for an extra support to highly dotable regions on the basis of a universal methodology.

For the purpose of the investment support of the regions it is advised to create a federal Fund of regional development which would accumulate the resources of the state capital investments currently managed as part of federal and regional programs, as well as of branch financing projects etc. The resources of this Fund are supposed to be granted on an «as is» basis (unlike those of the development budget, granted on a repayment basis) under the condition of presenting an investment program worked out by regional authorities in cooperation with the Ministry of Economy of the Russian Federation.

To facilitate economic reforms within regions and to stimulate the processes of financial recovery within regional budgets the Concept suggests creating a Federal Fund for regional finance development, the resources of which are supposed to be granted to unsubsidized и low-subsidized regions on a repayment basis and also to those creating favourable prerequisites and conditions for economic development, implying their sooner gaining financial independence and greater creditworthiness.

The Concept approved laid the foundation for working out FFSR distribution methods for 1999. In accordance with the Concept, the transfer design quantities were defined in a way to bring the regional budgets incomes adduced to the level determined by the Fund amount. To gain the compatibility of regional per capita revenues a budget expenditures index was employed, it being calculated however not with individual regions but with groups of regions, besides grouping of Federation Members (except for Moscow and Saint Petersburg) by economic regions was used, the regions of the Far North and the mountaineous areas of the

федерального бюджета", О.Луговой, С.Синельников, И.Трунин *"Разработка бюджетных нормативов и методики оценки межрегиональных различий в бюджетных потребностях субъектов Российской Федерации" // "Совершенствование межбюджетных отношений в Российской Федерации. Сборник статей".* Институт экономики переходного периода, Научные труды №24Р, М., 2000; Дж.Боекс, Х.Мартинес-Васкес *"Реформирование механизма распределения средств из Фонда финансовой поддержки регионов: анализ нового механизма выравнивания"*, рабочая группа экспертов правительства США по оказанию содействия налоговой реформе в Российской Федерации, Москва, 1998

Northern Caucasus highlighted. The Vologodskaya and the Kaliningradskaya regions were thereby ranked with the North - Western regions. The very budget spending index itself was calculated as a ratio of weighted average costs of living in a group of regions to the least costs of living value found in all the groups then multiplied into the ratio of a region's weighted average budget expenditures to the weighted average value of the budget per capita expenditures in a group of regions.

It's notable that the FFSR distribution project presented to the Federal Assembly was approved by the State Duma without any global corrections so typical of the previous years which is likely to be due to the participation of the State Duma representatives alongside with those from the Federation Council and regional authorities. It's for the first time that the Federal Budget Law affirmed the right of the Ministry of Finance to render FFSR transfers only to the regions which come to satisfy the demands of the federal and tax legislation completely, no exceptions, additions or special conditions admitted, which thereby creates a legislative basis for the federal government to exert an influence upon the process of economic performance in the regions.

The rates for distributing tax incomes between the Federal and Regional budgets, left unchanged since 1994, came to be overviewed in the Federal Budget Law and by other Acts of legislation adopted as part of the budget package. Thus the share of VAT revenues was increased up to 85%, whereas the rates of corporate profit tax (the federal and the maximum regional one) were reduced correspondingly to 11% and 19%, besides it was set that the personal income tax revenues from individuals be enlisted into the federal budget at a 3% rate (it's 16% of the personal income tax revenues that has been enrolled into the Federal Budget since 2000 January the 1st).

Reforms in interbudgetary relations initiated in 1997 and 1998 continued vigorously in 1999. It's notable that generally, beginning in 1999, the federal Government took a relatively firm line in relation to Federation members. During Yevgeny Primakov's premiership proposals were frequently voiced in favour of abolition of elections of heads of regional administrations and also for a greater concentration of powers over revenues, and a more effective control over the performance of regional authorities. In February 1999, the Government issued a directive on reform in housing and utility services, setting maximum rates of charges and utility services, which was differentiated by economic regions and provided a mandatory benchmark in financial support distribution to the re-

gions¹⁹. For all the imperfections of these rates, the directive was one of the few attempts so far launched to put budgetary relations with the regions within a legal framework.

These developments were bound to affect the quantitative aspects of relations between the federal centre and the regions. For a second year running, federal budget loans cannot, in general, be regarded as channels for the flow of financial aid – the balance in these operations has been unfavourable for the regions in both 1998 and 1999, which means that more loans were repaid than received throughout the year. It is a notable fact that the share of outstanding federal budget loans in total funds transferred into the budgets of federation members in 1996 and 1997 was 10 % and 25%, respectively. In 1999, the Ministry of Finance discontinued its practice of transferring funds from the FFSR by setting them off against the federal share in value added tax receipts. Previously, the amounts flowing through these channels reached nearly 17% of total federal financial support (including outstanding loans from the budget), creating a favourable field for federal and regional authorities to bargain over VAT amounts to be set off against federal transfers.

These positive changes in interbudgetary relations in Russia however failed to work off the backlog of problems that had built up in this area. The methods of allocating federal transfers and the basic principles and conditions of federal financial support allocation to the regions were badly in need of updating. The principal areas where reforms could start in methods of aid disbursement from the Fund of Financial Support to the Regions included the need for a fuller account to be taken of the tax potential and spending needs, methods to be developed to motivate the regional authorities into stepping up their efforts to collect taxes and restructure their budgetary spending, the process to be further formalized, and bias to be eliminated in the elaboration of the initial data and setting of actual amounts of financial support.

In 1999, the work was continued to update the relations between the federal and regional budgets as part of the tripartite working group. In particular, by the time work started on the draft federal budget for the year 2000 the group had discussed and approved of the methods to calculate the federation members' fis-

¹⁹ See resolution of the federal Government of the RF of 24/02/1999 №205 "On the federal standards of transition to the new system of the payment for housing and communal services"

cal potential, the spending needs of regional budgets, besides some changes were also introduced into the methodology for allocating the FFSR amounts²⁰.

The new methods of assessing the budgetary spending needs in Federation members was, in contrast to those used in previous years, based on differentiation of average countrywide forecasts taking account of factors characterizing the magnitude of demand for specific kinds of budgetary spending. Standard budgetary requirements were calculated in the following groups of expenditures: education, health care, housing and utility services, government administration, transport and communications, culture and the arts, social policy and law enforcement.

Interregional differentiating coefficients of countrywide spending average (calculated as GDP share) characterized the objective factors of growing costs of public services such as wages and prices of goods and services in a region, climate and transport infrastructure. Moreover, these coefficients were calculated from open statistical data that are not, normally, handled by the Ministry of Finance (and, accordingly, aren't capable of being agreed on with regional authorities) – such as the proportion of the population receiving «nothern» allowances in addition to their wages, the cost of living, existence of direct access to a motor or rail network, the share of the population living in areas reachable by good suppliers for a limited season only, and so on.

The chief positive result of the adoption of a new methodology to estimate standard spending rates was the fact that it was ultimately approved by the tripartite working group set up to enhance the interbudgetary relations, and that the budgetary spending indexes used to make FFSR disbursements under the 2000 Federal Budget Law were obtained on its basis. For the first time in the history of the budgetary system of the independent Russian state, the attempt to formalize region budget spending rates has proved successful. In addition, it was helped to considerably enhance the transparency of calculations of federal budget rates, deprived regional authorities of influence over the size of regional budget spending rates by bargaining over individual financial numbers separately, as was the case previously, and gave the Federal centre an opportunity to set priorities in the Federation members' spending policies by enlisting, in this way, yet another tool for implementing the regional budget policy at the federal level.

In addition to the methods of estimating the regions' spending needs in drafting a 2000 federal budget bill, a new technique was developed and applied for calculating the tax potential of Federation members. The need for an impartial

²⁰ See *"Russian Economy in 1999: Trends and Prospects"*, IET, Moscow, 2000

approach to estimating the tax potential was outlined already in the Concept of reform in Interbudgetary relations. At the time the transfers were calculated for 1999, an approved mechanism for calculating the regions' tax resources was non-existent, and FFSR disbursements were made on the basis of adjusted base year reports²¹.

The new methods of assessing territorial tax potentials used in making disbursements from the Fund of Financial Support to the regions in 2000 is based on the average tax load on the gross value added in the leading sectors of the economy in the base period. In other words, the average countrywide tax load calculated as a ratio of an industry's actual tax liabilities to the value added in that industry in the base period is used to determine the region's tax potential with account for the expected volume of value added in that industry in the region during the plan period. Calculations are made for manufacturing, construction, agriculture, and market services.

Major alternations were also made, at the drafting stage of the 2000 federal Budget, in the method of disbursements from the Fund of Financial Support to the Regions. The mechanism of the approved methodology of FFSR disbursements in 2000 is illustrated in Figs. 1 to 3, where the regions' adjusted GTR values before and after transfer disbursements from the FFSR arranged in the order of magnitude are given as tentative examples. Fig. 1 illustrates the transfer calculation principle used in 1999. It is clear from the figure that transfers go to Federation members whose adjusted gross tax resources are below a certain equalizing line that is, in turn, determined from the FFSR size. If, under these circumstances, the adjusted GTRs of a region rise above that line (the region shifts to the right along the adjusted GTR curve to equalization), the equalizing line remains actually unchanged and the amount of transfer made to that region is reduced by the amount of GTR growth.

²¹ Detailed discussion on measurement of regional fiscal capacity see *"Обзор существующих концепций и методов измерения фискального потенциала регионов и возможность их использования в Российской Федерации"*, Школа политэкономических исследований Университета штата Джорджия, июнь 1997

FIG. 1. THE EQUALIZING PRINCIPLE APPLIED IN THE METHODOLOGY OF FFSR RESOURCE ALLOCATION FOR 1999 (A HYPOTHETICAL EXAMPLE).

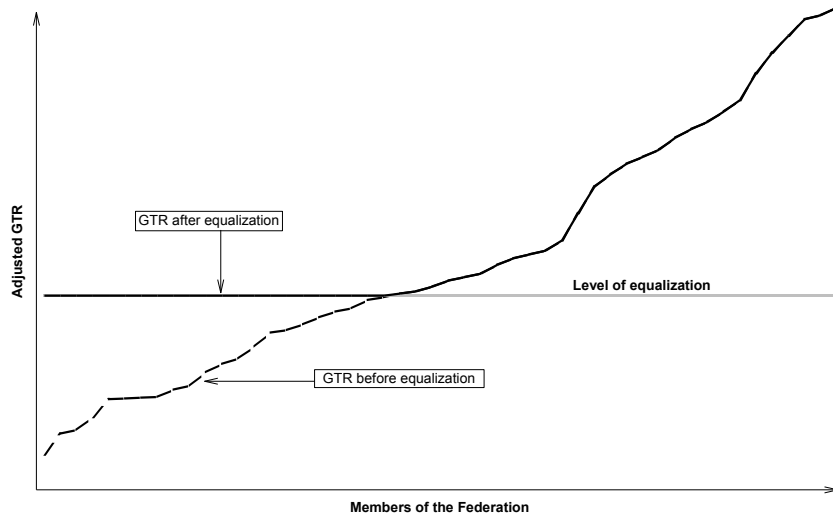


Fig. 2 illustrates another equalizing principle, under which the Fund of Financial Support is disbursed in proportion to the deflection of adjusted GTR values from the median level. The figure illustrates that in this situation, the number of transfer recipients doesn't depend on the FFSR volume and that a growth of adjusted GTRs causes the amount of a transfer to decrease in proportion to the total growth. This method is disadvantageous because of a possible fragmentation of the Fund among a large number of financial support recipients.

FIG. 2. THE PRINCIPLE OF EQUALIZATION IN PROPORTION TO ADJUSTED GTR'S DEVIATION FROM AVERAGE VALUES APPLIED IN THE ALLOCATION OF 80 % OF THE FSSR FOR 2000 (A HYPOTHETICAL EXAMPLE).

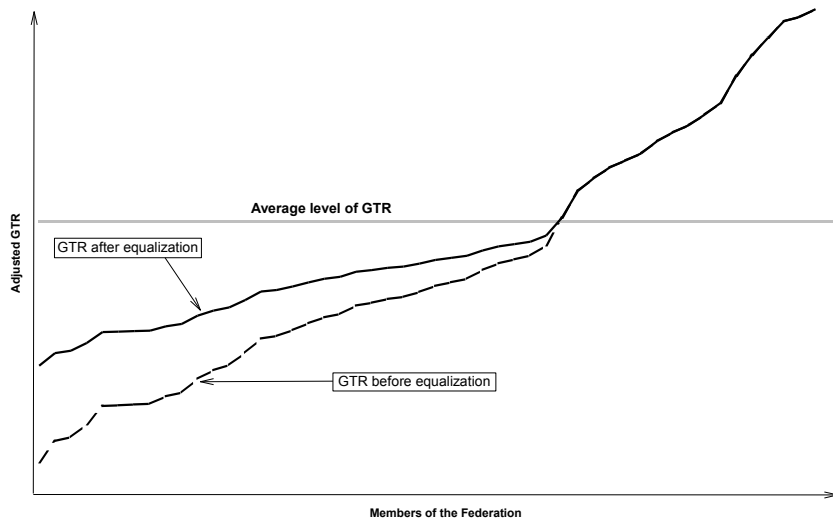
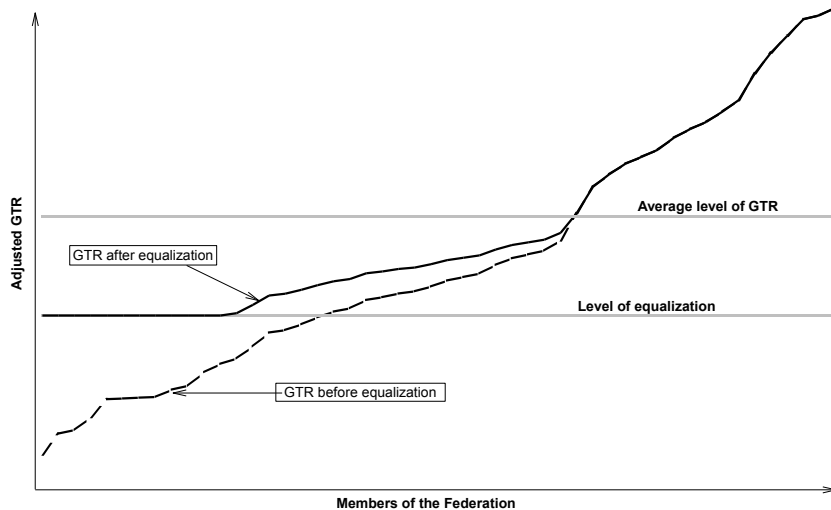


Fig. 3 illustrates a combined principle of FFSR disbursements, which was used in calculating transfers in 2000. According to the figure, the number of FFSR transfer recipients does not depend on the Fund size, where this principle is applied, and financial support is disbursed proportionally among them. In this case, however, a region is guaranteed a certain minimum of budgetary support, that is, a tax potential adjusted for the magnitude of demand for budgetary spending.

FIG. 3. THE COMBINED EQUALIZING PRINCIPLE APPLIED IN THE METHODOLOGY OF THE FFSR RESOURCE ALLOCATION FOR 2000 (A HYPOTHETICAL EXAMPLE).



As it was mentioned above, one of the problems facing the system of federal financial support to Federation members has, to this day, been the existence of numerous support distribution channels. In particular, earmarked sums were allocated to the regions within the framework of the federal Northern Program aid, which the Russian Government calculated and transferred during the fiscal year without regard for any approved methodology²². Meanwhile, the implementation of the Northern Program (financial livelihood aid to areas in the Far North and areas that can be supplied with provisions for only a few months during a year) amounts to a problem of unsupported higher spending requirements in the budget of respective regions which in this case brands placing the financial aid beyond the FFSR framework as unjustified.

An attempt was made, at the preparatory stages of the 1999 Federal Budget Law, to integrate funds to finance the Northern program within the FFSR transfers (it was proposed to allocate funds for these purposes in proportion to the actual sums transferred in the preceding year), but this proposal was never ap-

²² The irrationality of the separate financing of the Northern Program could be shown with the help of the following example: nobody can even imagine that federal budget would finance advanced shipment of goods to such northern regions as Khanty-Mansiisti or Yamalo-Nenetsky autonomous okrugs.

proved by the State Duma. The method of FFSR disbursements through 2000 was designed so that the budgetary spending index (spending requirements) takes account of the Northern location and remoteness of a region, making it possible to increase transfer sums to Federation members in need of financial aid under Northern Program. In 2000, therefore, a separate line for aid under the Northern Program and livelihood provision has been added to the amount of transfers to regions in the Far North.

Also, the FFSR disbursement methodology provided, with consent of the tripartite working group members, that transfers to all regions were to be cut by 2 %, and that the resultant saving (Rb.353.7 million) be used as financial aid to the Republic of Daghestan. The transfer to the Chechen Republic that could not, for obvious reasons, be reckoned with in FFSR disbursements by the standard technique, was calculated directly, on the basis of financial support for previous years. These factors reflect the tendency with state power authorities, to impart a systematic and transparent character to the process of federal financial resource disbursement.

The new methodology of FFSR disbursements led to a reduction in the number of Federation members eligible for transfers. Whereas the 1999 Federal budget Law named 13 regions that were ineligible to disbursements from the Fund of Financial Support to the Regions in 1999, the number of ineligible Federation members rose to as much as 18 under the 2000 Budget.

Therefore it proves necessary to state, that the period of 1998 – 1999 was the time marked by a «step ahead» – venture, undertaken as far as the interbudgetary relations are updated. The advantages of the FFSR disbursement methodology in the economic sense listed above can be added up with a supposition, that the Government has managed to find an effective way to cooperate with the representatives of the legislative power and regional authorities. Recently the mechanism of agreement on the decisions in the financial aid allocation has been justifying its value with the tripartite working group members: compared to the previous times, on having gained the approval of the working group, it takes the Governmental proposals or the Federal Budget bill a lesser effort (as well as a much smaller number of changes introduced) to be approved of at the Federal Assembly.

Moreover, the progress made in reforming the interbudgetary relations system for the last two years has manifested itself as a gradual transition from individual exponents agreement in transfer calculations to the agreements made on the methodologies to calculate these, reached by the tripartite working group members together with the representatives of regional financial authorities. This

has given an opportunity, as a result, to considerably reduce the possibility for some of the regions to receive big amounts of financial aid just because the Ministry of Finance is convinced of the additional transfer necessity.

It won't be superfluous to mention the graduate transition to initial exponent calculation for FFSR allocation, now based upon socially-economical and financial exponents (gross regional product, the number of the population and budget services' main consumers, tax arrears etc.), the responsibility for the calculation of which now rests with the corresponding ministries and institutions. The function of preparing the initial data is gradually being withdrawn from the domain of the Ministry of Finance, which is an additional factor preventing the influence regions could exert upon individual exponents.

It is a notable fact, that the 2000 State federal budget law takes a tough and rigid line in relation to the Federal Centre and regions' financial interrelationships. In this sense, it gives the RF Government a directive to convert such Federation members as the Republics of Althai, Daghestan and Tuva, as well as the Kemerovskaya oblast and the Komi-Permyatsky and Evenkiisky autonomous okrugs to the Treasury system of budget execution, adding up the regions that can't pay salaries to the budget sphere staff on time. As the document puts it, the further conversion of other regions to the treasury system of budget cash execution ought to take place as soon as the Ministry of Finance proves ready for it in the technical sense.

The law also ascribes the RF Government to bring all the agreements on interbudgetary relations, that have been reached with the regions, into the state of correspondence with the universal rates of tax income disbursement between the federal and regional budgets, set by the law²³.

First and foremost, it's those bilateral agreements made with some Federation members at the beginning of the 90-ies and setting specific (compared to other regions) conditions for federal tax proceeds to the budget, that are implied. Moreover, it's suggested that the FFSR transfers be offered only to the regions that ensure sticking to the budget and tax legislation of Russia on its territory, no exceptions or special conditions admitted, and that the Government and the Accounting Chamber have the right to perform revisions and checking procedures over the budgets of the Federation members which receive the FFSR aid.

Among the other settings of the 2000 Federal budget Law, there's another one no less notable, which toughens the manner of performing mutual repayment between the Federal and regional budgets, as well as the manner of budget loans

²³ See article 47 of the federal budget law for 2000

repayment²⁴. Since 2000 on, the offsetting of mutual claims between the federal and regional budgets can be carried out through territorial authorities of the Federal Treasury. Should the repayment be timed out or in case the federal budget resources offered to the Federation members on an «as is» or a repayment bases are used for purposes other than those agreed on, the RF Government has a right to stop transferring any kind of financial aid to the regions, and also to demand compensation for the resources at the expense of those transferred thereto within the framework of financial support and mutual settlements.

Another important setting is that the law relinquishes the practice of financing legislative and normative acts at the expense of the federal budget, in case they are not supplied with the sources of financing, the application of the same principle being advised to regional and local authorities when forming budgets of their own²⁵.

Introducing changes into the manner of carrying out the relations between the federal budget and the budgets of Federation members will be continued in 2001. In particular, the 2001 Federal budget bill presupposes a manner of disbursing tax proceeds and spending obligations between the budget system levels, different from the one currently operating, the manner of allocating the federal financial support to the regions being also slightly changed.

Just as in the year 2000, the Fund for Financial Support to the Regions is supposed to be disbursed according to the fiscal capacity (gross tax resources) and the regions' spending needs, besides the Fund is expected to partly be employed for subsidizing highly subsidized regions by means of equalizing their gross tax resources. Thereby the mechanism of discussing the FFSR disbursing and also calculations by a tripartite working group, which has been a success, will be retained.

In 2001, it is expected to implement one more novelty of major importance, which is building up a so called Compensation Fund within the framework of the Federal Budget, that is designed to spend its resources on funding federal spending mandates, whereas these are currently funded at the expense of Federation Member budgets. As to the source of building up the Fund, it is expected to use the 15 % of the value added tax revenues that are currently transferred to regional budgets (since 2000 on, the Federal budget will receive 100 % of VAT proceeds).

²⁴ See articles 72-73 of the federal budget law for 2000

²⁵ See article 129 of the federal budget law for 2000

TABLE 3. THE DISTRIBUTION OF FEDERAL, REGIONAL AND LOCAL TAXATION AUTHORITY

| Federal Taxes | Regional Taxes | Local Taxes |
|--|---|---|
| <ul style="list-style-type: none"> • Value Added Tax • Excises • Profit Tax (Enterprises and Organisations) • Profit Tax on Capital Income • Income Tax (Individuals) • Contributions to State Extra-Budgetary and Budgetary Funds • State Tax • Customs Duties and Charges • Subsurface Resource Use Tax • Reproduction of Mineral and Raw Material Base Tax • Tax on Extra Incomes Derived from Extraction of Hydrocarbons • Fee for the Right to Use Fauna and Biological Water Resources • Forestry Tax • Water Tax • Environmental Tax • Federal License Fees | <ul style="list-style-type: none"> • Estate Tax on Organisations • Real Estate Tax • Road Tax • Sales Tax • Gambling Business Tax • Imputed Income Tax • Charge for the Needs of Educational Institutions • Regional License Fees | <ul style="list-style-type: none"> • Land Tax • Property Tax on Individuals • Tax on Advertisement • Gift or Inheritance Tax • Local Purpose-Oriented Charges (Militia, Territorial Improvements, etc.) • Maintenance Tax (for Residential Housing, Objects of Social and Culture Sphere) • Local License Fees |

Source: RF Tax Code, law "On Principles of the RF Taxation System"

TABLE 4. DISTRIBUTION OF TAX REVENUES ACROSS BUDGETARY LEVELS

| Tax | Federal Budget | Regional budgets |
|---|--|---|
| 1. Profit Tax (Enterprises and Organisations) | at a 11% rate | At a rate below 19% |
| 2. Value Added Tax | 85% – up to 31.12.2000 100% – from 01.01.2001 | 15% – up to 31.12.2000 0% – from 01.01.2001 |
| 3. Personal Income Tax | 16% – up to 31.12.2000 1% – up to 31.12.2000 | 84% – up to 31.12.2000 99% – from 01.01.2001 |
| 4. Excises on Drinkable Alcohol, Vodka, and Spirits | 50% | 50% |
| 5. Excises on Import, Mineral Raw Materials, Fuel, Cars | 100% | 0% |

| Tax | Federal Budget | Regional budgets |
|---|--|---|
| 6. Other Excises | | |
| 7. Tax on Purchase of Foreign Currency Notes | 60% | 40% |
| 8. Land Tax | 30% | 20% – regional budgets, 50% – municipal budgets |
| 9. Sales Tax | 0% | 0% – municipal budgets |
| 10a. Uniform Tax on Imputed Income Payable by Organisations | 25% – federal budget 25% – social extra-budgetary funds and road fund | 50% |
| 10b. Uniform Tax on Imputed Income Payable by Businesspersons | 0% | 75% – regional budgets 25% – state extra-budgetary funds |

Source: RF Tax Code, law “On Principles of the RF Taxation System”

TABLE 5. DISTRIBUTION OF EXPENDITURE AUTHORITY ACROSS BUDGETARY LEVELS

| Federal Budget | Regional Budgets | Local Budgets |
|--|---|---|
| <ul style="list-style-type: none"> • Financing of federal legislative and executive authorities, state administration; • Functioning of the federal judiciary system; • International activity; • National defense and national security; • Fundamental research and assistance to scientific and technical progress; • State support to railroad, air, and sea transportation; • State support to atomic power engineering; • Prevention and liquidation of emergencies, consequences of natural calamities on the federal scale; • Research and space exploration; • Financing of entities in the federal ownership or | <ul style="list-style-type: none"> • Financing of legislative (representative) and executive authorities of the subjects of the Russian Federation; • Servicing and repayment of state debts of the subjects of the Russian Federation; • Carrying out elections and referendums in the subjects of the Russian Federation; • Implementation of regional purpose-oriented programs; • Formation of state property of the subjects of the Russian Federation; • International and foreign economic relations of the subjects of the Russian Federation; • Maintenance and development of enterprises, administrations, and organizations managed by | <ul style="list-style-type: none"> • Financing of local governments; • Formation and management of municipal property; • Organization, financing and development of institutions of education, public health, culture, physical culture and sports, mass media, of other entities in the municipal ownership, or under the management of local governments; • Financing of municipal law enforcement forces; • Organization and maintenance of municipal housing and communal services; • Municipal road construction and maintenance of local roads; • Improvement of territories of municipalities entities; |

| Federal Budget | Regional Budgets | Local Budgets |
|---|--|--|
| <p>under the federal government's management;</p> <ul style="list-style-type: none"> • Formation of federal property; • Servicing and repayment of the state debt of the Russian Federation; • Replenishment of the state stock of precious metals and gems, of the state material reserves; • Carrying out elections and referendums in the Russian Federation; • Implementation of decisions of federal authorities resulted in increases of budgetary expenditures, or decreases in budgetary revenues of budgets at other levels; • Provision for the execution of certain state powers transferred to other authority levels; • Financial aid to the subjects of the Russian Federation; • Official statistics; • Other expenditures. | <p>state authorities of the subjects of the Russian Federation;</p> <ul style="list-style-type: none"> • Provision of work of mass media of the subjects of the Russian Federation; • Financial aid to local budgets; • Provision for the execution of certain state powers transferred to the municipal level; • Compensation of additional expenditures resulted from decisions taken by authorities of the subjects of the Russian Federation, which resulted in increases of budgetary expenditures, or decreases in budgetary revenues of local budgets; • Other expenditures related to the execution of power of the subjects of the Russian Federation. | <ul style="list-style-type: none"> • Organization of utilization and processing of municipal waste (excluding radioactive waste); • Maintenance of cemeteries managed by municipal authorities; • Organization of mass transit and transport services for entities in municipal ownership or managed by local governments; • Fire safety; • Environmental protection on territories of municipalities; • Implementation of purpose-oriented programs adopted by local governments; • Servicing and repayment of municipal debts; • Targeted subsidizing of the populace; • Maintenance of municipal archives; • Carrying out municipal elections and local referendums; • Financing the implementation of other decisions approved by local governments and other expenditure determined as local expenditure and approved by the legislative authorities of local governments in accordance with the budgetary classification of the Russian Federation. |

| Expenditures Jointly Financed by the Federal Budget, Budgets of the Federation's Subjects, and Local Budgets |
|--|
| <ul style="list-style-type: none"> • State support of industries (excluding the atomic power engineering), construction and construction industry, agriculture, motor and river transport, communications, road infrastructure, subways; • Law enforcement; • Fire safety; • Research, development, design, engineering, and survey works ensuring the scientific and technical progress; • Social security net; • Environmental control, protection and reproduction of natural resources, hydro-meteorological activities; • Prevention and liquidation of consequences of emergencies and natural calamities on the inter-regional scale; • Development of the market infrastructure; • Development of federal and national relations; • Operation of election commissions of the subjects of the Russian Federation in accordance with the legislation of the Russian Federation; • Operation of mass media; • Financial aid to other budgets; |

Source: RF Budgetary Code

Chapter 2. Legal Aspects of Fiscal Federalism In the Russian Federation

Among all the aspects of the budgetary relations between the Russian Federation and its subjects, the issue of interbudgetary relations doesn't prove to be one of those that are subject to proper legal regulations. The Budget Code, which took effect on January 1, 2000, and became a turning point in the development of budget legislation, was of little concern to interbudgetary relations. Although a chapter of the Code features such relations (Chapter 16), its legal regulations are just of declarative and definitive character and are not designed for direct implementation. To a great extent, this results from the fact that interbudgetary relations generally reflect the level of federative relations, which are currently under formation. By the time of debating the Budget Code at the Government, tactical scheme of the federal policy in this field had only been outlined. (see: The Reformation Concept in the sphere of Interbudgetary Relations in the Russian Federation in 1999 to 2000, approved by the Resolution adopted by the Government of the Russian Federation on July 30, 1998, № 862). Under such terms, imposing rigid legal provisions on interbudgetary relations would be premature and even undesirable. In the chapters of the following paper we have made an attempt to reflect the key tendencies in the development of the interbudgetary relations in the Russian Federation relying upon the comparative analyses data of the federal budget legislation for the recent years and on analytical issues for budget projects submitted by the Government to the Federal Assembly.

The Budget System Structure in Russia.

After the dissolution of the USSR at the end of 1991, a legislative basis was laid for the tax and budget systems in Russia as an independent state.

According to **the RSFSR Law of «Budget Structure Basis and Budget Regulations in RSFSR» of 1991** (which had been the basic legal regulation act in the budget structure field before the Budget Code was passed in July 31, 1998) the RSFSR budgetary system comprised the following independent constituents: the federal budget of RSFSR, the budgets of the republics included in RSFSR, territorial budgets, regional budgets, budgets of the cities of Moscow and S.-Petersburg, autonomous regions' budgets, district budgets, municipal budgets, regional district budgets, municipal district budgets, budgets of villages and rural

areas. At the outset of the observation period, as well as to date, the budget system of Russia consisted of 89 budgets of the second level (21 republics, 10 autonomous districts, 6 territories, 1 autonomous region, 51 regions, the cities of Moscow and S.-Petersburg).

According to the law of «**Budget Structure Basis and Budget Regulations in RSFS**» the unity of the budgetary system in Russia was provided by a common legislative base, through unified budget classifications, via the budget records uniformity, and common statistic data shared at different levels of the budgetary system in order to design a consolidated RSFSR budget.

Alongside with the principle of budget system unity, the principle of budget independence at different levels, which was secured by own-source revenues and the authority of governments at each level to define the expenditure policy for corresponding budgets, was declared.

The basis for the Russian tax system was laid by the law of «**Tax System Basis**» adopted in 1991 and settling general principles for tax system in Russia including kinds of taxation, fees, and other payments. According to the law, three types of taxes are distinguishable: the federal taxes, the taxes raised by republics constituting the Russian Federation, territories, autonomous regions, autonomous districts, and local taxes. The list of the federal, regional and local taxes adopted in items 19 to 21 of the law still remains valid.

While the territorial structure, constituting the Russian Federation, hasn't changed since 1978, the political system of Russia declared in the Constitution of 1978 was much different from the current system. First of all, no «Subjects of the Russian Federation» were dwelled upon in the Constitution of 1978. The Republics formed on the basis of the national principle had a larger scope of rights if compared to territories and regions based on geographical principle though the latter often excelled the former in population. Besides, there were some specific differences in the legal status of the national autonomous districts, situated within the territories and regions of Russia. As a rule, they didn't have direct relations with the federal budget (avoiding the respective territorial and regional authorities). The fact that the principle of equal legal status was neglected, determined an absolutely discreditable nature of the interbudgetary relations.

Local authorities did not have their own budgets up to 1991: they were financed according to the expenditure calculations made by the regional authorities. For the period since July 1991 up to passing the Federal law of «General principles of self-government in Russian Federation» on August 28, 1995 self-government authorities in the largest municipal units had a right to build up the budget on their own. But the legal status and, therefore, the budget authority de-

gree of various municipal units was different. Rural and small urban settlements failed to be subjects of interbudgetary relations with the regions, while larger municipal units within the territory of their dislocation provided financing for them.

A new budget system structure was determined by the legal regulations of 1993 Constitution and the Law of « General principals of Self-government in the Russian Federation» adopted according to it, the latter dealing with the matters of the Russian Federation Political System. All large national and territorial administrative units received an equal status of the Russian Federation subjects. The introduction of the term «subject of the Federation» into the legislative practice wasn't just pro forma but meant the transition of all the territories comprising the Russian federation into legal state units, which determined regulations imposed on the relationships on the basis of the agreement and the recognition of their independence in the matters beyond the federative responsibility. The distribution of the authorities between the Russian Federation and its subjects resulted in the three spheres of authorities fixed and defined by the Constitution. The list of the responsibilities given to the Federation is short enough and includes such traditional authorities of the federal government as currency, credit, and customs regulations, monetary emission, the federal budget, the nuclear industry, the federal transport, foreign policy and international relations, national defense and security. The Federal laws applied direct within the territory of the whole country support the issues of the federal authority. The list of authorities shared by the Federation and its subjects is considerably longer. It comprises most matters of legislative regulation inclusive of the health care, public services, culture, labor, family, housing, land, water, and forest resources legislation. «Federal laws as well as laws and other legal regulations adopted by the subjects of the Russian Federation on the basis of the Federal laws» are enacted according to item 76 of the Constitution, which deals in authorities shared. The Subjects of the Russian Federation have all-encompassing power of the issues besides those of the federal competence and those shared by the Russian Federation and its subjects (i.e. the issues of the so called «residual competence»). Within the constitutional principal of authority distribution between the Russian Federation and its Subjects, the Budget Code (items 84 to 87) distinguishes expenditure competence for each of the budget system's three levels (the federal, the regional and local budgets) as well as expenditures shared.²⁵ According to part 4, item 5 of the Constitution « all

²⁵ For more details see section “ The Distribution of Expenditures and Revenues between budget system levels”.

subjects of the Russian Federation acquire equal rights within their relations with the federal authorities». The legal status of autonomous districts, which, in accordance with part 4 i. 66 of the Constitution, are ranked with territories or regions, proves to be specified. The uncertainty of this issue in the Constitution ignited a debate on the legislative consequences of such a status for the territories and the regions, on the one hand, and the respective autonomous districts, on the other. The discussion was carried on until the Constitutional Court of the Russian Federation provided official comments upon p.4 i.66 of the Constitution in its Resolution № 12-P adopted on July 14, 1997. According to these comments, «the fact that an autonomous district comes to be a constituent of a territory or a region means sharing the land and the population with the territory or the region to which the autonomous district belongs, as well as having common bodies of the state authority, which exercise control over the district within the limits settled by the federal law, the charter of the corresponding subjects of the Russian Federation as well as by the agreements between their authorities.» At the same time, joining a territory or a region as part does not affect the district in terms of rights equality as a subject of the Russian federation, especially as long as its relations with the Federal center are concerned. In the interbudgetary practice, this was reflected through the possibility to establish direct relations with the federal budget inclusive of the federal financial support, which might be allocated direct, avoiding the budgets of the corresponding territory or region. Shared (with the Federation) tax revenues raised on the territory of autonomous districts are transferred to their budgets according to general standards and are not redistributed between the district budget and the respective territory's or region's budget. Natural resource taxes don't prove to be an exception to the rule notwithstanding that the amount of coal and other mineral resources that several autonomous regions obtain (e.g. the Yamalo-Nenetsky, Khanty – Mansiysky, and Taimyr autonomous okrugs) turns to be of national value. The revenues generated by coal-mining and other mineral resource industries are collected by the autonomous districts' budgets according to the standards equivalent to the revenue distribution standards for other regions (30 and 25 per cents, respectively). In order to avoid possible conflicts between autonomous districts and territories or regions to which they belong, that might be ignited by this largest revenue source, the federal center shares half of its revenue value part with the territories and regions (20 and 12,5 per cent respectively)²⁶. Thus, it must be assumed that equal budget rights

²⁶ According to i. 42 of the Law of “Resources” adopted on February 21, 1992, № 2395-1, revenues from coal-mining are distributed in the following proportion: 30 % - local

exercised by all subjects of the Russian federation are currently secured by the federal budget.

Another considerable change in the budgetary system structure, which is determined by the Constitution and the law of «**General Principles of local self-government in the Russian Federation**» adopted on August 28, 1995 was the status equalization of all local budgets, which lead to the formation of the last (third) budget system level. The Constitution relies upon a settlement principle of local self-government structure, which declares the recognition of the local self-government right for residents of any settlement regardless of it's size. Alongside with that, the law of «**General Principles of local self-government in the Russian Federation**» does not presuppose any subordination between municipal units. Item 6 of this law reads:» in case there are any other municipal units within the territory of a given municipal unit (except for a city), subjects of municipal competence (municipal jurisdictions), items of municipal property, and sources of municipal budget revenues are distributed under the law adopted by the subject of the Russian Federation, and regarding inner municipal units of a city, by the Charter of the city.» This issue assumes that one municipal unit can't determine the budget revenue sources for other municipal units, in particular, they can't redistribute financial aid, received from the regional budget (except for the relations between a city and its interior unit). This concept formulated in the Constitution and the laws of municipal self-government had also been framed in the Budget Code, which declares in i. 129 that all municipal budgets should be equal with regard to the regional budget.

However, as was mentioned above, the local self-governmental system, which was shaped historically, has a two-level structure: in most regions small urban and rural settlements with neighbouring territories comprise a municipal district. And actually, the legal regulations quoted above are not obeyed almost anywhere: most regions prefer to maintain their relations with large cities and districts delegating them an authority to redistribute financial aid received from the regional budget between minor municipal authorities. Most subjects of the Federation evade the responsibility of distributing revenue sources between local budgets of different levels. Thus, the de facto basic subjects of local self-government defined by the Constitution as rural and urban settlements, fail to

budget, 30% - regional budget, and 40 % - federal budget; and revenues from other mineral resources are distributed correspondingly: 50% - local budget, 25% - regional budget, and 25 % - federal budget. But in case revenues are collected on the territory of an autonomous district, one half of the revenue received by the federal budget compensates for the territory or regional budget revenue.

obtain own-source revenue and receive financial support according to their expenditure needs, which apparently contradicts the budget rights of local self-government.

The most obvious way out of the above problem is to coordinate the actual situation in accordance with the Constitution norms, laws of local self-government, and the Budget Code, i.e. to delegate equal budget authorities to all municipal governments regardless of their size. But a direct implementation of the legal regulations within the current local self-government legislation proves to be irrational for the legislation itself is rather discrepant. On the one hand, it demands that all municipal governments have equal authorities, but, on the other hand, it assumes that one and the same territory be under the jurisdiction of two or more municipal governments and, consequently, their authorities can't be equal *a priori*. Equal authorities could be provided for the municipal governments of comparatively equal size and population. For the practical implementation of such an approach, it will be necessary that territories with local self-government be endlessly divided so that they could be balanced with the smallest ones in size. The successive implementation of the settlement principle in self-governmental structure, i.e. its application within solid settlements qualified for any direct forms of self-government, might cause the reduction of self-governmental authorities, while some of responsibilities addressed to local self-government (e.g. health care, education) prove to be unreasonable from the economic perspective or just impossible to carry out due to the minor scale of such settlements. Being unable to exercise the authorities of such kind, municipal governments would readdress them to the appointed territorial representatives of the regional administration. Thus, at first sight, a democratic conception of delegating equal authorities to each municipal government regardless of its size would result in the reduction of local self-government competence. At last, the necessity to establish direct interbudgetary relations with minor municipal administrations could raise another considerable problem for regional authorities for minor municipal units within most subjects of the Russian Federation account for several hundreds.

The most promising decision can be assumed as a legislative confirmation of the fact that there exist two levels of local self-government. Then several variants of local self-governmental structure prove to be available:

- 1) The fixation of the current administrative division of the territory within the subject of the Federation along with the division of current municipal units into two categories: larger ones receive the status of municipal units of the first level, and smaller ones gain the status of municipal units of the second level.

Alongside with that, the Federal subject legislation should contain universal principals concerning distribution of expenditure authorities as well as revenue sources between the municipal administrations of both levels. Then the principle of budget right equality (inclusive of the interbudgetary relations) takes its effect with the municipal authorities of the same level.

The problem whether it is possible that some of the authorities, inclusive of the interbudgetary authorities, be delegated by the subject of the Federation to the municipal administrations of the first level, proves to be more complicated for such delegation actually causes subordination between municipal administrations of the first and the second level. Taking into consideration that municipal units of the first level did not result from the desires of the people but were imposed on the administrative basis, the subordinate relations between the two levels must be assumed as inadmissible. The delegation of the authorities by the region to the municipal administration of the first level proves to be impossible unless no other but executive functions are delegated and regulative functions are still performed by the region, i.e. though the municipal administration of the first level performs itself as a representative of the regional government, the essence and the implementation order of the functions delegated are firmly fixed by the regional legislation, while in dubious cases the municipal administrations of the second level have a right to appeal to the regional authorities. In general, such a solution is similar to the delegation of the given authorities to territorial units of the regional administration, the only difference being that in the latter case the territorial units don't prove to be appointed but elected. But the regional authorities still face the problem of resolving inevitable conflicts between the municipal administrations of the first and the second level as long as only the second appear to be real subjects of the local self-government.

2) It can be assumed that in order to avoid such conflicts the most preferable way of local self-government system is to form larger municipal units by voluntary, associating smaller units based on the settlement principle. In this case the distribution of authorities and revenue sources between the municipal administrations of different levels is not performed by the legislation of the Federal subject but by the agreement between the municipal governments united in order to fulfill definite functions. Thus, the formation of the districts follows the opposite direction: it's not downward but upward, and local self-government levels have their positions changed visa versa: settlements prove to be primary and their associations appear to be secondary. Alongside with that, the municipal organs of local self-government of the second level could not be elected directly by the population but by the bodies of local self-government comprising subject association.

Considering the voluntary character of the intermediate local self-government level, formed according to this scheme, we can assume that it might not really exist. In this case the municipal administration of the first level must hold total control over the budget, and the functions of local self-government that it fails to perform due to some natural economic restrictions could be actualized through the system of appointed representatives of regional administration. At the same time, the formation of associations of local self-government, large in size and by population, must cause unconditional delegation of the authorities formerly exercised by the regional governments through their territorial representatives.

Although the second variant of local self-governmental system seems to be more preferable, it is reasonable that regional authorities should take the decision. Federal legislation on local self-government must only secure the minimum standard for budget authorities received by minor self-governmental units, and, in particular, avoid own-source reduction, which presupposes expenditure calculation principle of financing. For this purpose, it is necessary that minimum standards of expenditure and tax revenue authorities be fixed for municipal units of different levels in federal legislation. Besides, the Federation mustn't allow the competence of local self-government to be reduced in the subjects of the Federation by means of delegating some of their functions to the appointed entities of regional administration, as long as there are some bodies of local self-government qualified to fulfill the respective functions. In case the subject of the Federation delegates the authority of financial aid redistribution between municipal constituents to municipal units of the first level, the Federal legislation should define transparent criteria of financial aid distribution in order to secure financial independence of minor municipal governments.

The principles of pursuing interbudgetary relations

Interbudgetary relations of different levels are based upon chapter 16

Issues of the Budget Code, which fixes the following principles of interbudgetary relations in the Russian Federation:

- distribution and fixation of the budget expenditures between different levels of budget system in the Russian Federation;
- distinguishing (fixing) on the permanent basis and distributing on the basis of temporary standards of regulative revenue between different levels of budget system in the Russian Federation;
- the equality of budget rights for the RF subjects, the equality of budget rights for municipal units;

- equalization of minimum budget supply level of the RF subjects, municipal units;
- equality of all the budgets in the Russian Federation in their regard to federal budget, the equality of local budgets in their relations with the budget.

As it is generally recognized, standard principles do not perform any regulative function, but they are aimed at the conception integrity and inner homogeneity of the legislation. In our opinion, the list of interbudgetary relations principles fixed by the Budget Code fails to fulfill its function in full.

The principles of equality in budget rights among the participants of budget relations at the same level and their relations with budget of the upper level.

Among the principles of interbudgetary relations fixed in i.129 of BC, the principles of equality in budget rights among the participants of budget relations at the same level and their relations with budget of upper level prove to be of practical value. These principles have a dubious meaning. On the one hand, they deprive the Federation of the right to provide any individual budget benefits and, therefore, prevent some regions from discrimination if compared to other regions. But on the other hand, they generally limit the federal center competence in interbudgetary relations and, consequently, secure the independence of the regional budgets.

The possibility to nullify the agreements between the Russian Federation and those of its subjects that « establish norms, which break common order of budgetary relations between the federal center and subjects of Russian Federation (p.2, i.132 of BC)», manifests the principle of equality among all budgets of Russian Federation in their relations with the federal budget. The agreements on distribution of authorities and responsibilities concluded with the 13 subjects of Federation were supplemented by budget agreements defining special rules for distribution of revenues between the regional and the federal budgets. But only 3 of the 13 took effect: those concluded with the Republics of Tatarstan and Bashkortostan (concerning tax revenues delivered to the federal budget), and the Yakutia Republic (concerning the republican gold **reserve**). The agreement with Tatarstan, for instance, presupposed the delivery of total resource tax revenues and excise tax revenues to the republican budget, as well as a larger share of value-added tax revenues (if compared to other regions) received by the republican budget. The agreements took effect over 5 years (since 1993) and currently they are not in power. But some significant rules concerning the delivery of total resource tax revenues and excise tax revenues (fixed by the agreements on distribution of authorities without any expiry date) are still functioning. During the first

years of the Russian Federation such agreements were used by the weak federal center in order to reduce separatist tendencies on the part of the federal subjects. But very soon such policy turned to be of little benefit for the state and proved to have a negative impact upon the process of consolidation of the Federation, as it caused resentment of loyal regions, which held the majority. This fact being admitted, there appeared premises, which entailed the transition from individual agreements on interbudgetary relations concluded with separate regions to common rules for revenue regulation and the distribution of financial support amount on the basis of the criteria and calculations that have become formalized by that time and, consequently, more objective. In 2000, a political decision was made (formally initiated by Tatarstan and Bashkortostan leaders) on gradual unification of tax revenue distribution. It was agreed, that due to the higher rates in comparison to other regions, Tatarstan and Bashkortostan were obliged to provide financial support for some federal programs, which took effect on the territory of the republics.²⁷ At the beginning of 2001 the President of Bashkortostan announced that the republic would transfer 50% of its total revenue to the federal budget (according to BC).

The Principle of revenue and expenditure distribution among different levels of budget system

The other principles of interbudgetary relations fixed in the Budget Code are less concrete. Thus, according to i.30 of BC the Principle of revenue and expenditure distribution among different levels of the budget system determines distribution of certain kinds of revenues (totally or partially) and expenditure authority among the federal government, governments of the federal subjects, and local self-government. In our opinion, for to date, this principle is absolutely unreasonable, since the revenue and expenditure distribution proves to be the actual process of interbudgetary relations rather than their feature of qualitative characteristics. This or that kind of distribution of revenues and expenditure authorities is inevitable for any budget system, and the degree of democracy of the latter is not determined by the fact of the distribution itself, but by the ways this distribution takes effect. That's why it seems to be a must, that the content of this principle be specified considering that revenue and expenditure distribution among different budget levels be based upon the necessity to provide the maximum balance between revenue sources of a certain budget and its expenditure responsibil-

²⁷ For more details, see: section "Regional finance and interbudgetary relations" in "Russian Economy in 2000: tendencies and perspectives", M., IET, 2001.

ities. The problem of revenue and expenditure distribution among different levels of budget system is viewed in detail in chapter 2 of the following report.

The principle of minimum fiscal capacity level equalization²⁸ for the subjects of Russian Federation, and municipal units.

This principle fixes the traditional policy of federal financial support to the regions aimed at providing subsidies for their current expenses and based on the lack of mechanisms necessary for regional redistribution of the subsidies. It results in fixing traditional differences in fiscal capacity level, ruining incentives for regional infrastructure development, and reducing budget investment efficiency. But it must be admitted that some measures have been carried out lately in order to improve the situation. Thus, The concept of reform in the interbudgetary relations in the Russian Federation in 1999-2001 adopted in the Resolution of the Russian Federation Government on July 30, 1998, № 862 presupposes that, besides FFFS to the regions, a Fund of Regional Development (FRD) aimed at particular financial support to the regional development will be established. For the first time, this fund was entrenched into the budget of 2000 (for more detail about FRD functions, see chapter «Forms of federal financial aid to the regions».) But while the principle of equalization in social infrastructure of the RF subjects lacks legislative support, the positive tendencies in the budget development over last years might be lost.

Revenue and Expenditure distribution among different budget system levels

Revenue distribution among different budget system levels of RF

One of the main problems of interbudgetary relations is the possibility to achieve the optimum balance between the revenues received by sub-national budgets as tax revenues and as financial aid. In effect this problem has no simple decision. On the one hand, it seems to be more reasonable to increase the percentage share of total for tax revenues, because, in contrast to financial aid, which does not depend upon the local administration, the larger the tax base of the given territory is, the bigger amount of tax revenues is collected by the sub-national budget. Consequently, it is apparent that a larger share of total for tax revenues is of benefit to sub-national budgets, if compared to federal subsidies,

²⁸ It is necessary to note that the term is conventional for, in fact, only 20 % of total fund value is provided for the equalization of minimum budget level according to the current model of FFFS to the regions.

for it proves to be an incentive for regional and local administrations to increase their own tax efforts. The adherents of such an approach suggest eliminating of regulative taxation as it is and increasing percentage share of total revenue base for own-source tax revenues collected by sub-national budgets.

On the other hand, the level of tax base development in close perspective is determined by historical factors rather than by political ones, and in this sense the regional authority tax efforts are limited in their efficiency. While percentage share of total regional budget revenues for tax revenues increases, the revenues redistributed among the regions are reduced, which preserves actual disproportion in the current level of their development. Speaking of the thesis «one tax versus one budget» or about the necessity to coordinate expenditure responsibilities of different budget system levels in accordance with their revenue authorities, it must be considered that budget expenditure responsibilities should include responsibilities for horizontal equalization support. In other words, revenues (and tax authorities) of upper budgets must include some funds necessary for financial support allocated to the lower budgets and aimed at eliminating horizontal misbalance, as well as it must secure that lower budget revenues include transfers received.

The calculations show²⁹ that in case tax revenue delivery to the federal budget is substituted for by the elimination of federal financial support to the regions, the number of regions with the current expenditure deficit would increase as long as budget profits grow in some «prosperous» regions. Analyzing the assumptions stated above, it is possible to conclude that direct federal financial support as well as federal tax share allocated to the regional and local budgets prove to be important instruments of budget regulations. Optimum balance between them can't be permanently fixed, since it is determined by current economic-political situation, the correlation between regions with the developed tax base and those left behind, differentiation of budget supply level for all of them, the amount of expenditure responsibilities of sub-national budgets and by other factors. Thus, it is assumed that the fixation of a certain standard for tax revenue distribution among the different budget system levels in Budget Code be undesirable (according to i.48 of BC « while distributing tax revenues among the budget system levels, the tax revenues received by the subjects of the Russian Federation must account for 50 or more % of total revenue collected by the consolidated budget of the Russian Federation). In effect, this correlation proves to be true and is currently observed. As such, in 1999, the tax revenues received by the budgets

²⁹ For more details, see “ Paper review...”

of the RF subjects accounted for 52, 1 % of total tax revenue value received by the consolidated budget of RF (inclusive of 22,2% for tax revenue received by local budgets) or 13,74 % of GDP.

Besides the correlation of the revenues received by sub-national budgets as tax revenues or financial aid, the structure of tax revenues collected by budgets of different levels, i.e. their classification and correlation of own-source and regulative tax revenues for each budget, proves to be another significant problem. It should be noted that the division of taxes into federal, regional, and local adopted in the Russian legislation does not mean, that the respective tax revenues are received by the budget at the respective level. The dominant part of the budget system revenues currently comprises the federal tax revenues (first and foremost VAT, profits tax, personal income tax, and excise tax,). In the consolidated budget for 2000, the federal tax revenues and other payments (inclusive of payments to social and highway trust funds) account for 89% of total tax revenues.

The level of legislative (representative) authority being competent at establishing the tax rates and the territory which a particular tax rate can be applied to, prove to be a formal criterion for the division of total tax revenues into federal, regional, and local. But in practice, legislative authorities of regional and local governments are rather limited when establishing regional and local taxes, since all the main elements of the tax system are determined by the federal tax legislation. According to i.12 of the Tax Code, sub-national governments are qualified to determine a tax rate within the limits designed by the federal legislation, as well as to provide additional benefits, and define the order, payment terms, and accountability regarding the respective tax. Such an approach of the federal legislator can be accounted for by a previous negative experience, when regional and local authorities were qualified to introduce taxes besides those enlisted by federal legislation, as well as to provide benefits regarding federal taxes. In order to discriminate against producers from other regions, regional governments applied such legislative authorities, that resulted in the breach of the common economic system on the territory of RF. Besides, regional authorities being qualified to provide benefits regarding federal taxes, there appeared inner zones of reduced taxation within the territory of RF as attractive for taxpayers from other regions, who re-registered there pro forma, which caused tax revenue losses for whole budget system and a decrease in the tax discipline level.

Thus, to date the fiscal authority value of the federal subjects in Russia is small enough and presupposes neither raising own-source tax revenues, besides those enlisted by the federal legislation, nor increasing tax rates beyond the limits fixed by the federal law, which, in our opinion, corresponds to the current state of

the Russian federalism. Nonetheless, the fact that regional and local governments lack the authorities to mobilize additional fiscal sources can't be neglected while regulating other aspects of interbudgetary relations, first and foremost while solving the problem of unfunded mandates, which will be further discussed in detail.

Another basis for the classification of different kinds of taxes is the fact, that they might belong either to own-source or regulative type. The correlation between the fixed and regulative revenue sources proves to be a significant aspect of interbudgetary relations, for the degree of financial independence gained by sub-national budgets depends upon the stability of the revenue base rather than upon its size. The longer revenue fixation (consolidation) lasts, the more premises the regional administration has to perform budget planning on their own. While the federal allocation standards of tax revenue are re-examined annually, sub-national governments fail to perform even short-term budget policy on their own and totally depend upon the current situation in their relations with the upper budgets. According to i. 47 of BC, the revenues appointed to the respective budget totally or partially upon permanent basis, are qualified as own-source revenues. Up to the recent times, such allotment (fixation) of tax revenues to budgets of different levels was secured by the acts of tax legislation. For example, the Law of Net worth tax for enterprises defines the federal share rate of total profit tax revenue as 11 % and upper limit of regional share rate as 19%. But during the tax reform of some recent years, another approach, which presupposes that budget legislation should be accountable for the distribution of tax revenues among the levels of the budget system, has gained dominance. In the abstract, the refusal to regulate tax revenues by means of tax legislation seems to be reasonable but, if put into practice, it might cause some problems. It results from the fact that within the framework of the budget legislation, the distribution of tax revenues among different budgets has been regulated up to now by annual budget laws. Thus, by the time all chapters of the New Tax Code take effect, the current legislation system will have failed to provide any permanent standard act qualified to distribute tax revenues among budget system levels. Consequently, all actual taxes designed for sub-national budgets will be qualified as regulative, i.e. unwarranted and unstable revenue sources. In order to avoid the decrease in the level of financial independence achieved by sub-national budgets, it could be possible that own-source tax revenues be enlisted in the Budget Code. The scope of such revenues must be determined by the legislative status of regulative taxes, which proves to be rather contradictory at present.

Unlike own-source tax revenues, regulative revenues by their definition are qualified as temporary revenue sources, nevertheless, the time-period of their

fixation is of vital importance. In order to avoid negative consequences of annual changes introduced into the revenue base of sub-national budgets, the Budget Code gained a new rule, which proclaimed that standards for tax revenue distribution are fixed by respective budget laws, taking effect over a 3-year period (both in case of allocating regional and local share of total federal tax revenue and in case of allotting the RF subject share of total for federal and regional revenue to local budgets)

Unfortunately, there are a number of norms within the Code contradicting this sensible principle. For instance, i. 48 of BC gives the following definition of regulative revenues:» Regulative budget revenues are federal and regional taxes and other payments, which determine standards (in per cent) for the assignments received by the budgets of the RF Subjects or local budgets for the next fiscal year, as well as on a long-term basis (over a 3-year period).» However, as was mentioned above, ii. 50, 52, and 58 of BC do not allow fixing regulative revenues for a period under 3 years (unless some changes in the tax legislation occur). Another contradiction is manifested by i. 58, which says: «Budget own-source revenues delivered to the Subjects of the Russian Federation from regional taxes and other payments, as well as from the federal tax revenues and payments allocated to the Subjects of the Russian Federation could be allotted to local budgets on a permanent basis either totally or partially as a percentage share determined by legislative (representative) bodies of the RF Subjects for a period of 3 or more years.» However, by ii 47 and 48 of the Code, it can be concluded, that revenues allocated on a permanent basis, are significantly different from those allocated on 3-year period basis. While the former refer to budget own- source revenues, the latter are considered to be regulative revenues. Therefore, we can't treat these notions as equal as it is done in i. 58. It is more reasonable to state, that assignments' shares of total for federal tax revenues for allocated to the Subjects of the Russian Federation could be transferred to local budgets as a regulative revenue source on a 3-year standard basis, as well as shares of total regional tax revenues for local budgets could be allocated either on permanent or temporary basis for over a 3-year or a longer period.

Taking into consideration, that all the mentioned discrepancies between the norms of BC might cause serious problems in legislative practice, it is necessary that ii. 48 and 58 of BC be formulated according to the general principle established by i.52, which states that increment standards received from regulative tax revenues can't be changed within a 3-year period, unless any valid changes are introduced into tax legislation. An equivalent principle should be fixed in the Law of «Fiscal Basis of local self-government in RF», while the possibility of

fixing the assignments received from regulative taxes by local budgets for a period less than 3 years should be eliminated.

Besides, it is necessary that ii. 50 and 52 of Bc, which allow to reconsider the assignments' standards received from the federal and regional tax revenues «provided that tax legislation is changed» be detailed. These legal regulations were formulated while standards of tax revenue distribution among budget system levels were regulated by tax legislation. As it was noted above, as soon as the Tax Code takes effect in full, the norms will be given up. No doubt, some changes in tax legislation, e.g. concerning methods of administration, might entail redistribution of tax revenues among the budgets, but the present rules allow an arbitrary manipulation of the revenue base of lower-level budgets. In order to re-establish fixation/ allocation standards of regulative revenues it is enough to introduce any (inclusive of editorial) changes into tax legislation.

The distribution of expenditure among the levels of the RF budget system

The capacity to provide correlation between budget revenues at each level and their expenditure responsibilities proves to be one of the main characteristic features of the interbudgetary system. Naturally, it is impossible to achieve absolute coincidence, and any federative state faces the problem of so-called «unfunded mandates», i.e. the discrepancy between the expenditure accountability value, as delivered by federal legislation to sub-national budgets and the revenue sources value of these budgets.³⁰ But currently in Russia the gap between the budget system capacity and federal expenditure responsibilities acquired a daunting character. Mostly, if resulting from the legislation of the first years of the Russian federalism, which consisted in securing budget expenditures regardless of any analysis of the budget consequences or any reference to actual sources of financing. The Negative consequences of such a situation, first of all, manifest themselves by the fact, that fictitious unfunded legal regulations cause public mistrust of the State and laws adopted. Secondly, it ruins the integrity of one legal space: under the condition of revenue deficit, if compared to total expenditure needs, established by the federal legislation, the context of federal laws of financing is adopted by each region on its own. Thirdly, it provokes sub-national budgets into increasing their credit debts: the judicial authorities, dealing with creditor claims to sub-national budget based upon legal norms of the federal legislation,

³⁰ e.g. in the USA in order to eliminate the practice of delivery of unfunded mandates to state budgets a special Law of unfunded mandates reform was adopted in 1995. (Unfunded mandates Reform Act).

recognize the priority of the latter over the regional budget legislation and, therefore, might enforce regional budgets to withhold the funds from the account. The solution of the unfunded mandates' problem can't be found without taking stock of federal system of Standard acts based upon consolidated budget expenditure. The goal of making such an inventory should consist in enlisting federal standard acts actually financed (either totally or partially) by the budgets of each level within the budget system, and defining correspondence of actual budget expenditures at each level to the distribution of expenditure responsibilities among the budget system levels determined by the Budget Code, as well as to the revenue sources value. Regarding each kind of expenditure entitled by the federal legislation to sub-national budgets one of the following decisions should be made: either its suspension and elimination or its preservation under the condition of total or partial offset of the respective expenditures from federal budget, or without any offset.

The supplement to the following report contains a table of current unfunded mandates. The table is based upon the data of the inquest conducted by Ministry of Finance of RF in the regions in order to take stock of unfunded expenditure responsibilities. The regions were offered to name which items of the federal legislation they consider as expenditure responsibilities for their budgets. Among all legislative acts enlisted in the table some were mentioned more often, others more seldom, the rest of them weren't mentioned by the regions inquired at all. The difference in opinions the regions expressed on the problem of federal mandates' constituents proved the assumption stated above that an incredibly large value of expenditure responsibilities entitled to subnational budgets by the federal legislation diminishes the degree of responsibility towards each of them. Thus, the list of standard acts given in the table does not consider all resolutions of the federal legislation, formally entitling expenditure responsibilities to sub-national budgets but those, which are treated as such by the regions. Although such an approach proves to be subjective while outlining the scope of unfunded mandates, as a rule it reflects actual situation, which is explicit to show that federal financial responsibilities are true provided that regional authorities recognize them.

In fact, the Federation currently exerts control over the execution of a narrow range of federal laws, mostly those, financing of which is included in the list of regional expenditure needs while distributing financial aid (FL of «The Veterans», « Social Protection of the Disabled», «Federal Family Subsidies»). Considering the fact that up to 2001 the funds assigned for the purpose of these laws financing were provided for the regions along with general transfers, federal con-

trol did not prevent regional budgets from accruing debts for federal mandates funding.³¹ The execution of other expenditure responsibilities by the Subjects of the Russian Federation, which resulted from other federal laws, proves to be out of federal control, which makes it possible for the regions to evade the expenditure liabilities. The only up-to-date method of federal mandates enforcement consists in proceeding against regional budgets for the recovery of the respective funding by beneficiaries of this or that social transfer provided for by the federal legislation.

The contextual analysis of the expenditure responsibilities enlisted in the table, which are entitled by the federal legislation to sub-national budgets, makes it possible to conclude the following:

1) A considerable part of federal mandates (15 out of 57) refer to the sphere of federal competence, determined by i. 84 of BC.

Among them, the following expenditure liabilities should be noted: defense (lines 5,33,36,52 of the table), the provision of activity exercised by the federal authorities (lines 18,20,35,44,49), the federal judicial system functioning (lines 28, 43, 54), federal security (lines 32,37,40). In our opinion, respective expenditure responsibilities entitled to sub-national budgets must be supported by full offset of the corresponding expenditure needs provided by the federal budget.

2) A large scope of federal mandates has been concentrated in the sphere of education, health care, and culture.

These functional perspectives of the federal expenditures do not refer, within the Budget Code, to the responsibilities of any budget system level. But at the same time, the Budget Code confirms that funding of institutions and organizations owned by the Federation, its subjects, or municipal authorities be an exclusive responsibility of the budgets at each level. Such principle of distributing expenditure responsibilities can be regarded as a fair one provided that the jurisdictions of the federal, regional, and local authorities within the scope of entities mentioned are carefully outlined. But currently this distribution is not sequentially carried out. Considering the regional and local authorities as those qualified to provide financing for health care, education and cultural institutions, the legislator outlines minimum expenditure needs necessary to support these entities. For instance, the federal legislation regulates payroll level for public employees re-

³¹ In 2001 the order of federal mandates funding entitled by the three mentioned federal laws changed, for more details, see chapter “ Forms of federal financial aid received by the Subjects of the Russian Federation.”

regardless the budget the latter receive their salary from.³² The fact that Total Payroll Net (TPN) hasn't been mentioned in the table seems to be strange for it determines subnational budget expenditures, which are of considerable value. One of the possible reasons for it might consist in including expenditures for municipal entities calculated on the basis of TPN into transfers received by the RF subjects from the FFFSR, and can't be regarded as unfunded. But the expenditures based upon the laws of «Veterans», « Social Defense of the Disabled», «Federal Family Subsidies» were also referred to while calculating federal transfers allocated within FFFSR, which didn't prevent them from being included in the table. Therefore, we fail to find satisfactory explanation to such a blank in the table.

Coming back to the problem of distributing expenditure responsibilities for education, health care, and culture among the budgets of different levels, it must be noted that it would be reasonable:

- firstly, to enumerate all these significant budget expenditure perspectives on the list of expenditure liabilities imposed upon the budgets of different levels;
- secondly, to limit the application of the principle «financing should be provided by the budget owing or controlling the given entity», for the federal center has a right to define national standards for health-care, education, and culture financing.

3) Most of the federal mandates (24 out of 54) refer to the sphere of social protection provided for the population, i.e. to the sphere of common expenditure competence of budgets at different levels. Besides, social mandates comprise the dominating part of total sub-national expenditures determined by legal regulations of the federal legislation.

It is this sphere that provides the widest range of possibilities to reduce budget responsibilities by means of regulating social benefits system, and outlining funding for special purposes. In particular, we consider that the federal mandates mentioned in lines 6, 9,11,25,27,29 of the table require a precise revision. They prove to be either out-of-date (e.g. The Resolution of UCEC and SPC RFSSR on «Benefits provided to qualified employees in rural and workmen settlements» adopted in 1930 under collectivization and does not fit the current economic situation) or contradicting the principle of social aid rendered for a special purpose. In particular, death benefits, family subsidies, dependent benefits pro-

³² See The Resolution of the RF Government on “The increase in payroll rates of total payroll net for public employees” adopted on March 18, 1999, №309 (тарифные ставки единой тарифной сетки)

vided for the families raising 1-2 year-old children, offsets for higher food-cost provided for students of secondary and professional schools do not coincide with subsidy-recipients' income. Such federal mandates should be either revised or eliminated.

While distributing expenditures of common competence between the federal and local budgets, only some of these mandates could be referred to exclusive federal competence. These mandates should include, first of all, the social expenditures, which are distributed among the RF subjects regardless of their share of total population, e.g. expenditures for social benefits received by those who suffered from either nuclear catastrophes or were repressed, for those who have merits of national value. We distinguished 8 social mandates of this category (lines 4, 10, 14, 15, 30, 31, 55, and 56). In our opinion, the expenditures, which resulted from the mandates of this kind, must be compensated to all the regions regardless their budget revenue level.

It turns to be a more complicated problem as soon as the recipients of social benefits defined by the federal legislation are distributed among the regions pro rata to the population of the latter, which causes a collision of the federal and regional interests in the matter of expenditures entailed by the benefits financing. Such benefits comprise the most valuable expenditures in the structure of federal mandates adopted by the federal laws of «Veterans», «Public Service Provided for the Elderly and the Disabled», «Federal Family Subsidies», «Social Defense of the Disabled», etc. The distribution of responsibilities between RF and its subjects might follow one of the two ways:

1) It can be based upon the principle of function integrity in standard regulations and financing within the spheres of common accountability. It means that while having a right to define expenditure responsibilities for sub-national budgets, the Federation is assigned to offset the corresponding expenditures to the latter. Thus, the expenditures, assigned to the sphere of the federal competence, are to be compensated to all regions through special purpose subventions regardless of their budget revenue level. Unless the Federation provides subventions to cover the respective expenditures in the full amount, another rule, which entitles the regions to provide funding for federal expenditure mandates within the limits of the federal offset value, takes effect. Direct financing, provided by the federal budget to cover the respective expenditures through the system of regional representatives of the federal authorities, proves to be another variant of the same approach.

The benefit of such an approach consists in formal equality achieved by all the RF subjects (none of the regions takes on unfunded expenditure responsibili-

ties). It is nothing but formal equality for the increase in disposable funds of non-subsidized regions could be achieved by a considerable reduction in the federal social standard, i.e. in order to provide a compensation for the well-to-do regions it would be necessary to reduce the level of their financing for the poor regions. It might result in further disintegration at budget revenue levels of the Russian regions. Besides, it sets a dangerous political precedent for the refusal of the Federal authorities to make mandatory decisions for unsubsidized regions

2) It might be based on the premises of unfunded mandates, i.e. the differentiation between the functions of standard regulations in the spheres of shared responsibilities provided by the Federal Constitution and the functions of funding expenditures assigned by the legislation designed for this purpose.

In our opinion, such a method proves to be more available within the current constitutional concept on responsibilities shared by the Russian Federation and its subjects, which regards the sphere of shared liabilities as a zone of intersected interests of the Federation and its subjects, within which bounds any distribution of authorities turns to be of a conventional character, rather than as a sphere of mere «undistributed» jurisdictions. Regarding the fact, that regions display no less objective interest in shared expenditures (e.g. expenditures for social defense of the population) than the federal center does, it is hardly reasonable to entail the federal budget compensating for the shared expenditures defined by the federal legislation without any reference to the regional revenue amount.

At the same time, it is provided that some measures against the possible abuse of power on the part of the Federation be taken to shoulder expenditure responsibilities upon subnational budgets. First of all, it is necessary that the current federal legislation be correlated with i. 75 of the Constitution, which deals in the matters of shared responsibilities and regulates «all federal laws and other laws adopted in accordance with federal laws as well as legal regulations acts of the RF subjects». Thus, the federal laws on shared responsibilities should determine general principles but not detail legal regulations. Within the framework of the transformations done over the federal legislation in accordance with i. 76 of the Constitution, it is essential that elimination of too rigid federal legislation norms as well as extending of regional authorities in compiling the list of recipients, and defining the order, conditions, and amount of financing provided for expenditure needs be carried out.

Secondly, unfunded expenditure responsibilities shouldn't be levied upon subnational budgets due to the federal legislator's whim, but should result from preliminary study of funding recourses. Alongside with that, the offset provided by the federal budget in order to cover additional regional expenditure needs

should be based upon differentiation of the regions according to their revenue amounts, e.g. the compensation might be delivered only to recipient-regions, as long as donor-regions will cover additional expenditures by their own-source revenues. The benefit of this method consists in keeping the federal social standard at the same traditional level. The disadvantage of this approach lies in the expenditure authority constraints inflicted upon recipient regions.

In order to release interbudgetary relation strain concerning the problem of unfunded mandates, it is necessary that some rules of establishing the latter be fixed in the budgetary legislation. These rules should specify certain mechanisms of co-ordinating standard acts projects, which provide for funded or unfunded additional expenditures of subnational budgets in reference with the order and rules of the corresponding compensation if necessary defined in the legislation, with the RF subjects.

The Forms of federal financial aid provided for RF subjects.

According to i 133 of BC federal budget financial support can be provided for the regions as follows:

- the provision of subsidies for equalization of minimum budget level of RF subjects;
- the provision of subventions and subsidies for some special purpose expenditure financing;
- the provision of budgetary credits;
- the provision of budget loans for the purpose of covering temporary budget gap, which might occur while the RF subject budget performance.

Subsidies for equalization of minimum budgetary level of RF subjects

The most important source of the federal financial aid to the regions is currently based upon subsidies for equalization of the minimum budget level of the RF subjects, provided from the Federal Fund of Financial Support to the Regions (FFFSR) established in 1994. Around 70 to 80 out of the 89 RF subjects annually gain a right to receive transfers allocated from FFFSR. Traditionally, for the recent years FFFSR accounted for 14% of total for tax revenue amount received by the federal budget excluding customs fees revenues. In 2001, the fund value was reduced to 9 % of total tax revenues (due to the increase in tax revenues collected by the federal budget, which resulted from the re-distribution of value-added tax revenues to the federal budget formerly raised by the regions, which accounted

for 15% of total for regional VAT revenues). According to the legislative project designed for the federal budget in 2001, the amount of the FFFSR accounts for 100353722 thousand of rubles (8,4 % of total for federal budget expenditures, or 53,77% of the federal budget expenditures under «Financial Aid to the budgets of other levels»).

Up to date, FFFSR has been the only comparatively formalized source of federal financial aid (since 2000, besides FFFSR, there have appeared other funds aimed at financial support to the regions within the federal budget). The formalized character of this model for financial aid distribution was revealed in common methods of financial aid amount calculations done on the basis of specific formulas. The methods were designed by the RF Ministry of Finance and then were modified. In the project of the federal budget for 2001 the model goes as follows:

1 stage: the calculation of gross tax resources for each RF subject.

Unlike models formerly applied, the current model is not based upon actual revenue collected by the regional budget during the last years. It proves to be a considerable positive change. While estimating the regional tax base by means of direct calculations done on the «what is achieved» basis, the Subjects of the Russian Federation were interested in concealing their actual tax base (in particular, due to the transition of tax revenues into out-budget funds, as well as the negligence of tax dodging) rather than in the increasing of tax revenues collected, in order to justify their need for the federal financial aid.

Currently, a relative rate, the so called gross tax resources (GTR), takes affect in order to calculate regional budget revenues, which allows to consider tax efforts of regional authorities.

Specific gross tax resources of a region are equal to average revenue level of RF subjects per capita, as expected in 2001, multiplied by fiscal capacity rate of the RF subject.

Fiscal Capacity Ratio (FCR) performs a quantitative estimate of regional economy capacity to generate tax revenues considering its structure and level of development. FCR is calculated on the basis of the gross regional product rate.

2nd stage: the correlation of specific gross tax resources of the regions.

In order to correlate specific gross tax resources of different regions, it is necessary that GRP of each region be divided by budget expenditure index (BEI), which reflects the correlation of expected expenditure needs for the provision of budget services base amount in the region with average level in Russia (regarding the regional payroll coefficient, the price level, the duration of the heating season, the population structure, and other objective factors).

In this respect, it should be noted that during the last two years, transport availability as well as the level of the electricity tariff were included in the list of factors extending expenditure needs of the RF subjects, which resulted in a more objective fund resources distribution, formerly allocated on the target principle to provide financial support for the purchase and transportation of oil, oil products, fuel, and food to the regions of the Far North and other regions of the same status (so called «north supply») as well as to offset higher electricity tariff for the territories of the Far East and Archangelsk region.

Stage 3: the distribution of 80% of total for the FFFSR amount among the RF subjects, the correlated specific GRP of which do not exceed the average federal rate, pro rata to the deviation of specific STR from the average level.

After the distribution of the first part of FFFSR, the correlation of regional budget revenue for different regions to each other remains the same: the regions with higher GRP will be better provided after the equalization if compared to regions with low-revenue rate. Thus, the strategy of distribution of the first (and the main) part of FFFSR provides incentives for own-source tax base development.

Stage 4: The distribution of the rest 20 % from FFFSR among worse provided regions (after the distribution of the first part of the transfer) by means of equalization of their revenues to one and the same level guaranteed by the FFFSR amount.

Thus, the distribution of this transfer part is aimed at the support of common for whole Russia level of budget revenues in order to secure a scope of some budget services to the population.

In the conclusion, the final share of RF subject in the federal fund of financial support to the regions is defined by adding the second part of the transfer to the first.

Although the model of financial support through equalization of minimum budget level has been perfected for the last years, it still demonstrates some serious disadvantages. The most significant of them is the fact, that the model of financial aid provided from FFFSR described above hasn't been adopted by the law and has gained the status of a functional document in addition to the federal budget project. Although the share of each region in the FFFSR is fixed in the law of the federal budget for the current year and is usually calculated on the basis of the model, it might be changed while passing the law through the Parliament. It makes the model financial aid provided from FFFSR «untransparent» for the public and deprives regional authorities from the possibility to forecast their expected revenue amount both for an average and the shortest period of time.

Besides, it contradicts the federal law adopted on July 9, 1999, №159-FL, which assigns the federal law of the federal budget for the current year to determine financial aid provided for equalization of minimum budget level and its amount calculations unless a special federal law is adopted.

With reference to the future adoption of the law concerning the order and amount of financial aid provided for equalization of minimum budget level, it must be admitted that legal regulations of i. 135 of Budget Code, which make the adoption the law dependant upon preliminary law of minimum social standards as well as upon the resolutions of the Government on expenditure standards necessary to provide public (state) services and minimum budget revenues, complicate the matter. According to the item of the BC mentioned, federal budget financial support provided for the budget of RF subject for the purpose of equalization of minimum budget level is calculated on the basis of expenditure standards necessary to provide state services in order to cover the expenditure needs for minimum social standards adopted by the state.

In our opinion, the idea of relying upon minimum social standards as the basic point for federal financial aid calculations fails to be successful. According to the i. 6 of the BC minimum social standards comprise «those state services, the delivery of which to the citizens on the ir retrievable and gratuitous basis by means of financing from budgets of all levels as well as from state out-budget funds is secured by the state at a possible minimum level on the whole territory of the Russian Federation. The list, kinds and quantitative amount of minimum state social standards are determined by the federal legislation. Unlike social standards, expenditure standards necessary to provide state services (per one service unit) are adopted by the Government and used in order to calculate financial aid amount provided either for some certain major executor, or budget executor, or budget institution in reference with its certain service objectives (i. 173). In other words, while following the minimum social standards within the territory of all RF subjects proves to be the goal of budget regulations, observing expenditure standards necessary to provide state services is just a means of it.

In our opinion, the calculations of the federal transfers received by the budgets of RF subjects shouldn't be based upon minimum social standards adopted by the state but upon expenditure standards necessary to provide state services. The difference between these two approaches can be illustrated by the following example. Let's assume that the population of regions A and B is the same and accounts for 1000 people, but health care services of A provide 100 openings for the sick per hospital and, as for B, here they have 50 openings. The expenditure standard for one opening accounts for 100 rubles. Minimal social

standard for **health care services can be calculated both in money value and real terms**. While it is in money terms, e.g. in health care it accounts for 1 ruble per capita, then regions A and B require the same amount of federal financial aid. But in this case, expenditure standard per one service unit for region B will be doubled. Then it can be concluded that while social standards are calculated in money terms, they will inevitably contradict expenditure standards per one service unit. Considering that the former are determined by the legislation and the latter by a legislative act, social standards will gain the priority, which might exert a negative influence upon the validity of federal financial support distribution.

In case the social standard is calculated in real terms, e.g. hospital opening место per 100 residents, region B, besides financial aid calculated on the basis of expenditure standard (i.e. 5000 rubles), will receive financial aid for building additional hospitals for the purpose of equalization of the level of public welfare if compared to social standard. But federal transfers aimed at equalization of budget обеспеченности level for RF subjects are not provided for capital but for current expenditure needs. According to this example, in order to equalize the level of opening provision at hospitals in region B up to social standard, expenditure needs will many times exceed financial aid amount provided for A region. Thus, financial aid allocation based upon minimum social standards might cause outstanding growth of the federal fund of financial support to the RF subjects, which might exceed federal budget capacity. The negative influence exerted by social standards upon the budget system can be avoided provided that the Government is qualified to establish social standards on the basis of actual but not desirable capacity. But in this case social standards lose their meaning and turn to be expenditure standards calculated in real terms. Thus, the concept adopted in the Budget Code, which regards both minimum social standards and expenditure standards per one service unit as criteria for financial support to the RF subjects provided from FFFSR for the purpose of equalization their levels of fiscal capacity, might result in practice in disability to outline any model for the allocation of such aid and complete chaos in the interbudgetary relations. In this respect it is necessary that minimum social standards be excluded from the scope of criteria for the distribution of financial aid received from FFFSR. But on the other hand, minimum social standards adopted by the legislation might be useful in the following situations: they can be regarded as a pivot, while providing capital investments, target transfers from federal budget for the regions.

The main feature of financial aid received from FFFDR is the fact, that it has a general character. The economic essence of the transfers received from FFFSR consists in the fact, that these transfers being subsidies, transfers were

used by regional authorities without any accountability. During the first years of the Fund it proved to be a disadvantage, for the RF subjects being absolutely unlimited in choosing financial aid expenditure perspectives, there were no any minimum expenditure requirements imposed upon recipient –subjects of the Russian Federation. Moreover, target transfers, which were necessary to provide functioning of federal social legislation in the regions, were also allocated through FFFSR. It often resulted in addressing the transfers to the economically and socially unreasonable expenditure needs (e.g. housing subsidies) alongside with the increase in regional budget debt for funding social benefits.

During the last two years some measures were taken in order to avoid the drawbacks mentioned above. Firstly, the federal government has become qualified to control target transfers received by the regional budgets in order to provide for federal social mandates, which resulted from extracting these transfers from the FFFSR and organizing another fund aimed at such kind of offsets. (for more detail see below).

Secondly, the Budget Code fixed general conditions for financial aid allocation in order to equalize the minimum fiscal capacity level. Thus, according to i.134 of the BC financial aid received by RF subject's budget from the federal budget for the purpose of equalization of the minimum fiscal capacity level is provided under the condition of entering into an agreement on the performance of the RF subject's budget through Federal Treasury of the Russian Federation. Besides, the recipient-region does not have a right:

- to provide better conditions for regional public employees if compared to federal employees (payroll, business trips and other expenses)
- to provide budget credits to bodies corporate, which might account for more than 3 per cent of total budget expenditure of RF subject;
- to provide state RF subject guarantees, which might account for more than 5 per cent of total budget expenditures exercised by the Subject of the Russian federation.

Thus, the transfers received from the FFFSR preserve their «general»nature, but the Federation still prevents the regions from using them for the purposes discrepant to federal concept of expenditure preferences. Nevertheless, all the conditions mentioned above seem to be insufficient with regard to the mechanisms of the federal economic and financing policy. We assume that one of the obligatory requirements established for all regions-recipients of transfers from the FFFSR consists in strict obedience to the norms of federal budget legislation (inclusive of the requirements for servicing and discharging credit obligations including credit debts to public employees). In order to escape continuous transfer

dependence of strongly recipient – regions (receiving 50 per cent of their total budget revenues from the federal budget) it is necessary that specific conditions of financial aid allocation be stipulated, inclusive of the requirements that the plan of regional budget sanitation mapped out with the assistance of the federal authorities should take effect.

The Fund for Compensation.

As it was mentioned above, in the budget project for 2001 outlined by the government the funds provided for the execution of the most « expenditure-taking» federal laws such as «State subsidies to Citizens having children», «Veterans», «Social Defense for the Disabled» were excluded from the FFFSR and comprised a special fund for Compensation. Since now the federal aid provided for the execution of these laws will be allocated in the form of transfers, subventions, and mutual settlements by accounting the funds of the RF Subjects' budgets in the Federal Treasury, which will secure federal control over their target application. Another significant change in the approach to financial support for the expenditure needs of such a kind consists in the right to receive compensations from the federal budget gained by donor-subjects of the Russian Federation. Before that, the RF subjects, which did not receive any financial aid from the federal center had to cover the expenditures at their own expense.

As it was outlined in the initial budget project, the Fund was to be formed on the basis of those 15 per cent of total VAT, which were formerly delivered to the budgets of the RF subjects. According to the calculations made by the government, such a redistribution of total VAT revenues proves to be of benefit to most RF subjects for the tax base of this tax fails to be equally distributed. As such, 17 % of total regional VAT revenues share is transferred to Moscow budget, the population of which accounts for 6 %, 55 % is allocated to 10 regions with the population of 28%, as long as 50 RF subject, comprising 40% of total population receive only 20% of regional budgets VAT revenues. The regional revenue misbalance caused resulted in non -equalized social expenditure funding, assigned by the federal laws enumerated above, e.g. some regions provided 100% funding, others failed to provide 10% support. Such a situation enhanced the difference between the regions and deprived the citizens of a right to receive equal social guarantees on the whole territory of the country.

Besides, while designing the Compensation fund model, the Government declared their intention to provide complete equality between the fund amount and expenditure liabilities of the regional budget resulted from the norms of the three given federal laws of social nature. In case the fund fails to provide for all

expenditure liabilities to the full degree, some norms of the legislation must be suspended. In particular, the budget project for 2001 entails inserting an amendment into FL of «Federal subsidies to the citizens having children», which limits the list of the recipients of the subsidies by those families whose revenues are below minimum living standard. The sequential execution of the approach suggested by the Government could become an important step in solving the problem of «unfunded mandates».

Unfortunately, during the discussion of the budget project for 2001 at the State Duma the initial model for Offset fund underwent certain changes. The total amount of the Fund was reduced from 71 116 125 thousand rubles to 33 381 638 thousand rubles (2,8 per cent of total federal budget expenditures or 17.9 per cent of federal budget expenditures on the part of «Financial Aid provided for the budgets of other levels») due to exclusion from it the funds assigned to cover mutual settlements with the regions within the execution of FL «Veterans». According to the budget project, adopted after the third reading the total amount of target transfers provided for regional budgets in order to execute federal benefit responsibilities within the FL of «Veterans» accounts for 4000 mln. rubles (instead of 38 571,2 mln. Rubles) Another 8 351,7 mln. Rubles will be provided for recipient subjects of the Russian Federation as general transfers due to the changes introduced in the initial fund amount and the order of offset fund design. Thus, the amount of the federal budget support delivered to the regions for a special purpose has been reduced by more than twice if compared to the one planned due to the growth of the general part of federal financial aid.

The Fund of Regional Development.

The fund of regional development (FRD) has become another source of federal financial aid. The idea of the fund was for the first time formulated in the Concept of interbudgetary relations' reform in the Russian Federation in 1999-2001. According to the concept, the FRD consolidates formerly separate funds of the federal budget expenditures (inclusive of those addressed to the federal and regional target programs, the projects of branch financing, etc.), which are aimed at setting within the whole territory of the Russian Federation an infrastructure necessary for the provision of guarantees declared in the Constitution of the Russian Federation and the federal legislation. In order to distribute transfers from the FRD, it is required that minimum objects of social infrastructure to provide public services assigned by the federal legislation be defined on the territory of each RF subject. At the next stage, it is required that total amount of the FRD, distributed among the RF subjects with rather poor social infrastructure, be calcu-

lated. According to the concept, the main peculiarity of the FRD consists in its funds being allocated only as transfers, i.e. on the terms of shared financing of target expenditures. The RF subject's share of the project funding must account for more than 50 per cent. We assume, that such kind of shared financing might be carried out while equalization of economic potential (within the Budget of Development), but as for social equalization it proves to be too tough, for depressive regions often suffer from the deficit of budget current expenditures and are hardly able to accumulate recourses for capital investments.

According to the federal budget project for 2001, the amount of the FRD accounts for 3 335 000 thousand of roubles (0,28 per cent of total federal budget expenditures or 1,78 per cent of federal budget expenditures within «Financial aid to the budgets of other levels»). The FRD performs an integrity of the assignments providing all kinds of federal target programs of regional development. Within the budget for 2001 the FRD accumulates funds for 41 of such programs.

Despite considerable amount of funds within the FRD, the order and conditions of their distribution are not regulated by the legislation and are controlled by the RF Government. Moreover, the Government do not pursue any clear-cut policy to distribute FRD funds, for the programs launched for the purpose of regional development, which comprise the Fund, were introduced by the Resolutions of the Government in different time-periods and were aimed at different goals, which resulted from regional lobbying rather than from the global federal strategy.

The following facts are explicit to show the glaring discrepancy between current model for the FRD and the concept formulated above. According to the concept, the FRD is qualified to provide financing only for the purpose of social structure equalization on the whole territory of the Russian Federation. As for financial support to the regional industry development, the matter rests within the competence of the RF development budget on a repay basis. But among 41 programs of regional development adopted by the fund 10 do not make use of the term «social development» at all. In 2001, it is assumed that the FRD will provide financial support for several ecological programs, the program of «the Restoration and Development of the Historical Center of St.-Petersburg», the program of seismic stability of national economy utilities in the Kamchatka region, the program of socio-economic development of Sochi, etc. The federal share within financing of different target programs is different. Among the recipients receiving financial aid from the FRD there are regions with a considerably higher

level of social infrastructure than average RF level, e.g. St.-Petersburg, Kalinin-grad region, Chelyabinsk region, the Republic of Saha (Jakutsk).

Besides, the efficiency of expenditures within federal target programs (of both regional and federal level) in general proves to be low. First of all, it results from the fact that expenditures within these programs are presented out of budget classification and, therefore, fail to be transparent. Secondly, the budget legislation does not allow to introduce personal accounts into the Federal Treasury in order to design non-public kinds of property, which usually take the burden of carrying out financial projects within programs of such kind. Thus, there is no opportunity to control the expenditure of target funds provided from the budget. Although, in the abstract, it is possible to call the officials responsible for the project to account in case the target program fails to take effect on the part of the contractor, but it can't secure that budget funds spent would be recovered.

With respect to the things mentioned above, it is necessary that the model of the FRD be considerably changed. In particular it is provided that:

- principles and conditions of the FRD distribution be adopted by the law;
- take stock of the current programs for regional development in order to introduce repay principles of financing (through budget of development aimed at support on competitive basis provided for commercial investment projects) the projects, which do not correspond the FRD objectives; provide equal rights for the RF subjects in their appeal to the fund; unify the conditions of federal aid allocation
- to design a legislative mechanism providing for target expenditure of the funds, received within the FTP, inclusive of the FTP financed through the Fund of Regional Development.

The Fund of regional finance development (FRFD)

Like the Fund of Regional Development, the fund of regional finance development appeared within federal budget since 2000. For 2001, it has been planned that its amount will account for 600 000 thousand rubles. (0,32 per cent of total expenditure within «Financial aid to the budgets of other levels»).

Budget law outlines general goals of the FRFD («activation of financial sanitation of RF subjects' budgets, support for budget sphere and budget process reform, economic reform incentives»), delegating the right to specify the expenditure order to the Government of the Russian Federation, which must rely in this respect upon the agreement achieved with the International Bank of Development and Reconstruction on the loan for definite purposes. To date, the con-

cept of interbudgetary system reform in the Russian Federation in 1999-2001 proves to be the only standard document of the Government, which touches upon the problem of the FRFD expenditures.

According to the concept, the two main objectives of FRFD expenditures are:

1. Granting credits to the regions successful at financial sanitation Non-cash forms of budget execution, the transmission to treasury system, the introduction of control systems for the state and municipal debts, the reconstruction of enterprise debts as well as budget liabilities, the distribution of state and municipal order on the competitive basis, the elimination of out-budget funds, which are not allowed by the federal legislation, etc.) and active at economic reform (the reduction in the funding provided for housing and other branches of economy, the reduction in cross-subsidies for tariffs, establishing a stable and transparent system of interbudgetary relations between the federal and municipal budgets, etc.).

The fact that such credits are target-oriented is not mentioned within the concept explicitly, but considering the goal of the credits, which consists in «financial independence and creditability of unsubsidized and lowly-subsidized regions», we can assume that the credits should be technical and should be aimed at market reforms. In this respect, the FRFD proves to be a kind of counterbalance to the fund of regional development, the latter being oriented to the financial support of recipient-regions.

2. Providing technical aid to the authorities of the RF subjects in carrying out budget reform.

Within this sphere, it is assumed that systematic aid be provided for regional and local authorities in finance control, tax and budget development, as well as teaching regional and local financial staff.

* * *

Besides the funds discussed in this part, a considerable percentage of federal budget expenditure within «Financial aid to the budgets of other levels»

a) State support for the Road management, which accounts for 20 300 000 thousand rubles (10,9 % of total expenditure within the program)

In 2001, it first appeared within «Financial aid to the budgets of other levels» along with the elimination of the Road fund, which was responsible, for instance, for subsidies and subventions provided for Road reconstruction, the support for international and interregional communications, as well as transfers for the support and repair of public Roads, which belonged to the RF subjects, unless the highway funds were enough to provide support for them.

- b) Subsidies and subventions of different kinds provided for the budgets of classified (secret) Territorial Entities (hereinafter referred to as CTE) amounting 10 148 914 in rouble value (5, 43% of the expenditures for the section).

This item of expenditure is traditional for the federal budget and comes to reflect the specificity of the CTE status, which is understood as «a territorial entity, having local autonomous bodies, within which area plant facilities for the development, production, storage and utilization of mass destruction weapons are located, inclusive of those for nuclear and other waste processing, and other military facilities, for which a special order safety performance and State secret protection is established, inclusive of specific conditions of habitation» (Сноска 10). In contrast to other municipal entities, CTE are under the federal jurisdiction. In particular, this is reflected by the fact, that the current CTE budget expenditures are subsidized direct by the federal budget (but not by the budgets of the RF Subjects within which domain they are located, which is the case for other kinds of municipalities).

Another remarkable peculiarity to be observed about the CTE status is the order of entering tax revenues on their budgets. Up to 1999, the revenues of federal, regional and local taxes of all kinds, collected within their area, were subject to entering on their budgets (The Budget Act, passage 2, point 1, Article 5), whereby the local autonomous bodies were entitled to issue extra remissions for the taxes of all kinds with respect to the taxpayers registered within their domain. The negative impact of such legislative acts ramified into two. First of all, these additional tax remissions were financed by the federal budget, by which subsidies were granted to cover the CTE budgetary deficit. In the second place, the pro forma rewrite of taxpayers waging economical activities in other regions within the CTE territory, has lead to an all-encompassing reduction of tax revenues, accrued to the federal and the regional budgets.

In 1999, an attempt was undertaken to block the tax-dodging channel by registering the institutions transacting economic activities in other regions within the CTE bounds. The federal legislation # 67-F3 dated April 1999 was meant for introducing amendments into Article 5 of the RF «On CTE legislation. It is assigned, that the right to supplementary tax and due remissions rest only with the institutions having no less than 90% of their assets allocated and transacting no less than 90% of their activities within the domain of the respective CTE (also, no less than 70% of the average of such institutions' employees is to be accounted for by permanent residents of the respective CTE, while these respective resi-

dent employees are to be paid wages accounting for no smaller share than 70% of total for the labor remuneration fund.

Besides, as provided by State #227-F3 «On 2000 Federal budget» Legislation, dated Dec. 31, 1999, the taxpayers – both enterprises and institutions under the aegis of CTE - enter part of the federal taxes and dues, subject thereto, on the account of the federal budget, the only exception being the CTE within which the federal nuclear centers are located. Extra tax and due remissions do not apply to VAT, excise-duties and nor do they apply to the taxes and dues entering in the state purpose budgetary funds. Above all, for the nuclear center-locating regions, total for the funds placed under the jurisdiction of bodies corporate exercised a contraction up to 50% of the tax and due combined values, charged for the accounting period with no remissions applying as a result of providing additional tax and due remissions and making payments in obligation, no excise remissions applicable to excise-subjected goods.

In accordance with # 15-F3 of the 2001 Federal budget Act, dated Dec.12. 2000, the term is prolonged for the year 2000 dated order of revenue allocation for the taxes collected within the CTE area, whereby this order was extended to embrace the federal nuclear center-locating CTE. Under art. 52 of the legislation quoted, of all federal tax variety, additional tax remissions for CTE local authorities only be provided for income tax within the rate and the value bounds accrued to their budget revenues.

Appendix. The list of expenditure authorities incumbent upon sub-national budget by the Federal Legislation (by the RF Ministry of Finance).

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|---|----------------------------|---------------------------|---|
| 1 | The 12.01.95 №5-FL "On the veterans" | benefits for the veterans | Social public security | Combined; in 2001, the expenditures are actually compensated by the Federal Budget to the Subsidized RF Subjects. |
| 2 | The 24.11.95 №181-FL "On Social Protection of the Disabled in the Russian Federation" | Benefits for the disabled | Social public security | Combined; in 2001, the expenditures are actually compensated by the Federal Budget to all the RF Subjects. |
| 3 | The 19.05.95 №81-FL "On State grants | Allowances for children | Social public security | Combined; in 2001, the expenditures are |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|--|--|---------------------------|---|
| | to individuals raising children”, The 4.09.95 № 883 RF Government Decree "On the adoption of the Resolution on the order of awarding state grants to individuals raising children” | | | actually compensated by the Federal Budget to the Subsidized RF Subjects. |
| 4 | The 15.05.91 №1244-1 FL "On social protection of the individuals injured by nuclear energy as a consequence the Chernobyl Nuclear Station catastrophe | Facilities, benefits and compensations to individuals, injured by nuclear energy as a consequence of the Chernobyl Nuclear Station catastrophe | Social public security | combined |
| 5 | The 25.05.98 № 76-FL "On the status of the servicemen” | Facilities, Benefits and compensations to the servicemen and individuals transferred to the reserve, and to their family members | State Defense | federal |
| 6 | The 05.05.92 №431 RF President federal Decree “On measures to be taken for delivering social support to big families” | Allowances for big families | Social public security | combined |
| 7 | The RF 09.06.93 №5142-1 "On donorship of blood and its constituents” Federal Law | Benefits for donors | Health care | Does not defined by the Budget Code |
| 8 | The RF 13.01.96 №12-FL "On education” (art. 40, 54, 55) | Exemption of educational establishments from paying taxes of all kinds for the income of their specialization. Ensuring salaries for | Education | Does not defined by the Budget Code, Funding is actually carried out by the budgets, under the jurisdiction of which the stated |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|---|---|--|---|
| | | the teachers; granting privileges to the teachers | | institutions are placed. |
| 9 | The 12.01.96 № 8-FL "On burial and funeral issue" | Funeral benefits | Social public security | Combined |
| 10 | The RSFSR 18.10.91# 1761-1 "On rehabilitation of the repressed for political reasons" | Facilities for the victims of political repressions | Social public security | Combined |
| 11 | The 01.08.96 № 107-FL "On compensation granted to students of state municipal primary vocational and secondary vocational educational establishments for nutrition. | Compensation of rise in the cost of nourishment for students of state, municipal and general educational establishments,, and also for students of elementary vocational and secondary vocational institutions. | Social public security | Combined |
| 12 | The RSFSR 18.04.91 1026-1 "On Militia" | The maintenance of criminal militia is financed by the Federal Budget, while social security militia (unless numbered under the minimum settled by the federal legislation) is supported by the regional and local budgets. | Performance of law-enforcement activities. | Combined, although having some specifications of expenditure authorities |
| 13 | The RF President Decree of 15.10.92 №1235 "On granting benefits to the former under-age prisoners of concentration camps, ghetto and other places | Applying the benefits, granted to the disabled Second World War veterans and ex-service-men, to under-age concentration camp prisoners for public | Social public security | Combined; the compensation principles coincide with those of "On Veterans" Federal Law and "On Social Protection of the Disabled" Federal |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----|---|---|---|---|
| | of captivity established by the fascists and their allies for the period of the Second World War. | services and utilities. | | Law |
| 14 | The RF 09.01.97 № 5-FL "On granting social insurance arrangements to Heroes of Socialist Labor and those awarded the Order of Labor Glory" Federal law. | Facilities to the veterans from among the Heroes Of Socialist Labor and those awarded Orders of Labor Glory. | Social public security | Combined; the compensation principles coincide with those of "On Veterans" Federal Law and "On Social Protection of the Disabled" Federal Law |
| 15 | The RF 15.01.93 №4301-1 "On status of USSR and RF Heroes and those awarded Order of Glory | Facilities for veterans from among the USSR Heroes, RF Heroes and those awarded Order of Glory | Social public security | Combined; the compensation principles coincide with those of "On Veterans" Federal Law and "On Social Protection of the Disabled" Federal Law |
| 16 | The RF Government decree of 20.06.92 №409 "On urgent measures of social protection of orphan kids and those left out of the charge of parents" | Norm-fixing of the expenditures for maintenance of teaching and educational institutions for orphans and those left out of the charge of parents. | Social public security | Combined; Funding is actually carried out by the budgets, under the jurisdiction of which the stated institutions are placed. |
| 17 | The 21.12.96 №159-FL "On extra insurance arrangements for social protection of orphan kids and those left out of the charge of parents | Benefits to orphan kids and those left out of the charge of parents. | Social public security | Combined; expenditures not segregated de jure |
| 18 | The RF 17.01.92 № 2202-1 "On the Office of Public Prosecutor in the Russian Federation" | Financing bodies of the Office of Public Prosecutor | Maintenance of activities fulfilled by the federal power bodies | federal |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|---|--|---|--|
| 19 | The 21.12.94 №69-FL "On fire safety" Federal Law | Financing the State fire fighting service | Ensuring fire safety | Combined, although having some specifications of expenditure authorities |
| 20 | The RF Customs Code of 18.06.93 №5221-1 | Financing customs bodies | Maintenance of activities fulfilled by the federal executive power bodies | federal |
| 21 | The 02.08.95 №122-FL "On ensuring social security for old-aged individuals and for the disabled". | Financing State and municipal institutions of social security for old-aged individuals and the disabled ones. | Social public security | Combined |
| 22 | The Decree of the Supreme Council № 4202-1 of 23.12.92 "Statute for the service in bodies of domestic affairs". | Material and social security of domestic affairs service-men | Performance of law-enforcement activities. | Combined, although having some specifications of expenditure authorities |
| 23 | The RF Government Decree of 30.07.94r № 890 "On the state support of Medical industry and improvement of supply with medicine and medical commodities to the people and health care institutions. | Financial support to medical industry | State support of industry branches | Combined |
| 24 | The RSFS 21.12.90 № 438 "On village social development" | n/a | Rendering financial aid to local budgets | regional |
| 25 | The 19.02.93 №4520-1 "On state insurance arrangements and compensations for people working or residing in the regions of the Far North and the Far North and the | State insurance arrangements and compensations for individuals working or residing in the regions of the Far North and in the territories likened to | Social public security | Combined |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|--|--|--------------------------------------|---|
| | territories likened to them” | them. | | |
| 26 | The Decree of the RF Government of 21.08.92 №610 "On urgent measures of improving the position of children in the Russian Federation." | n/a | Social public security | Combined |
| 27 | The All-Union Central Executive Committee and People's Commissar Council Decree of 10.06.30 №409 "On benefits to qualified staff in the rural areas and industrial communities” with the successive supplements. | n/a | Social public security | Combined |
| 28 | The RF 26.06.92 №3132-1 "On the judges' status in the Russian federation" | Material and social security of the judges | The federal judicial system function | federal |
| 29 | The RF Government 13.08.97 №1005 "On improvement of free diary product supply to the children aged 1 to 2 years old” Federal Law | A free specific diary product supply to the children aged 1 to 2 years old. | Social public security | Combined; expenditures not segregated de jure |
| 30 | The .05.94 №419 "On affirmation of the regulation on the order of granting benefits to the individuals rehabilitated and those acknowledged as victims of political repression”. | Benefits to the rehabilitated individuals and to those acknowledged as victims of political repression”. | Social public security | Combined; expenditures not segregated de jure |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----|--|---|--|--|
| | sions" Federal Law. | | | |
| 31 | The 19.08.95 №149-FL "On social protection of individuals exposed to nuclear energy as a result of nuclear tests at the Semypalatynsk proof ground. | Benefits to individuals, affected by nuclear energy as a result of nuclear tests at the Semypalatynsk proof ground. | Social public security | Combined; expenditures not segregated de jure |
| 32 | The RF President Decree dated 02.10.92 №1153 "On the measures for improvement of social protection of domestic forces service-men, rank and file and commanding individuals of domestic forces and their family members. | Material and social security of the domestic forces service-men and Domestic Affairs Bodies staff. | Ensuring State Security | federal |
| 33 | The RF 26.06.95 №604 "On the order of rendering gratuitous financial aid for building (purchasing) real estate and paying cash compensation for renting (sublease of) quarters to servicemen and individuals transferred to the reserve. | Housing supply to military personnel | State Defense | federal |
| 34 | The RF President 12.03.93 № 209 "On social safety militia (local militia) in the Russian Federation" Decree. | Financing social safety militia (local militia) | Performance of law-enforcement activities. | Combined, although having some specifications of expenditure authorities |
| 35 | The RSFSR Gov- | Logistical support of | Maintenance of | federal |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|---|---|--|---|
| | ernment of 26.11.91 №20 "On the affirmation of regulations on Russian transport inspection department of the RF transportation Ministry" | the Transportation Inspection department personnel of the RF Transportation Ministry | activities fulfilled by the federal executive power bodies | |
| 36 | The RF Government 19.08.94 №979 "On affirmation of the statute of military registration and enlistment offices" Decree | financing military registration and enlistment offices | State Defense | federal |
| 37 | The RF 03.04.95 N40-FL "On Federal Security Service Bodies in the Russian Federation" Decree | Financing Federal Security Service Bodies | Ensuring State security | federal |
| 38 | The RF 14.05.93 №4979-1 "On veterinary medicine" Federal Law | Financing veterinary medicine institutions | Not defined by the Budget Code | Funding is actually carried out by the budgets, under the jurisdiction of which the stated institutions are placed. |
| 39 | The RF President 12.04.93 №443 "On urgent measures of state support to students and post-graduate students of higher professional educational establishments" Decree. | Scholarships and grants to students and post-graduate students of higher educational establishments | education | Not defined by the Budget Code |
| 40 | The RF 06.02.97 №27-FL "On internal forces of the RF Ministry for Internal Affairs" federal Law | Financing internal forces | Ensuring State security | federal |
| 41 | The RF 28.06.91 г. "On medical insurance of the RF citi- | Assignments for medical insurance for the unemployed | Health Care | Not defined by the Budget Code, financing is actually |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|---|---|---|----------------------------------|
| | zens” Decree. | citizens at the expense of sub-national budgets. | | carried out by regional budgets. |
| 42 | The RSFSR Council of Ministers 26.08.65 №994 Enactment "On schoolchildren residing in the rural area. | n/a | Social public security | Combined |
| 43 | The 21.07.97 №118-FL "On officers of the court” | Financing the service of officers of the court | The performance of the federal judicial system. | federal |
| 44 | The RF 08.05.94 №3-FL "On the status of Federation Council Deputy and the RF Federal Assembly State Duma Deputy” | Material and social security of State Duma and Federation Council Deputies. | The performance of Federal Assembly activities | federal |
| 45 | The RSFSR Ministry for Transportation 24.12.87 №176 "Rules of conveyance of passengers and luggage by motor transport in RSFSR” Order (dated 12.06.90 N 63) | Subsidizing haulier losses inflicted by issuing reduced fare for specific sections of the population. | State support for motor transport | Combined |
| 46 | The RF Government 18.01.92. N 33 "On supplementary measures of social protection of students” enactment | Financial support of students | Education | Not defined by the Budget Code |
| 47 | The RF Government 24.06.96. N 741 "On adoption of the statute scholarships and other kinds of student support in State and Municipal primary and second- | Financial support of students | education | Not defined by the Budget Code |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|---|---|---|--------------------------------|
| | ary vocational schooling institutions. | | | |
| 48 | The RF Government 6.12.92. N 981 "On fare facilities for students of State and municipal secondary educational institutions and colleges, and for postgraduate students of State and municipal higher educational institutions, and research institutions, and for preliminary course students attached to state and municipal higher educational institutions. | Financial support of students | education | Not defined by the Budget Code |
| 49 | The RF President 24.12.98 N 1638 "On increment in money allowances for military personnel, for the RF Internal Affairs Bodies' staff, for institutions and bodies of Ministry of Justice criminal-executive system, for the RF customs bodies, and cash allowance for tax police federal bodies' personnel. | Material security of the federal force control staff | Maintenance of activities fulfilled by the federal executive power bodies | federal |
| 50 | The Rf Government Act of 11.08.92 №572 "On the compensation of costs caused by migration from the Northern regions and territories | compensation of costs caused by migration from the Northern regions and territories equated to the Northern regions | Social public security | Combined |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----------|--|---|--|--------------------------------|
| | ries equated to the Northern regions" | | | |
| 51 | The RF Government 28.02.96 №213 "On long-service increments to medical personnel, filling established positions in health care and social protection institutions pluralistically. | Material security of medical personnel | Health Care | Not defined by the Budget Code |
| 52 | The 28.03.98 №53-FL "On military service" Federal law. | Material and social security of armed forces personnel | State Defense | federal |
| 53 | Fundamentals of the RF Legislation on health protection of the RF citizens dated 22.06.93 N5487-1 | Financing health care | Health Care | Not defined by the Budget Code |
| 54 | The Criminal and procedural "reformatory" Code since 01.07.97 | Financing criminal-execution system | Carrying criminal system penalties into effect | Not defined by the Budget Code |
| 55 | The 26.11.98 №175-FL "On social protection of the RF citizens exposed to nuclear radiation as a result of the 1957 "Mayak" industrial merger catastrophe and nuclear wastes burial in the Techya river" Federal Law. | Benefits and compensations to the RF citizens, exposed to nuclear radiation as a result of the 1957 "Mayak" industrial merger catastrophe and nuclear wastes burial in the Techya river." | Social public security | Combined |
| 56 | The RF Supreme Council 27.12.91 №2123-1 "On extending the RSFSR "On social protection of citizens exposed to nuclear | Benefits and Compensations to the RF citizens exposed to nuclear radiation as a result of the Chernobyl APP catastrophe and to individu- | Social public security | Combined |

| № | Standard Act | Expenditure essence | Expenditure target | Expenditure competence |
|----|--|--------------------------------------|--------------------|---|
| | radiation as a result of the Chernobyl APP catastrophe” Law to individuals of special risk departments” enactment. | als of special risk departments. | | |
| 57 | The RF 09.10.92 №3612-1 "Fundamentals of the RF State Culture Legislation” | Maintenance of Culture institutions. | culture | Not set by the Budget Code, Funding is actually carried out by the budgets, under the jurisdiction of which the stated institutions are placed. |

Chapter 3. Tendencies in the Federal Budget Financial Aid Allocation to the Subjects of the Russian Federation: 1992 to 2001

Financial aid rendered to the subjects of the Russian Federation from the federal budget constitutes a basic component part of the interbudgetary relations system. The research goal is to overview and analyze the key tendencies in rendering federal financial assistance to the regional budgets since 1992. It is notable, that a historical overview of the interbudgetary relations development in the Russian Federation and the legal provision for the relationships between the budgets of different levels (inclusive of financial aid distribution) is represented in the following papers done within the bounds Consortium for Economic Policy Research and Advice (CEPRA): Trounin I.V. "The Record of Interbudgetary Relations Development in Russia" and Zolotaryova A.B. "Legal aspects of interbudgetary relations in the Russian Federation".

For the above reason the issues are not addressed in detail below.

Total for federal support for the period of 1992 to 2000 is illustrated by Table 1. The figures show that the aggregate amount of funds allocated to the Subjects of the Federation fluctuated within a relatively wide range during the nine years in point: from 1, 37% of GDP in 1999 to 3,4 % of GDP in 1994. Apart from that, it is notable that the spread-spectrum fluctuation of total for financial aid to the regions was basically caused by the changes in the aggregate funding amount transferred via such distribution channels as "funds assigned through mutual settlements", "subventions" and through other varieties of non-regular financial support. In contrast to the aggregate financial assistance rate, which volatility would be difficult to ascribe to economic reasons (this inconstancy rather arises from the political situation of each period), the very structure of the federal financial aid reveals more comprehensible tendencies. Thus, after 1995, a growth of the FFSR (Fund for Financial Support to the Regions) transfer share of total for Federal support delivered to the Subjects of the Federation is evidenced - all after this kind of financial aid was introduced in 1994, at which time the transfers' aggregate value was relatively low and accounted for 10% only (this

low transfer share was also for the reason, that transfer funding, in fact, came into effect in mid-1994)³³.

In 1995, a large increase of FFSR transfer share of total for the Federal funding allocated to the regions is displayed (to 64 %). In effect, the year 1995 is to be treated as the first full-fledged effect year for such a kind of financial support, as FFSR transfers, since it is for the first time that the Ministry of Finance made a calculation for FFSR transfers within the budgetary process, provided for by Russia's new Constitution, which accounts were later adopted by the State Duma as part of the 1995 Federal Budget Act. It should be noted, however, that the increased FFSR transfer share of total for the federal financial aid can be just partly accounted for by the conversion of the formula distributed transfers into the dominant financial aid for that period. The resolution adopted a year before to make FFSR transfers a key financing source of interbudgetary equalization, was accomplished by the federal government to a major extent, however, a possibility to finance a FFSR transfer by offsetting a region's VAT revenues against the federal budget, dated the same year, shall be considered. Table 1 depicts, that the year 1995 evidences the maximum transfer share growth owing to the federal VAT share of total for the federal financial support to the regions (17%) for the whole observation period.

In 1996 through to 1997, a certain decrease of FFSR transfer share of total for the federal funding can be traced. Such a reduction is elucidated by two facts: in 1996, a share growth of funding allocated to the RF Subjects as funding assigned through mutual settlements (up to 35% of total for financial aid) took place, and 1997 earmarks funding regional budgets' expenditures by budget loans, assigned by the federal budget (around 25% of the aggregate funding allocated to the regions)³⁴.

The federal support funding policy made tougher in 1998³⁵, it resulted in an increase of FFSR transfers share of total for the federal aid. It should be observed, that alongside of FFSR transfer share growth within the federal financial

³³ Due to the 1993 autumn disturbances, the bill "On the Federal Budget for 1994" was finally approved of by the State Duma as late as June 24, 1994 and came into effect since July 1 1994

³⁴ The federal budget loans for 1997 could be treated as the federal financial aid, since the funds allocated to the regions throughout this period for the purpose of paying salaries to public employees were not repaid to the federal budget, but numerous delays and installments were granted for them. (For more detail see "The Record of the Interbudgetary Relations' Development in the Russian Federation", 2000, CEPRA, Moscow)

³⁵ Ibid.

aid bounds, there's a contraction for the funds appropriated at the account the federal VAT share (both in absolute and relative values). Consequently, in 1999 and 2000 the amount of transfers from the federal budget settled at 0,98% of GDP, and their percentage share of the federal financial support structure accounted for 71% and 67%, respectively.

Thus, the following observations could be made with respect to the structure of the financial aid delivered by the federal budget. The period of 1992 to 2000 marks the following sources of the federal support to the budgets of the RF Subjects as the major ones:

- subventions (the federal budget appropriations allocated to the budgets of the RF Subjects for a special purpose), which was a major variety of financial aid to the subjects in 1992 (53%). An emphasis should be placed upon the growth of the subventions share within the federal support structure for 1999 (up to 14%), however, since that year, the federal funds appropriated for «north supply»everного (calculated by a scheme similar to that of FFSR distribution) has taken the form of subventions, while this has also been the case for some other kinds of financial aid for a special purpose, included in a FFSR transfer;

- funds transferred to the RF Subjects via mutual settlements (a to-the-region gratuitous transfer channel for appropriations made available for the current financial aid goals during the federal budget performance period) retained a status of one of the basic financial aid types for 1992 to 1998, while the biggest share of funding awarded to the regions via this channel is characteristic of 1993/94 (at 72% and 74%, respectively);

- FFSR transfers (a major kind of the federal general financial support, delivered to the Subjects of the Federation on the basis of a unified scheme) have been a key channel to allocate funds among the Subjects of the Federation since 1995, its share having increased from 10% to 70% for its whole lifetime.

- eventually (in 1996 and 1997), the budget loans unrepaid to the RF Subjects tend to possess high shares (10% and 25%, respectively).

- the whole observation period exhibits a steady increase of the grants share of total for the federal budget's financial aid (appropriations transferred from the federal budget to those of Classified (secret) territorial entities (CTE) - this is partly due to the changes in the policy pursued towards the CTE budgets, which are financed by the federal grants, - starting from 1998, the funds accrued to CTE budgets through federal and regional tax remissions are replaced by grants coming direct from the Federal budget.

TABLE 1. AMOUNT AND STRUCTURE OF FEDERAL AID TO RF SUBJECTS RENDERED BY FEDERAL BUDGET FOR 1999 – 2000.

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--|-------|-------|-------|-------|-------|-------|--------|--------|-------|
| Grants | | | | | | | | | |
| % of GDP | 0,00% | 0,02% | 0,09% | 0,06% | 0,09% | 0,13% | 0,10% | 0,06% | 0,16% |
| % of financial aid | 0% | 1% | 3% | 3% | 4% | 5% | 6% | 4% | 11% |
| Subventions | | | | | | | | | |
| % of GDP | 0,79% | 0,69% | 0,42% | 0,12% | 0,12% | 0,09% | 0,02% | 0,20% | 0,03% |
| % of financial aid | 53% | 26% | 12% | 7% | 5% | 4% | 1% | 14% | 2% |
| Total for FFSR transfers | | | | | | | | | |
| % of GDP | 0,00% | 0,00% | 0,36% | 1,17% | 1,04% | 1,22% | 1,12% | 0,98% | 0,98% |
| % of federal aid | 0% | 0% | 10% | 64% | 44% | 49% | 70% | 71% | 67% |
| Inclusive of : | | | | | | | | | |
| Transfers | | | | | | | | | |
| % of GDP | 0,00% | 0,00% | 0,36% | 0,86% | 0,68% | 0,86% | 1,00% | 0,98% | 0,98% |
| % of financial aid | 0% | 0% | 10% | 47% | 29% | 35% | 62% | 71% | 67% |
| Transfers at the account of VAT | | | | | | | | | |
| % of GDP | 0,00% | 0,00% | 0,00% | 0,31% | 0,36% | 0,36% | 0,12% | 0,00% | 0,00% |
| % of financial aid | 0% | 0% | 0% | 17% | 16% | 14% | 8% | 0% | 0% |
| Funds assigned through mutual settlements | | | | | | | | | |
| % of GDP | 0,61% | 1,95% | 2,54% | 0,42% | 0,81% | 0,43% | 0,36% | 0,14% | 0,29% |
| % of financial aid | 41% | 72% | 74% | 23% | 35% | 17% | 22% | 10% | 20% |
| Loands reduced by repaying to other levels of government: | | | | | | | | | |
| % of GDP | 0,09% | 0,03% | 0,02% | 0,04% | 0,23% | 0,64% | -0,03% | -0,28% | 0,00% |
| % of financial aid | 6% | 1% | 1% | 2% | 10% | 25% | 0% | 0% | 0% |
| Assignments underpaid by the RF Subjects' budgets to budget funds created for special purpose | | | | | | | | | |
| % of GDP | 0,00% | 0,00% | 0,00% | 0,02% | 0,05% | 0,00% | 0,00% | 0,00% | 0,00% |
| % of financial aid | 0% | 0% | 0% | 1% | 2% | 0% | 0% | 0% | 0% |
| Total for funds transferred to budgets of other levels of government | | | | | | | | | |
| % of GDP | 1,49% | 2,70% | 3,40% | 1,80% | 2,30% | 2,50% | 1,60% | 1,37% | 1,87% |
| % of Financial aid | 100% | 100% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |

Source: RF Ministry of Finance; estimates by the authors.

The 1992 to 2000 dynamics of the key rates reflecting the budget financing of the RF Subjects via federal aid will be considered below. Table 2 represents the share values of the budget revenues by the Subjects of the Federation, generated by appropriations assigned by the federal budget throughout the whole observation period, as well as the respective budget expenditure share, financed by the federal financial aid. The table displays, that the combined dependency rate by the regional budgets on the federal support is the lowest one for the last two

years since 1991 (For the Subjects of the Federation as a whole, the federal budget appropriations share of the budget revenues doesn't tend to exceed 9,6% for 1999/2000). Thereby, the regional budgets' dependence on the federal financial aid being rather low in 1992, it increased by a factor of 2 by 1994, while the federal funding share of both regional budgets' expenditures and revenues accounted for 19%-20%). Later on, in 1995, a drastic drop for the respective rates was observed (to 12,8% of the regional budgets' expenditures/revenues), which was determined by the implementation of FFSR transfer mechanism. In 1996/97, apart from the simultaneous increase of the unrepaid amount allocated between the Subjects of the Federation, there was, however, an increase of the federal financial aid share by the regions' expenditure and revenue rates. The consequent policy toughening towards the relations between the federal center and the regional budgets in 1998, and the outset of a new stage of reforming the interbudgetary relationships lead to a decline for the dependence by the RF Subjects on the federal financial aid as a whole. It is also notable, that the invariance of the federal support share of the regional budgets' revenues for 2000, against the absolute volumes growth by the federal budget funds, allocated among the Subjects of the Federation, is also accounted for by the budgets' own-source revenue increase.

TABLE 2. SHARE OF FEDERAL FINANCIAL AID OF REVENUES AND EXPENDITURES OF RF SUBJECTS' BUDGETS IN 1992 TO 2000.

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|-------|-------|-------|-------|-------|-------|-------|------|-------|
| Share of federal financial aid of RF Subjects' budget revenues | 10,4% | 15,2% | 19,4% | 12,8% | 16,2% | 16,1% | 10,8% | 9,6% | 9,6% |
| Share of federal financial aid of RF Subjects budget expenditures | 11,7% | 15,9% | 19,8% | 12,8% | 15,5% | 15,2% | 10,7% | 9,7% | 10,1% |

Source: RF Ministry of Finance; estimates by the authors.

While analysing the federal support delivery to the RF Subjects by the federal budget, one should concentrate on the objectives of the above bankroll allocation as well as upon the way the federal grant-in-aid system happens to run its business. Thus, a major goal of financing regional expenditures by the federal budget is to reduce the degree of fiscal capacity differentiation between the regions, i.e. the capacity of the regions to produce public goods that could stand for the regional budgets' per capita revenue. The bankroll sharing system coping with its task, the dispersion of the regional budgets' per capita revenues, if calcu-

lated as before and after the federal aid delivery, shall be reduced, which would imply a lesser extent of interregional differentiation reached through the federal funds distribution.

The calculations made are explicit to show that the "Total for Revenues" rate per capita dispersion by the regional budget, calculated as prior to and after the federal aid acceptance tends to increase on receiving the federal aid. Besides, the budget receipts of the regions adjusted for the federal transfers tend to surpass the respective value unadjusted for the federal support by 10% to 140%, applied to a particular period. A similar result was achieved (although displaying lower values of the excess described) by regarding just one of the federal support varieties: that of the Fund for Financial Support to the Regions transfer (see Table 3).

It would be fair to remark, that the above results, which frequently happen to be interpreted as proving the lack of equalization effect inherent in the federal financial aid of the Russian Federation come to witness an inter-regional differentiation increase only by the absolute values of the regional budget revenues and expenditures. However, as was stated above, the major goal of interbudgetary levelling consists in balancing the levels of the state services, whereby a sheer comparison of the dispersion rates by the regional budgets' revenues, estimated as prior to and after the delivery of the federal support is inappropriate, which results from the fact that a region's specific conditions would account for different output per each rouble of the budget revenues in terms of financing the budget services. It is for the above reason, that the equalization capacity of the federal financial aid³⁶ should be evaluated with regard to the state services per unit cost factors within the regions, that can be assessed by applying the interregional living-wage ratio, as well as by their need for financing the production of public goods, the latter being understood as the on-budget expenditure ratio involved in the FFSR funds distribution, and also the standard expenditure needs of the RF subjects, calculated under CEPRA "Estimating expenditure needs and fiscal capacity of the RF Subjects" project.

To evaluate the equalization effect inherent in the federal financial aid from the perspective of fiscal capacity, the per capita dispersion dynamics was calculated for a number of regional budget revenues, adjusted for both an interregional living-wage ratio (which value is calculated as the relation of the average per capita living wage to the respective average for Russia as a whole) and for the

³⁶ Here the equalization capacity is understood as the ability of the federal financial aid to smooth away the interregional disparities in the per capita distribution of the budget revenues.

budget expenditures rise ratio, associated with the changed cost of public goods or with the altered demand for them (calculated similarly to the living standard ratio)³⁷.

TABLE 3. RF SUBJECTS' BUDGET PER CAPITA REVENUE DISPERSION DYNAMICS BY GRANTING FINANCIAL AID TO THE REGIONS

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--|------|------|------|------|------|------|------|------|------|
| RF Subjects' budget per capita revenue dispersion dynamics by granting financial aid to the regions | | | | | | | | | |
| - nonstandardized budget revenue rates | 127% | 11% | 17% | 110% | 88% | 140% | 89% | 123% | 49% |
| - standardized by living standard rates (price ratio) | 39% | 7% | 9% | -24% | 3% | -10% | -25% | -12% | -18% |
| - budget revenues standardized by expenditure needs guideline | 41% | 7% | 10% | -29% | 2% | -10% | -25% | -13% | -18% |
| - budget revenues standardized by budget expenditure needs ratio made use of in FFSR distribution for 2001 | -6% | 5% | 7% | -23% | -17% | -18% | -22% | -23% | -15% |
| Regional budget revenues per capita dispersion dynamics at granting federal support from FFSR. | | | | | | | | | |
| - unstandardized budget revenue ratio | | | 2% | 62% | 59% | 77% | 68% | 35% | 46% |
| - standardized by living standard rate (price ratio) | | | 2% | -20% | -1% | -11% | -19% | -16% | -16% |
| - budget revenues standardized by expenditure needs guideline | | | 2% | -20% | 1% | -10% | -17% | -17% | -16% |
| - budget revenues standardized budget expenditure ratio made use of in FFSR distribution for 2001. | | | 2% | -22% | -20% | -19% | -19% | -20% | -14% |

Source: RF Ministry of Finance; Cadochnikov, Synelnikov, Trounin (2001), estimates by the authors

Variant 1 of the adjustment (with regard to the regional living standard indices) was to reflect the interregional differentiation by the cost of rendering the budget services. Apart from the interregional differentiation by the cost of rendering the budget services, Variant 2 also reflects the need for rendering the regional budget services. Variant 2 adjustment involved both the expenditure needs regional guideline for 1999, calculated in the paper by Kadochnikov, Synelnikov-

³⁷ To provide the compatibility of the calculation results the values of the living standards and the budget expenditure guideline for 1999 were applied.

Murilyov, Trounine (2001) and expenditure needs guideline which actually served as a basis for the Gross Tax resources adjustment by the Subjects of the Federation for the 2001 FFSR distribution. (all the calculations were based on region selection having the expenditure needs guideline calculated).

The calculation data signify indeed, that the federal financial aid distribution system has been reducing the per capita budget revenues' interregional dispersion since 1995, calculated with regard to the need for funding public goods; besides, the above dispersion decrease is evidenced regardless of the way of accounting the need for the budget expenditure performance. It is notable, that the equalization effect (dispersion decrease) as calculated for the budget revenues, adjusted with the help of the budget expenditure official ratio, has proved to be greater on average, than for the revenues normalized according to the expenditure needs guideline as estimated by CEPRA project. The above results from the fact, that the federal government appropriates the financial aid tending to rely on the Ministry of Finance for their estimates of the need for it. Further on, attention should be drawn hitherto that, under the adjustment of the average per capita budget revenues for living-wage ratio, the change of the resultant value dispersion in case of the federal financial aid acceptance proved to be proximate to the rates originating from the adjustment of the regional budget revenues for the budget expenditure ratio. In other words, the application of the budget expenditure standards, calculated under CEPRA project research, attains a result equivalent to that of the application of the living-wage ratio in terms of reflecting the fiscal capacity interregional differentiation. It should be also emphasized, that the maximum equalization effect is characteristic of the periods marked by the maximum FFSR transfer value in total for the federal funding to the regions (1995, 1998 and 1999). The latter phenomenon might manifest a stronger intention of this federal support type to eliminate the fiscal capacity interregional disparities, than is embedded in the funds allocated via other channels. At the same time, the calculations data do allow a definite conclusion, whether it is through the FFSR transfers alone, that a more considerable contraction of the fiscal capacity interregional disparities is facilitated, than is accomplished through the allocation of total for the federal financial aid. (see Table 3). Provided that, on the one hand, the financial aid distribution between the regions takes place in a manner that the federal government bases its calculations on the criteria of fiscal capacity equalisation, and on other considerations, on the other hand, it might also be admitted that the dominant periods for such federal support types as the FFSR formalized transfers will also be marked by toughening the federal government's policy towards the funds transferred to the regions through other channels.

In reference with the interregional federal support distribution structure it should be pointed out, that such distribution has been ultimately unequitable. While the federal financial aid recipients were represented by nearly all the regions of Russia, around 50% of funding was directed just to some Subjects of the Federation, numbered 13 (1992) to 23 (1997/1998) within each respective period. Of all the regions having the biggest share of the federal financial support for many years, the following ones are notable (as the biggest federal support recipients for 5 years or longer): the Khabarovsk Krai, the Altaysky Krai, the Krasnodarsky krai, the Prymorsky Krai, the Republic of Daghestan, the Kemerovo region, the Stavropolsky Krai, the city of Moscow, the Moscow region, the Buryat Republic, the Sakha Republic (Yakutia), the Rostov region, the Sakhalin region, the Amur region, the Kamtchatka region, the Magadan region, the Mourmansk region. It should be mentioned, that that the Subjects of the Federation listed above are not unconditionally highly-subsidized ones, i.e. highly dependent on the federal support, since the awarded funds' share of the budget revenues by the above regions may be smaller than that by the regions highly dependent on the federal appropriations in aid.

The regions highly dependent on the federal support (the so called «highly subsidized» Subjects of the Federation) would be defined as a group of regions comprising 20 Subjects of the Federation having the biggest budget expenditure shares funded by the federal financial aid³⁸. For the whole observation period, the analysis shows that the scope of the «highly-subsidized» regions happened to include the below Subjects of the Federation most frequently: the Agynsky-Buryatsky Autonomous okrug, the Northern Ossetya republic, The republic of Tyva, the Tambov region, the Evenkee Autonomous okrug, the Ingush Republic, The Kabardino-Balkar Republic, the Karachaevo-Tcherkesskaya Republic, the Komi-Permyatsky AO, the Adygeya Republic, the republic of Altai, the Daghestan Republic, the Jewish AO, the Koryaksky AO, the Republic of Kalmykia, the Kamtchatskaya region, the Tchukotsky AO, The Altaysky Krai. As has been vividly shown, of all the major federal aid-recipient regions (in terms of the federal

³⁸ The expedience of singling out a criterion like that for outlining highly-subsidized regions (in contrast to setting forward a marginal criterion, exceeding which ranks an RF Subject with a number of those highly-subsidized ones) is accounted for by the fact, that the notion of “a highly-subsidized region” signifies its specific status within the system of interbudgetary relationships. In case a criterion to define the marginal expenditure share financed by the federal aid happens to unwarrantably rank many more RF Subjects with those highly-subsidized, this will evidence just a higher extent of the vertical misbalance within the budgetary system.

funds absolute value), there are only three «highly-subsidized» Subjects of the Federation that could be distinguishable by our criterion.

Thus, the end results of the analysis of total for the federal financial support delivered to the budgets of the RF Subjects could account for the following conclusions:

1. For the whole lifetime of the Russian Federation as of an independent state having a multilevel budget structure, considerable volatility was displayed equally on the part of both the federal financial aid amounts and the structure of the funds transferred to the budgets of the Subjects of the Federation. For the recent years, percentage share of total for the federal support delivered through the channels under observation has been evaluated at no more than 1,8% of GDP amount, while the financial aid is structured so as to prioritize the funds allocated as the FFSR transfers.

2. The combined dependence by the regional budgets on the federal support for funding has also undergone remarkable changes for the whole observation period. Lately, however, the federal support share of the regional budgets' revenues has failed to exceed 10%, which is partly due to the cutback of total for the federal financial aid and eventually for the reason of own-source revenue growth by the Subjects' of the Federation consolidated budget.

3. The federal support allocation among the Subjects of the Federation notably exerts an equalization impact - specifically since 1995, the federal funds acceptance by the regions has steadily diminished the dispersion of the regional budgets' average per capita revenues, adjusted for the needs of generating the regional public goods.

4. The figures stress the ultimate unequity as the case for the federal support allocation between the regions (calculated both per capita and as the absolute values of the amounts, directed to the federal aid-recipient regions), which fact could still be rooted in the areal unevenness of the population density and industry location, as well as in the high interregional differentiation rate for the federal financial support requirements. At the same time, around 20 Subjects of the Federation are currently replenishing their budgets' revenue share by the federal funds to a major degree. These regions could be referred to as the «highly-subsidized» Subjects of the Federation.

The Fund for Financial Support to the Regions Transfers

The transfers from the Fund for Financial Support to the Regions (FFSR) have currently become a major kind of general financial support to the Subjects of the Federation. As was stated above, since the FFSR foundation in 1994, the

transfer share of total for the federal support to the regions has increased by 60% from 10% to 70%. For its whole lifetime, the amount of funds awarded through FFSR has shown an increase from 0,36% of GDP in 1994 to 0,95-1% of GDP in 1998/2000. The above transfer share of the federal on-budget expenditures for the same period has increased from 1,55% to 7-8%. Eventually, 80 to 64 Subjects of the Russian Federation were entitled to receive a FFSR transfer. The 2001 Federal Budget Act prescribes transfers to 70 regions.

The FFSR transfers are allocated among the Subjects of the Federation according to a unified scheme, while the transfer value distribution between the regions is annually set as part of the Federal Budget Act for the respective year. For the last three years, the FFSR transfer allocation rests with the data on the average per capita fiscal capacity of the Subjects of the Federation (calculated by the tax load imposed upon the Gross Regional Product branches), adjusted for the ratio which describes the interregional differentiation of the objective expenditure needs. After the fiscal capacity is calculated (the so called «Gross tax resources of the RF Subjects»), the appropriations assigned by the Fund for Financial Support to the Regions are allocated as follows: the transfers of a 20% combined value of total for FFSR are entailed to the regions to bring the average per capita gross tax resources of the aid-recipient regions to one and the same level, which is calculated endogenously within the bounds of a scheme, with regard to the amount of the funds allocated. The FFSR remainder is allocated between the regions, the gross tax resources of which (although increased by the transfer's first part received) are below Russia's average, pro rata to the deviation from the average³⁹.

In reference with the dependency by the RF Subjects' budgets on FFSR for transfers, which comes as a transfer share of a Subject's consolidated budgetary revenues/expenditures, a tendency is notable for this dependence to decline throughout the whole full-fledged performance period of this financial aid type. Thus, while an 8% of the regional budget expenditures was financed in 1995 by the FFSR funds, the regional aggregate budget revenues being shaped at 8,2%, the share of the regional budget expenditures, sourced by FFSR transfers, diminished up to 6,8 % in 2000, whereas the share of the budget revenues, gained in transfers, reduced to 6,6%. (See Table 4).

³⁹ The scheme of FFSR funds allocation and the genesis of its key counterparts are considered in more detail in the following paper: I. Trounin, «The кyсцкв of the interbudgetary relationships in the Russian Federation», 2001, CEPRA, Moscow.

For the RF subjects as a whole, the reduced dependence on the FFSR transfers against the simultaneous share increase of the latter in total for the federal financial aid, could not, however, be the consequence of the financial performance improvement with all the Subjects of the Federation. This tendency is rather caused both by a certain decrease of the FFSR absolute volume (see Table 1) reinforced by a smaller number of transfer recipients and by the revenue rise by more prosperous regions: while the dependency extent by all the RF subjects on the FFSR funds has been constrained for the recent years, the disparity rise in transfer distribution (the dispersion of some transfer shares of the regional budget revenues increased by factor of 1,5 by 2000 against the 1995 figures) resulted in generating a larger number of the RF subjects as highly dependent on the transfers - while the FFSR funds accounted for 50% of the budget revenues or more for just 7 regions (1995), the number of such regions was brought to 11 in 2000.

TABLE 4. DEPENDENCY LEVEL BY RF SUBJECTS' BUDGETS ON FFSR FOR TRANSFERS IN 1994 TO 2000.

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|------|------|------|------|------|------|------|
| Percentage share of FFSR transfers of total for budget revenues for RF Subjects | 2,0% | 8,2% | 8,0% | 8,5% | 7,5% | 7,0% | 6,6% |
| Percentage share of FFSR transfers of budget expenditures for RF Subjects. | 2,0% | 8,0% | 7,7% | 7,8% | 7,3% | 7,0% | 6,8% |

Source: RF Ministry of Finance; estimates by the authors.

With regard to the FFSR transfers as a kind of the federal financial aid rendered to the Subjects of the Federation, an analysis of financing the regions highly dependent on the federal aid (referred to as depressive or highly subsidized RF subjects) should be adduced hitherto. The issue of highly subsidized regions having been touched on above in this paper, the criterion to define these regions was that of total for the federal financial aid. The resultant data came to evidence, that those Subjects of the Federation receiving the larger part of the federal funding are not regions highly dependent on the federal aid in most cases. The analysis of the FFSR transfer distribution structure reveals a different picture. The FFSR distribution scheme implies, that the transfers amounting 20% of the aggregate FFSR funds are delivered to the Subjects having the least fiscal capacity (adjusted for the cost reference of the normative expenditure needs) with regard to the funds, received while allocating 80 % of the FFSR funds. This criterion might also be applicable for defining a status of a highly-subsidized region. In this case,

the scope of highly-subsidized RF subjects would embrace 33 regions⁴⁰, i.e. somewhat less than a half of such aid recipients. Thereby, the share of the transfers to the regions outlined has been steadily rising for the whole FFSR lifetime from 45% in 1995 to 63% in 2000 (the FFSR funds distribution for 2001 is projected at around 65% of the aggregate transfer amount to be directed to highly-dotable regions).

It is notable, that outlining highly-subsidized regions on the basis of involving an RF Subject in the distribution of 20% of the FFSR funds at the second stage would not be a perfect criterion to define the actual dependence of such RF subjects on the financial aid. On the one hand, a criterion like that means the real budget revenues value, provided by the federal center (with regard to the interregional differentiation of the federal services' costs and amount) which is naturally the case for the regions having the least fiscal capacity. On the other hand, in case there is some certain scatter to be found within the regional tax resources rates after the first FFSR part has been assigned, the number of recipients subject to the transfer's second part would increase to comprise the majority of the regions (implying to «disperse» this transfer part among a large number of the RF subjects), since the applying FFSR distribution scheme doesn't presuppose applying any restrictive mechanism hitherto. It should further be regarded, to what extent the highly-subsidized RF subjects' bulk correlates with the actual transfer value for the regional budgets.

Of the 30 RF Subjects having top transfer shares of the consolidated regional budgets' expenditures in 1999/2000, there was but a single region devoid of the right to an equalization transfer of the FFSR 20% for the respective period (the Republic of Kalmykiya). All the other regions are enlisted in the interbudgetary equalization process, provided with a minimum fiscal capacity by the funding distribution scheme, so the objective set forward by the second stage of the funds' distribution as supporting the highly-subsidized (depressive) regions could be asserted as attained. Considering that on the whole it is more than the half of the FFSR funding that is allocated among such regions, the above result appears to be quite logical.

On the other hand, attention should be drawn to the RF Subjects characterized by a low dependency extent for the FFSR funding. As an example, the transfer share of the budget expenditures funding happened to account for 5 % and less with 11 regions in 1999. In 2000, the number of such RF subjects dropped to

⁴⁰ This group comprised the RF Subjects, entitled to receive the transfer of 20% FFSR both in 2000 and 2001.

9. Thereby, the size of the regions itemized should however be considered (the Belgorodskaya, the Vologodskaya, the Lenigradskaya region etc.). While the FFSR transfer percentage share of their budget revenues was insignificant, they happened to have received 24% and 16% of all the FFSR transfers, respectively. Should a modification be introduced to the FFSR funds distribution scheme to further expell such-like regions from the transfer recipients, the effiience would evidently rise for this federal aid type⁴¹.

Thus, the following conclusions could be drawn with regard to the transfers from the Fund for Financial Support to the Regions. First of all, despite growing its significance within the aggregate federal-to-the-regions funding amount, this financial aid type has noticeably diminished its funding role for the expenditures of the RF Subjects' budgets, all in all for the whole FFSR age. Secondly, a combined smaller share of the regional budget expenditures, FFSR being the funding source for them, is simultaneous to the transfers' re-distribution between the recipients as well as to the number contraction of the RF Subjects empowered to receive the FFSR transfers. Thirdly, the interregional transfer redistribution, determined by the change to the FFSR distribution scheme, has resulted in gradual shifting the transfer distribution interregional structure towards the Subjects of the Federation having the least fiscal capacity and currently receiving around 65% of total for FFSR transfers.

Other varieties of the federal financial aid.

Apart from the major type of financial aid to the regional budgets, i.e. the the Fund for Financial Support to the Regions transfers, as stated above, there are some other channels to perform the federal financing of the RF Subjects' budgets. Namely, these are subventions, grants, funds assigned as mutual settlements and budget loans. Of these federal aid types, part of regular nature and is meant for special purpose financing of particular regional budget expenditures or for financing specific административно-территориальных образований, and part is distributed on a non-regular basis and serves the purposes of funding the regions in case of emergency or under the occurance of other demands for extra funding.

⁴¹ It should be noted, that the improvement of the interbudgetary relationships inclusive of reforming the distribution of the FFSR funds happens to gradually shorten the number of the recipient-regions at the expense of those RF Subjects, which are not highly dependent on this kind of financial aid. This is due to the application of more objective methods for the evaluation of the regional needs for financial support. The question is, whether such a restriction should be deliberated.

The key tendencies in the distribution of the above federal support types will be addressed below.

Grants. Grants as a specific kind of the federal support represent a special item in the «Financial Aid to the Other Levels of Government» section of the Budget and are aimed at financing the budget expenditures of CTE, the jurisdiction of which comprises the facilities of the RF Ministry of Defense and the RF Ministry for nuclear energy. In accordance with № 3297-F3 «On CTE» Federal Legislation dated July 14, 1992, it is asserted that a CTE be understood as a «territorial entity, having local autonomous bodies, within which area plant facilities for the development, production, storage and utilization of mass destruction weapons are located, inclusive of those for nuclear and other waste processing, and other military facilities, for which a special regulation of safety performance State secret protection is established, inclusive of specific conditions of habitation».

The noteworthy special position occupied by CTE in Russia's tax and budgetary system is described by the below items:

- the budget revenues of a CTE are replenished with all the tax proceeds and other inpayments coming from its territory;
- additional tax and due privileges are provided for bodies corporate registered as taxpayers in the CTE tax body by the respective autonomous bodies in the order established by the Government of the Russian Federation (it is essential, that a number of constraints for the CTE authorities to grant the federal tax remissions has been imposed by the Federal Budget and Tax Legislation for the recent years);
- A CTE budgeted deficit is covered by the subsidies, subventions and grants from the Federal budget funds in the order established by the Government of the Russian Federation. The items in the budget granting the above funds are protected items.

Thus, all the tax proceeds within the CTE area enter in the revenues of CTE budgets, and the budgeted deficit of CTE is entirely covered by the federal budget funding. Besides, by 1998 the local CTE authorities had had no restrictions for introducing tax remissions of any kinds, inclusive of the federal taxes, for the purpose of plant facility industrial intake to the CTE area. The consequent CTE transformation into a kind of inside-Russia «tax harbours», as attracting the enterprises aspiring to reduce their tax payments, resulted from the above. Since 1998, such practice tended to contract. It was set by the 1998 Federal Budget Act, that all the tax and tallage amounts collected within a ÇÀÒÎ area enter in account of the Federal Treasury authorities, whereas providing tax

remissions other than those fixed by the Legislation, be only allowed in the order of granting such privileges' adopted by the government which came into effect in May 1998. The 2000 Federal Budget Act passed end-1999, the right to tax privileges was prescribed to the enterprises having 90% of funds and 70% of transactions concentrated within the CTE area. Above all, it is set by the federal budget law, that the amount of grants to the CTE budgets may be contracted by the tax privilege value as provided by the CTE administration.

In 2001, the tax treatment of the classified administrative-territorial entities was exposed to extra toughening. Apart from disabling those budget Code items empowering the CTE administration to change tax rates and to introduce tax remissions for both regional and local taxes but in accordance with the respective RF Subject's legislation, the same as for 1999, the changeability of tax rates and privileges by the CTE administration remains limited to a high degree. The 2001 Federal Budget Act lays a particular stress thereupon, that the federal tax and due amounts collected within a CTE area enter in the federal budget revenues in the order equivalent to the one valid for all the Subjects of the Federation, whereas the regional and local tax inpayments as well as highway-user tax revenues accrue to the CTE budgets⁴².

The examples adduced come to actually signify CTE's being equated to a Subject of a Federation for its budgetary and tax status. In contrast to 1999, as should be noted thereby, this equation was made with no exceptions admitted (the 2000 Federal Budget Act implied the same conditions for all CTE but those locating the federal nuclear centers - in 2000, all the tax and tollage revenues collected within the CTE area entered in those two CTE budgets. Also, a key item of 2001 Federal Budget Law is imposing a constraint upon the tax remissions provided by the CTE administration: it is particularly stressed that, of all the federal taxes, extra remissions could only be assigned to income tax and only for their rates and amounts that are directed to CTE budgets.

As was stated above, the federal budget provides funding to the budgets of classified territorial entities to cover the gap between the expenditures and the revenues, whereby the federal funds are awarded through both the budgets of the respective RF Subjects, locating the CTE, and directly to the budgets of the latter. However, the grants to the CTE budgets lack a unified calculation scheme. It is also noteworthy, that the funding awarded to CTE as grants could not be ranked with general funding in full, for since 1999, the amounts for capital in-

⁴² See art. 52 of the "2001 Federal Budget Act".

vestments and a transfer for abandoning the CTE area have also been included in the grant as a special item.

In reference with the quantitative analysis of the federal grants distribution to the Budgets of CTE, it should be noted, that the above changes of the CTE tax status have stimulated the grants growth both in their absolute values and within the structure of the federal support to the regions. Since the grants focused on are directly allocated to the budgets recipient of financial aid which are no part of the regional budgets, an interregional structure analysis of the grants' distribution appears both hardly feasible and inexpedient.

Subventions. In accordance with the RF Legislation, subventions are understood as financial support delivered to the minor budgets on a special- purpose basis for financing particular types of expenditures. Eventually, the «Subventions» article happened to dwell upon various kinds of financial support. For 1992 to 1993, a ponderous amount (up to the half) of the federal financial support to the regions was allocated according to this article (calculated on an unformalized basis and actually spent in the general manner). Throughout the period of 1994 to 1998, the «Subventions» federal budget expenditure article was constituted by transfers to one region only - namely, the city of Moscow - as delivered to offset the expenditures of fulfilling the RF capital functions. Later on, in 1999, the form of subventions was taken by granting the funds to support pre-schedule goods supply to the regions, including hard-to-reach areas, while in 2000, this was the case for part of a FFSR transfer, initially meant for the compensation of the losses inflicted by the transition to the new transfer distribution scheme and actually transferred as subventions, funding the the state benefits to individuals raising children.

Due to the significant denotation variance for «subventions» issue throughout many years, little interest could be taken in an analysis of tendencies found in the delivery of this kind of financial support, since no denotation compatibility for different years will be accomplished, while for the largest part of the observation period, the financial aid was confined to a single RF subject. In our opinion, it is therefore necessary to dwell upon such a major federal support kind, as the federal funding of pre-schedule goods supply to hard-to-reach (season-subject) areas (the so called «north supply»). A more in-depth consideration of the relationships between the federal budget and those of the Northern regions, as well as the north supply problem, is found in the paper «Radygin's North project».

The Russian Federation sets forward a specific kind of regional expenditure funding for special purposes - that of financing some goods' pre-schedule supply to hard-to-reach regions. Financial aid of this kind is applied to provide a pre-

schedule oil, fuel and food supply to the low-access regions during the navigation period or any other access period for the regions pointed out. For the regions as a whole, around 10 % of the aggregate regional expenditures for «North supply» funding is covered by the federal appropriations, however, some of the regions appear remarkably dependent on the 'north supply' federal transfers. The support assignments for 'north supply' are directed to the regional authorities that carry out open tenders for goods supply and distribute the funds between shipping organizations.

The federal budget funds for supporting 'north supply' are still very significant items for financial aid to the regions on the federal level despite the considerable decrease of the 'north supply» federal financing for the last nine years. Thus, while around 200 bln roubles, or 1,1% of GDP (accounting for 5,1% of the federal budget expenditures) was transferred to the targeted regions as 'north supply support' in 1992, the respective value for 1997 accounted for 3,5 bln roubles in denominated rouble value (or 0,13% of GDP as 0,86% of total for the federal expenditures). A 3 bln roubles (which is around 0,07% of GDP (0, 45% of the federal budget expenditures) being the case for 1999, funds committed to the regions for 'north supply' are projected at 3 bln roubles (0,056% of GDP as 0, 35% of total for the federal budget expenditures) by the 2000 federal budget law, while the 2000 federal budget law grants 6, 65 bln roubles (0,086% of GDP, 0,56% of total for the federal expenditures) for the same purpose.

Particular attention should be given to issuing budget loans for goods supply as specific kind of 'north supply' financing. In 1994/95, the federal budget didn't sponsor just oil and fuel transportation only, but the procurement of the above products as well, for which purpose budget loans amounting 1,2% of GDP (1994) and 0,5% of GDP (1995) were issued. Later on, as the regional authorities failed to repay the above amounts, a decision was made to pass those funds into the trust of the RF subjects' administration inclusive of the interest added. Specifically, an amount equivalent to 0,5 % of GDP was passed into the regions' trust in 1999. Of this amount, part was charged off during the recent years, while part of the funds (basically passed into the trust of high fiscal capacity regions) was transferred to the federal budget revenues.

Funds transferred to the Subjects of the Federation as mutual settlements.

Mutual settlements represent one of the most significant big-amount channels for transferring the federal budget funds to the regions, via which compensation funds of the regional budgets' additional expenditures are transferred, the

latter associated with certain decisions made by the federal government (for instance, those concerning effecting payments in accordance with «On Veterans» federal legislation), also, funds for the compensation of the expenditures for passing departmental housing to the budget of the local administration and other regional budget expenditures, also including those occurring during the process of cash deficit coverage. Funds distributed as mutual settlements represent some of the few federal budget items, which amount is not set in the federal budget law and which allocation between the recipient regions is not set by the State Duma and the Federation Council. For different periods of Russia's latest history, all RF subjects happened to be the recipients of funds transferred as mutual settlements. Table 1 depicts, that the type of financial aid focused on accounted for 2% of GDP (50%-70% of total for the federal support) in early 1990-ies, as mutual settlements (along with subventions) were the major federal aid rendered to the regions, to 0,2%-0,4% of GDP (10% to 20% of total for the federal financial aid) for the recent years. (Table 5).

TABLE 5. DEPENDENCY BY RF SUBJECTS ON FUNDS ASSIGNED THROUGH MUTUAL SETTLEMENTS IN 1992 TO 2000.

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--|------|-------|-------|------|------|------|------|------|------|
| funds assigned via mutual settlements as percentage share of budget revenues | 6,4% | 14,1% | 15,7% | 4,8% | 7,3% | 5,2% | 4,5% | 1,4% | 1,9% |
| funds assigned via mutual settlements as percentage share of budget expenditures | 6,9% | 15,4% | 16,3% | 4,7% | 7,0% | 4,8% | 4,4% | 1,4% | 2,0% |

Source: RF Ministry of Finance; estimates by the authors

For 1992 to 2000, the dependency by the RF subjects on the federal budget for the funds awarded as mutual settlements is represented as their share of the regional budget expenditures and revenues by Table 5. For the Russian Federation as a whole, the Table depicts a gradual decline of the dependence on the stated financial aid type, it accounting for 1,5% to 2% of the regional budgets for the recent years. Nonetheless, the analysis has revealed essential unconstancy for the dependence rate in terms of regarding mutual settlements in the regional context - unlike the FFSR case, the analysis of the data for the past 6 years has failed to outline a group of regions steadily dependent on the federal support of this kind, although an eventual mutual settlements' share of the expenditures for some

regions accounts for up to 20%. The same is due for the interregional allocation of this kind of the federal support - for the past 6 years, it is impossible to outline a stable group of regions the basic funding amount of which is allocated in this manner.

Such results above the non-formalized distribution of the funds under analysis put the financial aid of this kind as utterly ineffective, it being distributed by unobjective criteria. Further to the above, the increase of total for funding coming as mutual settlements in 2000 as well as the growth of its share of total for the federal support to the regions, rising the dependency rate of the regional budgets on the federal aid of this kind appear unfavorable.

Budget loans. Those granted on a repay basis are a way of providing the federal funding for the purpose of compensation of the cash deficit while executing the budgets of the RA subjects, and also for other purposes (specifically, end-1997, ponderous amounts were granted to the public employees as budget loans under the payroll debt compensation campaign). Peculiar for this kind of financial aid, its repay nature presupposes that the budget loan aggregate annual value can have both positive and negative sign (a region might be either a sheer recipient or a sheer repayer of the federal funds previously loaned). For this reason, the federal budget loans could be worth including in the federal financial aid provided, that there has been a firm positive balance in their accounting within several years, i.e. in case this mechanism is applied by the federal center as a means of gratuitous financial support by allowing adjournments and deferred payments of the loans offered, and also by offering more loans.

This was the case to observe about the Russian Federation for 1992 through to 1997. However, since 1998 the federal center-to-regions policy was toughened to a high degree for this kind of the federal support: while around 2,5% of the regional budget expenditures was financed by the budget loans proper granted to the RF subjects from the federal budget in 1997, (for the regions repaying the federal budget loans to the federal budget the figure is 3,4%), the respective figure for 198 - 1999 was a negative value, i.e. the regional budgets tended to repay the previous budget loans rather than to obtain new funds.

In reference with both the interregional budget loan distribution structure stability and the dependance by the regional budgets on this kind of financial aid in the regional context, the case is notably similar to that for the funds allocated as mutual settlements (namely, the rates tend to display volatility to a high degree). For this reason, performing an in-depth analysis of the key tendencies in the distribution of this kind of financial support to the RF Subjects proves inexpedient.

* * *

The analysis of the above kinds of the federal financial aid to the regions (which account for around 30% of the federal support to the regions and finance around 3% of the regional budget expenditures) depicts that their big variety, as well as the non-formalized distribution, demand that the approaches to federal funding of some subnational budget expenditures be reconsidered. Thus, funding executed on the basis of mutual settlements doesn't display an evident justification of its existence. It is essential to introduce a formalized scheme of grant distribution to the budgets of classified territorial entities which should be based on the objective criteria of financing requirements. Reforming the system of federal budget loans should consist in listing the purposes and the terms of issuing loan proceeds.

Varieties of the federal financial aid the the Subjects of the Russian Federation

The above overview was made to regard the delivery of the federal financial aid, which is viewed as the channels of a direct federal support to the regions. Above all, there's a number of types for financial flows coming from the federal budget, which can also be considered as federal support to the regions. First and foremost, these are federal programs of regional development and the grants from the federal Road fund to the respective regional funds, and also (to a certain extent) the federal budget expenditures on the regions' territory.

The implementation of the federal programs of regional development, as a kind of the federal budget expenditures, could be ranked among the federal support to the regions, since all the financial resources, assigned by the federal budget in such a way are consumed within the territory of the RF subjects, also constitute the tax base of the regional budgets and are, in fact, budget-substituting expenditures in relation to the regional budgets. The key goal of the целевых federal programs is accomplishing particular tasks within the domain of specific regions' development (in the field of culture, education, health-care), such as the reconstruction or building social or cultural sphere facilities within the territory of the regions, also, rendering support to some specific population groups or nations inhabiting the area of one or several regions etc. Taking a decision to establish a federal program for the development of a particular region rests with the government of the Russian Federation, while the funding amount awarded under the program is settled as an agreement between the Ministry of Finance and the regional authorities. A peculiar feature of funding the federal programs for regional development implies offering direct grants to the recipients, no interme-

diation like regional budgets supposed. Thereby it is notable, that the expenditures of funding the federal programs of regional development are not given as a special line in the federal budget performance accounting up to now.

Since 2000, the funds directed to the objectives of regional development programs are assigned from a particular Regional Development Fund, which was created within the «Financial Aid to other levels of government» federal budget section. The 2001 federal budget law assigns funds for the implementation of 42 federal programs of regional development, the aggregate value of funding for these objectives accounting for 3,3 bln. roubles (0,3% of the federal budget expenditures).

The relationships for funding highway construction and operation appear to be a specific kind of center-to-regions financial relationships. The expenditures for the above state services rest with the federal and territorial road funds, which are replenished by some specific tax revenues. In most regions, a status of budget funds of a special purpose is awarded to the territorial дорожным фондам, besides, this was the case for the federal road fund prior to 2001. The fiscal capacity interregional equalization is carried out by the federal Road Fund as dotations to the respective regional funds, which are allocated on funding requirements criteria, as put by the federal Road Service (an authority in charge of the allocation of federal Road Fund assets). For the recent period, the aggregate value of funds granted as **dotations** to the territorial road funds, has decreased from 0,34% in 1997 to 0,11% of GDP in 2000.

For the issue of financial aid to the regions rendered from the federal budget, the federal budget expenditures should be considered in the territorial context in particular. Evidently, actual federal budget consumption is carried out within the domain of particular regions, which creates a possibility of viewing them as a way of indirect financial support to the RF subjects. Thus, the federal expenditures execution for representing the federal authorities in the regions, for law-enforcement activity, for the State defence, or for funding certain facilities of the federal standing results in the economic activity growth within the region, and consequently (for the regional tax base growth) - in the revenue growth for the budgets of the RF subjects. It is notable, that the current legislation basically confines itself to committing funds to some special expenditure targets, or even to some particular social facilities, however, neither the common policy of the federal expenditures for the regions, nor the federal regional policy of funding particular programs for social, political and economic development are sufficiently grounded. Nor are the statistic data on the federal budget funds consumption in

common access, which impedes to evaluate the interregional structure of the funds consumed.

Thus, above the direct channels of delivering federal support to the regions, there are some other ones to be itemized. Dotations to the federal Road Funds funds appear to be the most transparent of them, however, they also fail to be allocated on the basis of a unified and formalized методики. Total for funding transferred both as dotations from the federal Road fund and under the federal programs of regional development doesn't exceed 0,2% of GDP. Planning and executing federal expenditures in the regional context requires a special approach, since such structure planning should be based on the consideration of the regional policy tasks.

Federal Support to the Regions System in 2001.

The 2001 Federal budget law, adopted end-2000, presupposes the introduction of an additional kind of the federal financial aid to be rendered to the regional budgets - transfers from the Fund for Compensation granted for a special purpose. The above fund was created within the budget at the expense of the funds obtained through VAT revenue centralization, while the federal aid amounts from this fund are allocated among all the Subjects of the Federation and are directed for a special purpose at funding some federal expenditure mandates, namely, at the implementation of the federal laws like «On allowances to individuals raising children» and «On social protection of the disabled in the Russian Federation».

The transfers (**grants**) from the Offset fund are received by all the regions without an exception and are distributed according to the **scheme** with regard to the consumers quantity of the budget services awarded in this way and the number of social transfer recipients, as well as the average per capita cost of such services and the per capita grant total. The lack of special expenditure accounting for the **Disabled State Support** federal legislation performance in the RF subjects before January 1, 2001 adds to the problems of estimating the Federal Compensation Fund expenditures. For this reason, a transfer amount to be calculated for a region under the Fund allocations is based on the estimates of Russia's average for expenditures adjusted for the regional differentiation. Changes introduced into the budgetary classification, since 2001 the execution expenditures of the «On the Disabled State Support in the Russian Federation» federal law « have been accounted separately.

As previously informed, the Offset Fund sourced its funding in the federal budget's supplementary resources gained by a complete centralization of VAT

revenues within the federal budget. For Russia as a whole, the estimates we've made come to illustrate that the proportion is mostly kept: the amount of the Offset Fund (projected at 41,7 bln roubles for 2001) is just a little less than the potential revenues of the regional budgets according to the normative 15% of VAT assessments to the budgets of the RF subjects for 2000 (43,3 bln roubles)⁴³. While estimating the correlation of VAT revenues in the budgets of the Rf subjects and the **grants** coming from the Compensation Fund in the regional context (by the data and on the terms of 2000), it is notable that the mechanism of funding some regional expenditures adopted for 2001 causes an essential interregional resource **re-allocation**. Thus, the replacement of entering 15% of VAT in the budgets of the RF Subjects by the federal budget **grants** has mostly affected the regions with the fiscal capacity level traditionally high, such as the city of Moscow and St Petersburg, **the Samara, Sverdlovsk and Perm regions, the republics of Tatarstan and Bashkortostan, the Khanty-Mansy and Yamalo-Nenets Autonomous okrugs**. At the same time, the amount of resources allocated to the **highly-subsidized** RF subjects, has significantly increased: the positive balance of the funds extracted from the regional budgets by VAT centralization and those additionally gained as **dotations** from the Offset Fund reaches the maximum per capita rates in such regions as the republic of **Daghestan, Tyva, Sakha, North Ossetya, The Chuckchi, Komi-permyatsky, Ust-Ordinsky and Agynsky Bur-yatsky autonomous okrugs, the Altaysky krai, the Amur, Magadan and Bryansk regions**.

During the preparation of the 2001 federal budget bill some changes were introduced into the **scheme** of transfer distribution from the Fund for financial Support to the Regions, which has brought along the below results. First, the number of no-transfer-recipient regions has displayed a minor increase: this number is 19 compared to the 18 for the previous year data (the regions that hadn't received the transfers one year before were joined by the Nenets Autonomous region, also by the Orenburg and Belgorod regions, while the Moscow and Chelyabinsk regions were excluded from the regions that didn't receive the transfer in 2000. If to regard the FFSR assignments interregional structure, a significant funds *перераспределение* as compared to the previous year would be noticed plan. Thus, among the aggrieved RF subjects, (the FFSR share of which has diminished by more than one third), there are the following regions to be named: the Mourmansk region, The Irkutsk region, The Tomsk region, the Astrakhan,

⁴³ The amount evaluated was that of the projected federal revenues raised by VAT with the deduction of the estimated amount of tax indemnification to the exporters.

the Novgorod, the Kemerovo, the Sakhalin, the Smolensk, the Oryol regions and the republics of Udmurtiya and Karelya. The regions which were lucky to benefit from the modification introduced into the методика (the planned FFSR share has increased by one third in their case) comprise the Volgograd, the Omsk, the Kurgan, the Leningrad and the Kirov regions, also, the Taimyr autonomous okrug, the republics of Altai, Sakha and Kalmykiya, the Primorsky Krai, the Chuvash and the Chechen republics. Thereby the FFSR share for the Chechen republic and the Leningrad regions have grown more than twice as much. At the same time, the bulk of the FFSR first-rate recipients hasn't altered: in 2001, approximately 28% of the transfers (compared to 24% for 2000) was accounted for by 5 regions – the Rostov region, the Primorsky and the Altaysky Krai, the republics of Sakha and Dagestan.

It is noteworthy, that the list of the regions that happened to have benefited from the modification to transfer allocation scheme comprises more regions that have traditionally been less prosperous in the long run, inclusive of those «ag-grieved» ones, which manifests the optimisation of funds redistribution, caused thereby.

As to the Fund for Compensation grants, the redistribution of these also comes to exhibit a high interregional difference rate: the estimated per capita grant value to the top-rate recipient (the Ingush republic) surpasses the amount subsidized to the region having the least value of the latter. Regarding the funds allocation structure, the city of Moscow proves to be a top-rate Offset Fund appropriations recipient (6,1% of the Fund assets), while the least grant was awarded to the Evenkee Autonomous region (0,03%). Thereby, the 20 regions having the maximum population rate (52% share of total for Russia's population) happened to receive around 50% of the Compensation Funds assets, which prompts that the distribution of the funds was basically pro rata to the population rate within the regions.

The analysis of the fund for Compensation transfers draws our attention to such federal item of expenditure as «grants» to the RF Subjects' budgets for the compensation of the losses inflicted by the changes in the order of the Offset fund formation and amounting», which accounts for around 25% of total for the Offset Fund assets⁴⁴. Thereby the above extra grants allocation is subject to a particular RF subject: some of the regions happen not to be the recipients of this financial aid at all, while the amounts appropriated to some other regions tend to exceed the «major» Compensation Fund transfer value (the Ivanovo and the Voronezh

⁴⁴ See art. 44 of the “2001 Federal Budget Act”.

regions and the Komy-permyatsky autonomous okrug). Taking into account, that the Offset fund was first introduced in 2001 as part of the Federal Budget, the extra transfers could be supposed to reward the regions for the approval of the Offset Fund calculation modification, since now based on objective expenditure requirements, the very transfers calculated on the basis of the actual budget expenditures consumed by the subsidized federal laws implementation in the regions.

If to regard the combined total for the federal aid of both the Offset Fund and that for the Financial Support to the regions for the period of 2001, it is notable, that the federal support distribution structure is practically the same as that of FFSR transfer distribution (especially regarding the aspects of minor- and top-rate recipients). On the other hand, the biggest per capita financial aid amounts are directed to the least-numbered and most backward regions of Russia: the Republics of Tyve and Altai, the Taimyr, the Koryak, the Chuckchee and the Evenkee autonomous okrugs, while the regions having the least per capita financial aid amounts mostly comprise regions of high industrial development and fiscal capacity.

In accordance with the interbudgetary relations reforming Concept for 1999 through to 2001, a Fund for Regional development was created as part of the 2001 Federal Budget Law (for the purpose of accumulating the funds assigned to the regions for investment purposes) alongside of the Fund for Regional Finance Development (established to render the federal aid to the regional authorities for improving the quality of the federal funds' regional administration). However, the order of assigning the above funds remains utterly non-formalized, since the authorities to provide and consume the funds mentioned rest with the RF government, while the latter hasn't got any kind of a formalized calculation scheme developed⁴⁵.

Reviewing the development of the interbudgetary relations in Russia for the recent years, it would be important to emphasize a continuous formalization process of the federal aid distribution besides the tendency towards eliminating the skewness phenomena in the budgetary status of the various-level interbudgetary relations subjects. It should be also noted, that the measures taken within the tax and budgetary policy bounds in 2000 aspire to reduce the fiscal capacity interregional differentiation and to reallocate the budget revenues in favour of highly-subsidized regions. At the same time, the reforming rates for the relations of various-level budgets and for the regional finance administrations were below

⁴⁵ See art. 46 of the "2001 Federal Budget Act".

the required ones. Despite the pro forma accomplishment of most tasks, the federal government has failed to gain the due rigidity of budgetary restrictions for the authorities of the rf subjects, nor has it gained control over the resource efficiency at the regional level, nor has it attained a due growth of interbudgetary relations formalization. all these are the problems set for the rf government within the medium-term measures program for the nearest years.

Chapter 4. Review of theoretical aspects of assignment of expenditure responsibilities and taxing powers of subnational budgets

One of the principal problems of organising a system of state finances within a multilevel structure of state administration is that of how to distribute the powers for spending between the levels of the budgetary system. More than a century ago Alexis de Tocqueville, one of the founders of political investigations on federalism, suggested that the federal system emerged as a result of the desire to unite within one and the same state all those different benefits that are encountered in different nations inhabiting different territories⁴⁶. From the point of view of fiscal relationships Tocqueville's hypothesis can be understood as a supposition stating that the presence of several levels of state administration makes it possible to centralize the decision-making process in those spheres of the economy where it is necessary to have a uniform national policy, as well as to ensure decision-making at the local level in those places where it turns out to be most effective.

In the above-mentioned work by *R. Musgrave (1959)* the hypothesis referred to was made more concrete through formulating the basic principles for distributing the spending obligations between the levels of state authority. It is argued that fiscal federalism is based on the assumption that the policy in the area of providing state services must differ between various sub-national administrative territorial entities whereas for the purposes of the state policy in revenue redistribution and macro-economic stabilization these functions have to be delegated to the national (central) bodies of authority⁴⁷.

The sufficiently general hypotheses of *Musgrave (1956)* on the distribution of the powers between different levels of state authority which were subject to many discussions have nevertheless preserved their importance until the present phase of the development of the economy of the social sector. Thus, it is agreed that the functions of developing and implementing the macro-economic policy

⁴⁶ See: Wallace E. Oates "Federalism and Government Finance" // *Modern Public Finance*, John M. Quigley & Eugene Smolensky (eds), Chapter 5, Cambridge, MA: Harvard University Press, 1994, p.128

⁴⁷ See: Richard A. Musgrave "*The Theory of Public Finance: A Study in Public Economy*", New York: McGraw-Hill, 1959, p.181-182

must be centralized to a maximum degree: virtually in all the countries of the world the powers for exercising the monetary policy belong to the central monetary authorities. As regards fiscal policy decentralization, it can be noted that stimulating the total demand at the regional level offers limited possibilities because of the high degree of openness of the regional economic systems.

On the other hand, in some works it has been stated that sub-national administrative bodies can ensure a successful enough policy of stabilization⁴⁸. Thus, external macro-economic factors (for instance, dramatic growth of the prices on energy resources) have different importance for different regions. The administrative bodies at the sub-national level have the possibility of taking measures that take into account the specific regional differences which is impossible when the total demand is being regulated at the national level. Besides, the sub-national administrative bodies have the possibility to create special stabilization funds for maintaining the level of state expenditures and taxes in the different periods of the economic cycle. However it should be noted that the opportunities for exercising a decentralized policy of macro-economic stabilization are limited, and the main powers in this field must be delegated to the national government.

Similarly, there are also limitations imposed on the possibility for exercising a decentralized policy in the area of revenue redistribution. Thus, the administrative bodies of a sub-national territorial entity while implementing an active policy of redistributing revenues between the well-off and not so well-off social strata may witness an inflow of low-income social groups and an outflow of well-off households⁴⁹. A number of authors offer empirical data that prove the reality of such an outcome of the policy of revenue redistribution at the sub-national⁵⁰, besides, some works suggest that supporting low-income households is a kind of nationally important social benefit and the powers to ensure it are by definition is the prerogative of the national (central) government⁵¹.

⁴⁸ See, for example: Edward M. Gramlich "Federalism and Federal Deficit Reduction" // *National Tax Journal*, #40 (September), 1987, pp.299-313

⁴⁹ Naturally, this statement is true in cases when there is no legal limitations on citizens' migration within a country and their choice of a place of residence, and vice versa,— an active pursuit by the sub-national authorities of their own redistribution policy can lead to imposing limitations upon granting privileges to the residents of other territories (for example, preserving "residence registration" in the city of Moscow).

⁵⁰ See: Charles C. Brown & Wallace E. Oates "Assistance to the Poor in a Federal System" // *Journal of Public Economics*, #32 (April), 1987, pp.307-330

⁵¹ See, for example, Helen F. Ladd & Fred C. Doolittle "Which Level of Government Should Assist the Poor?" // *National Tax Journal*, #35 (September), 1982, pp.323-336

However excessive centralization of the powers in the area of revenue redistribution is also against the principles of fiscal federalism. Thus, it can be presumed that the smaller the administrative territorial entity, the greater are the informational capacity of the administrative bodies as regards a realistic estimation of the existing demand for financial support as well as the efficacy of social support provided to low-income households⁵². Thus it becomes possible to redistribute the powers in the area of the revenue redistribution policy in such a way that the general national redistribution policy is defined at the level of the central (federal) government, and the sub-national administrative bodies can change the degree of redistribution within the limits set by the national legislation⁵³.

To be able to understand more comprehensively the reasons why a certain part of the spending obligations should be delegated to the lower levels of the budgetary system, we are going to take a look at the models of providing State-financed services in a situation when there are several equally empowered administrative bodies managing separate budgets. As it was already mentioned earlier, one of the principal functions of the administrative bodies at the sub-national level is to distribute local social benefits in accordance with the preferences of the residents of a given administrative-territorial entity. In a classic model of the State finances functioning at the sub-national level constructed by C. Tiebout, the behavior of individuals is compared to the process of choosing the most appropriate commodity in the form of social benefits out of a number of variants offered at different outlets, that is, administrative-territorial entities⁵⁴. As it was shown by Tiebout and a number of later studies in this field, in an ideal situation such behavior leads to a result which represents full realization of all the potential benefits of decentralization: both the public and the private sectors of the economy grant an individual full liberty to choose the most effective level of consumption for each of the benefits, where the price of the public benefits is represented by the local and regional taxes paid by the individual. Until the marginal value of the taxes paid by an individual is equivalent to the marginal costs of the available public benefits, the equilibrium, similar to that in the private sector, will be effective, according to Pareto⁵⁵.

⁵² See: M.V. Pauly "Income Redistribution as a Local Public Good" // *Journal of Public Economics*, #2 (February), 1973, pp.35-58

⁵³ For more details see David King "*Fiscal Tiers: The Economics of Multi-Level Government*", London: Allen and Unwin, 1984, pp.36-37

⁵⁴ See: Charles M. Tiebout "A Pure Theory of Local Expenditures" // *Journal of Political Economy*, #64, 1956, pp.416-424

⁵⁵ See: Tiebout (1956), p. 422

From the economic theory pertaining to the public sector we know the condition for the optimal availability of social (public) benefits outside the context of a multilevel budgetary system⁵⁶: when there exists an aggregated industrial (production?) ratio between private and public benefits

$$F(X, G) = 0,$$

where X — is the vector of the total volume of production of private benefits (1symbol 180 \f «Symbol» \s 12 \times i);

G — the total volume of production of the public benefit consumed by each citizen accepted as a measure unit.

In this connection it is presumed that the administrative bodies choose level G on their own and have the possibility to establish the vector of consumption of private benefits X^h for each household h ($h = 1, \dots, H$). The goal of the administrative bodies is to maximize the individual functions of public welfare. Then, if we represent the function of the utility of each consumer in the terms of private and public benefits as $U^h(X^h, G)$, the function of public welfare can be expressed as *symbol 89 \f «Symbol» \s 12* $\Psi(U^1, \dots, U^h, \dots, U^H)$. Thus, it is necessary to solve the problem of maximization of the public welfare function *symbol 89 \f «Symbol» \s 12* Ψ when the only existing limitation is the production ratio F between private and public benefits.

By differentiating the Lagrange function $L(X^h, G)$ for each of the variables the following conditions of the first order are found:

$$\left. \begin{aligned} \frac{\partial L}{\partial X_i^h} = \frac{\partial \Psi}{\partial U^h} \frac{\partial U^h}{\partial X_i^h} - \lambda \cdot \frac{\partial F}{\partial X_i} = 0 \\ \frac{\partial L}{\partial G} = \sum_h \frac{\partial \Psi}{\partial U^h} \frac{\partial U^h}{\partial G} - \lambda \cdot \frac{\partial F}{\partial G} = 0 \end{aligned} \right\}, \text{ for all } h, i$$

If we divide the first equation by the second one, we shall obtain the principal condition for the optimal level of public benefits supply:

$$\sum_h \left(\frac{\partial U^h}{\partial G} / \frac{\partial U^h}{\partial X_i^h} \right) = \frac{\partial F}{\partial G} / \frac{\partial F}{\partial X_i}$$

which means equivalence of the sum of the marginal substitution rate (*MRS*) between the public benefit and some private benefit for all individuals, and the

⁵⁶ For more details, see Atkinson E.B., Stieglitz D.E.. "Lektsii po ekonomicheskoi teorii gosudarstvennogo sektora", Moscow, Aspekt Press, 1995, p. 658

marginal transformation rate (*MRT*) between the public and the private benefit for society as a whole. *C. Tiebout's* model for the first time extended the standard conditions for the optimality of choice of public benefits to a state system containing several budgetary units. Despite the high degree of arbitrariness of this model, some of its basic provisions are actively employed also at the present time in analyzing federal state finances, therefore it seems necessary to take a more detailed look at the model itself. The following preconditions are established:

1. The consumers are absolutely mobile and free in their choice of the place of residence. Also, the consumer chooses for his or her activity a territory where the level of public servicing is the most satisfactory for his or her personal needs.
2. It is presumed that consumers possess complete information on the difference between the revenues and the expenses of the state budget and correspondingly react to any changes of this variable.
3. The number of the administrative-territorial entities is sufficiently great.
4. The limitations imposed on the freedom of movement by the different employment levels existing in different regions are not taken into consideration.
5. The public services provided in the regions do not cause external effects.
6. For each set of public services there is an established optimal size (population number) of an administrative-territorial entity whose budget provides funds for such services.
7. The region whose population number is lower than the optimal level takes efforts to attract new citizens in order to reduce the average costs of providing public services.

When these preconditions are applied, the citizens of a state with a complex administrative division of territories are compared to the consumers on the market of private benefits who can choose as their place of residence the most appropriate region, and their desire or lack of desire to move on to another place of residence demonstrates the demand for public services.

It follows from the model of providing public services at the sub-national level that the consumer chooses as a place of residence the region where the set of public services provided exactly corresponds to his or her preferences. However when the precondition of absolute mobility of consumers is weakened, mobility rate represents the cost of revealing the demand for public services, therefore the lower is the mobility rate the farther from the optimal level is the level of the distribution of resources, all the other preconditions being equal⁵⁷. Thus the state policy aimed at increasing the mobility of the citizens of the state and also

⁵⁷ See: Tiebout (1956), pp. 421-422

increasing the level of the voters' knowledge about the status of the state budget and the level of providing public services contributes to the efficiency of public fund spending. Besides, even in the absence of the necessary freedom to move a growth of welfare can be seen due providing certain public services at the regional (local) level in accordance with the preferences of the population of a given territory that does not depend on the existence of the freedom to move from one administrative-territorial entity to another⁵⁸.

Thus it can be concluded that providing public services yields better results if it is exercised by the local administrative bodies. In such a case the necessary inter-regional differentiation in the structure and the quality of public services is achieved that corresponds to the preferences of the population of a given region which leads to general growth in welfare. However within the framework of the demonstrated models it impossible to answer the question which powers for financing which public services and in which degree should be delegated to the sub-national budgets. The solution for this problem has to be looked for in the results of the studies on the efficiency of public expenditures in countries with different variants of the distribution of spending obligations.

While estimating the distribution of spending obligations between the levels of the state authority it is necessary to distinguish three component parts of any spending obligation - legislative regulation, financing and administration⁵⁹. It should be noted that regulation cannot be estimated quantitatively, and financing and administration, even if they can be subjected to a quantitative estimation, do not reflect the complete set of the activities of an administrative body on implementing a spending obligation. The difference between the variables of financing and administratively controlling public spending is represented by inter-budgetary transfers where the grantor often has no administrative powers to provide public services. When such an approach is applied the variable of public services financing can be defined as the total cost including the grants allocated,

⁵⁸For more details on the benefits of decentralized provision of public services and their quantitative evaluations see Wallace E. Oates "*Fiscal Federalism*", New York: Hartcourt, Brace, Jovanovich, 1972; David F. Bradford & Wallace E. Oates "Suburban Exploitation of Central Cities and Governmental Structure" // *Redistribution through Public Choice*, ed. H.Hochman & G.Peterson. New York: Columbia University Press, 1975

⁵⁹ See J.Levin "Measuring the Role of Subnational Governments" // *Public Finance with Several Levels of Government*, ed. by Remy Prud'homme, The Hague: Foundation Journal Public, 1990

and the administration variable as the total costs excluding the grants allocated⁶⁰. Thus, in the analysis of the distribution of expenditures it is necessary to rely upon the complex variables of decentralized spending obligations which must include, in addition to the administered financial flows, the variables of financing and regulation.

In the international practice, different models of the distribution of spending expenditures and the corresponding mechanisms of their financing are applied, and the availability of a local revenue base and unconditional non-target transfers from the higher levels of the budgetary system demonstrates the degree of autonomy of the regional and local administrative bodies in the public services that they provide⁶¹. However there are also certain kinds of public services that are assigned to the sub-national levels of authority virtually in all countries. Those are primarily the services in the area of housing, land maintenance, local public transportation, fire services, police, etc., that is, such kinds of spending that are rather neatly fit into the *Tiebout* model⁶².

Below we are going to consider the expediency of assigning to the lower levels of the state authority the three principal kinds of spending whose structure of distribution between the levels of State authority is not so evident as in the case of other local expenditures: social security, education, and health care. The analysis of the data on the shares of different budget levels in those expenditures has demonstrated that in the majority of the industrialized countries (with the exception of the USA and Great Britain) education is financed by the central government which is different from the developing countries where the existing statistical data show that education and health care are financed mainly by the regional and local budgets⁶³.

As for social security expenditures, it should be noted that in addition to the function of revenue redistribution they also possess certain properties of insurance. This is especially typical of the developed countries where social guarantees include superannuation pension, benefits compensating a loss of the source of income including unemployment benefit, children's allowance, and social security benefits. The basic element of any insurance, including insurance coverage

⁶⁰ Those are primarily non-target unconditional grants because in case of covering expenditures with conditioned transfers the grantor can exercise a degree of control over the spending at the lower levels of the budgetary system.

⁶¹ See: Mueller D.C. "*Public Choice II*", New York: Cambridge University Press, 1989

⁶² See: T. Ter-Minassian, ed. "*Fiscal Federalism in Theory and Practice*", IMF, Washington, D.C., 1997

⁶³ See: *Government Finance Statistics Yearbook*, Vol.13. – Washington, IMF, 1989.

in cases of unemployment and disability is the widest possible risk pooling. Therefore despite the fact that regional or local insurance coverage of superannuation and disability appears to be more expedient from the point of view of low cost of obtaining information on the recipients at the local level, the mechanisms of social insurance by definition should not be based on regional coverage of insurance risks, i.e. the network of social insurance must have the widest possible scope.⁶⁴

However in certain cases the drawbacks of a fully centralized order of financing social insurance expenditures exceed the above-mentioned benefits. In the instances when it is necessary to ensure strict targeting of social subsidies, the role of low costs of obtaining information at the local level becomes more prominent which means a necessity of creating stimuli for finding out those who are truly needy of a subsidy. However on the other hand when the powers for spending management in the area of social insurance are delegated to the local level it is necessary either supplement those powers also with the powers for mobilizing the revenues into the social insurance funds or to establish a stable order of receiving financing from a higher-level budget. In the first case the condition of nation-wide risk pooling is not observed, and in the second, there will be created negative stimuli for the regional authorities to find out potential recipients of social subsidies⁶⁵.

Education is a classical example of conflicting goals and different levels of the state authority. From country to country, there are very dramatic differences in the levels of the budgetary system that are employed as the sources for financing elementary, primary, secondary, and higher education. Practically in all the developed countries of the world, free-of-charge primary education is guaranteed, and in many developed countries there is also free-of-charge secondary and heavily State-subsidized higher education. It should be noted that education in the first approximation does not satisfy the demands of the pure state welfare: the profit that comes from receiving education is the human capital growth and, consequently, the level of personal income expected in the future. We cannot say that the price of private education is higher than the increment of society's welfare

⁶⁴ The peculiarities of population age structure, natural and economic factors can become the reason for huge social subsidies in certain regions while in other regions there will be no such payments which will require supplementary sources of financing and unfavorable flow of resources.

⁶⁵ A more detailed discussion on this theme see in E.Ahmad, D.Hewitt, E.Ruggiero "Assigning Expenditure Responsibilities" // *"Fiscal Federalism in Theory and Practice"*, T.Ter-Minassian, ed., IMF, Washington, D.C., 1997

from receiving an education. Nevertheless, low-income social strata do not have access to private education because of the imperfect capital and information market. For this reason, providing a country-wide minimum of education standards is the main argument in favor of revenue redistribution⁶⁶.

Primary and secondary education, as a rule, is financed from the budgets of local (municipal) administrative bodies, whereas the powers for financing higher education are more centralized which is necessary in order to enjoy the benefits of economy through scope. Sometimes in countries with vast territories municipal financing of primary education is not expedient because the need to maintain a large number of small schools. However the main arguments in favor of local financing of primary education are, firstly, that educational services by definition have to cover wide expanses geographically, secondly, small-size schools usually provide a better level of education., and, thirdly, the direct participation of the students' parents is a factor that has a positive influence upon the quality of primary education.⁶⁷ At the same time it should be noted that the outcome of education expenditures decentralization is usually the interregional differentiation of those expenditures and the quality of education which only leads to an increased differentiation of the regions by revenues. Therefore in many countries, along with decentralized spending powers in financing the educational services, there have also been established minimal educational standards that must be ensured by local educational establishments, and in this connection the non-covered spending obligations are as a rule financed from the central budget in the form of target transfers.

Health care is an example of a combination of the private and the public sectors in providing services and different levels of authority that ensure the most effective financial coverage of health care services⁶⁸. Thus, sanitary and epidemiological control service and medical prevention institutions are as a rule financed and managed by local administrative bodies. Infection control is most effective when it is financed by the upper levels of the state authority. The activity of in-patient medical institutions is associated with the effect of economy through scope which is also the reason for their financing from upper-level budgets.

⁶⁶ See: Jimenez E., Paqueo V. & Ma. Lourdes de Vera "Does Local Financing Make Primary Schools More Efficient? The Philippine Case", PPR Working Paper WPS 69, Washington: World Bank, 1988

⁶⁷ See: E.Ahmad, D.Hewitt, E.Ruggiero (1997)

⁶⁸ See: Mills A., ed. "Health System Decentralization: Concepts, Issues and Country Experience", Geneva: World Health Organization, 1990

Following from the above considerations on the principles of spending powers distribution between the levels of State authority, it can be concluded that from the point of view of macro-economic control of the expenditures status in the state budget it is the task of controlling the overall level of State expenditures that is important, and not the way of distributing spending powers.

It should be noted that decentralized budgetary systems with a large share of the expenditures within a consolidated budget allocated to the budgets of regional and local administrative bodies are more flexible and are often able to react more quickly to the changing preferences of the populations of different territories. At the same time, a lack of well-developed mechanisms of inter-territorial revenue redistribution in the presence of a high degree of expenditure decentralization may result in an unacceptable interregional differentiation of expenditures.

The Revenues of Sub-National Budgets and the Distribution of Authority for Revenue Assignment Among the Levels of State Power

Together with the problem of distribution of the function of spending among the levels of state power and administration, the problem of authority distribution for revenue assignment among the levels of state authority is one of the major questions of the theory of fiscal federalism. Examination of the international experience in building a vertical structure of tax assignment reveals that there exists no predominant strategy of assigning certain spending powers to definite levels of state authority. nevertheless, on the other hand, theoretic studies in this field show that certain forms of distribution of tax assignments can result in considerable losses on the part of society as far as both justice and efficiency are concerned⁶⁹.

The economic theory of public finances emphasizes that whenever there are several territories, individuals are free to choose their territory of residence on the basis of a comparison of the highest advantages of having an access to social benefits with the highest costs of obtaining these benefits. And the process of revealing the preferences of individuals by means of «voting by choosing the place of residence» will lead to emergence of communities of individuals with largely similar preferences, granted that there exists a freedom of movement between the territories. From the fiscal point of view, this system is an optimal one, and with the preferences being uniform, the residents within each community

⁶⁹ See Richard A. Musgrave “Who Should Tax, Where and What?” // *Tax Assignment in Federal Countries*, ed. Charles E. McLure, Chapter 1, Canberra: Centre for Research on Federal Fiscal Relations, Australian National University, 1983, pp.2-19.

would cover the costs of the received social benefits through taxes and other payments. Notwithstanding the corrections associated with the costs of overpopulation, the costs of outflow and other complicating features of the model, this system remains a self-regulating mechanism guaranteeing optimal results⁷⁰.

The real structure of multilevel states is far from the one described in classical theoretic models. Firstly, the territorial entities within the existing federal and unitary states are forming primarily under the influence of politico-geographical and national as well as of socioeconomic factors. And it cannot be asserted that while these administrative-territorial entities were being formed the questions of territorial distribution of the advantages from social benefits were taken into account, and that individuals were grouped according to the criterion of maximization of personal advantages and uniformity of preferences.

We are going here to take a look at the possible variants of distributing tax assignments to different levels of state authority from the point of view of the practice of inter-budgetary relations. The term «tax assignment» in this case relates to the levels of state authority responsible for setting the rates and the structure of distributing revenues coming from certain taxes by the levels of the budgetary system irrespective of whether those revenues generated by taxation are directed to the budget of a particular level of state authority or not.⁷¹

It should be noted that tax assignment to different levels of state authority can follow the principles of decentralization of spending obligations, according to which the distributive function of regional and local administrative bodies has to take mainly the form of providing public services directly to the population of an administrative-territorial entity. Generally speaking, there are three variants of fixing specific tax assignments to the sub-national administrative bodies⁷²:

1) The sub-national administrative bodies can be granted the powers for regulating all the revenues coming from the territory under their jurisdiction. It is also stipulated that a certain part of these revenues is to be directed to a higher level of the budgetary system in order to cover the spending obligations of the national government. As far as this variant can lead to a reduction of the efficiency of inter-territorial redistribution of revenues and also obstruct fiscal stabiliza-

⁷⁰ See James M. Buchanan "An Economic Theory of Clubs" // *Economica*, XXXII (125), February, 1965, pp. 1-14; Roger H. Gordon "An Optimal Taxation Approach to Fiscal Federalism" // *Quarterly Journal of Economics*, XCVIII, November, 1983, pp. 567-586

⁷¹ See J.Norregaard "Tax Assignment" // *Fiscal Federalism in Theory and Practice*, ed. T.Ter-Minassian. – Washington, IMF, 1997.

⁷² See: King, D.N. "Local Government Economics in Theory and Practice", London: Routledge, 1992

tion, it cannot be considered as the most effective method of mobilizing national resources; it can also create inadequate stimuli for local administrative bodies in their task of financing the national spending obligations.

2) The second variant of distribution of tax revenues, a direct opposite of the first one, means delegating all tax assignments to the national government with subsequent direction of the available funds to the lower administrative bodies in the form of grants and other transfers, as well as by setting the standard rates for allocating the revenues generated by all or some of the existing taxes to the lower-level budgets. The main drawback of such a system is the total lack of any link between the level of administrative authority controlling the territory where specific taxes are collected and the level of decision-making pertaining to spending which is the major precondition for creating an effective system of inter-budgetary relations. When such a link is missing, there is always a risk of falling into a budgetary illusion, i.e. the risk of excessive financing of local spending needs. On the other hand, the possibility of frequent and unmotivated cuts in the volume of financial resources allocated to the lower levels of the budgetary system can result in an inability to create a stable system of financing public services at the local and/or regional level.

3) The third, intermediate, variant of distributing the powers over revenues means delegating a certain part of tax authority to the level of local or regional administrative bodies, and in case of a necessity - compensating a deficit in revenues by fixing a share of regulating taxes or through allocating transfers to the local budget. The key problem in implementing this scheme of revenue distribution is how to select the taxes to be assigned to local regional administrative (local/regional taxes) and also federal taxes of which a certain part is assigned to regional/local budget (regulating taxes). In case of taxes being assigned to the lower levels of authority which makes it possible to coordinate the volume of the tax burden and the decisions on spending, local administrative bodies must act according to the principle of cost-effectiveness, which results in better economic efficiency.

It should be noted that the solution to the problem of tax-revenue assignment is not reduced to total assignment of specific taxes to the local or the national level of authority; more likely, this solution includes a whole spectrum of different schemes of allocating tax revenues and tax assignment. Table 1 demonstrates different types of revenues assigned to the lower level of administration.

The table indicates that tax revenues of the sub-national budgets can take different forms: a) local revenues entirely allocated to the budget of the respective administrative body which has the authority to set the tax rate, and in certain

cases to influence the system of calculating of the tax base; b) overlapping taxes with the base set by the federal law for all the territory of the country, and the rates which the sub-national administrative bodies are free to set on their own. Different ways of tax assignment and tax-revenue assignment as well as the economic consequences of such a distribution will be treated later in more detail.

TABLE I. TYPES OF TAX ASSIGNMENTS OF SUB-NATIONAL ADMINISTRATIVE BODIES

| Types of Budget Revenues of the Lower Level | Level of Authority to Control the Type of Revenue |
|--|---|
| Local Taxes | The authority to set the rates and the base of a tax belongs to the administrative bodies of the respective level. |
| « Overlapping » Taxes | The tax base is defined by the Federal law; the authority to set the rates rests in the administrative bodies of the respective level. |
| Regulating (shared) taxes | The rates and the base of a tax are set by the Federal law, but a fixed share of tax revenues is allocated to the budget of the administrative bodies of the respective level (the ratios can be determined on the basis of the share of tax revenues coming from the territory under the jurisdiction of the administrative bodies of the respective level, or on the basis of other criteria such as population size, consumption requirements, potential revenues) |

Source: Fiscal Federalism in Theory and Practice, IMF, 1997

The Rules of Tax Assignment. The necessity to assign tax prerogatives to different levels of state administration proceeds, firstly, from the existence of social benefits most effectively produced at the national (federal) level, and secondly, from the efficiency of a total assignment of all taxes to the sub-national administrative bodies. Thus, when the administrative bodies of the sub-national level receive the rights to regulate income tax, a tax competition between different territorial entities becomes inevitable, which would result in the necessity to introduce a principle of income taxation in the given territory. It would be also necessary to decide whether all the incomes of an individual or a company residing in the given administrative-territorial entity are to be taxed in compliance with the rules of this administrative-territorial entity, or taxation is to be carried out irrespective of the origins of the recipient of the income. Apart from the difficulties associated with defining the origins of an individual and especially of a company within the framework of the state as a whole, this situation can lead to emergence of intrastate borders and barriers hindering free circulation of goods and resources within the country, as well as any attempts at exporting the tax burden which must be considered absolutely unwelcome.

The problem of fiscal autonomy of the sub-national administrative bodies can be treated separately from the matters of administration and tax collection by different levels of state authority. The key aspect of the problem of granting fiscal autonomy to the sub-national governments is certainly the question of whether the administrative bodies of a particular level of the budgetary system have the right to set income rates in their territory. On the one hand, it is important to limit the autonomy of the sub-national administrative bodies in the area of setting the tax base at the level of an administrative-territorial entity, because an introduction of additional tax exemptions, etc. can result in deformities in resource-allocation among the administrative-territorial entities. In case when the local bodies have no right to influence the tax rates, they are incapable of changing the level of public services rendered to the population in accordance with the regional preferences. In a number of countries, the revenues of the sub-national budgets are formed mainly by taxes collected according to the rates set by the central government (e.g. countries with a developed system of the budgetary system like Portugal and Germany), or by taxes with the rates whose upper limits are specified by the federal law.

The urgency of the problem of fiscal autonomy of the sub-national administrative bodies is proportional to their expected role in the economic system of the state. In case when the economic role of the administrative-territorial entities is reduced to the practical implementation of a policy developed at the highest levels of authority, there is no need for any broad fiscal autonomy to be delegated to them. If, on the contrary, it is expected that the sub-national administrative bodies conduct their own spending programs are free to determine the volume and the quality of the public services provided at the respective levels, then their inability to change the tax rates, and consequently the volume of budgetary revenues as well, will pose a serious problem, as a result of a discrepancy between the expectations, requirements and desires of the population, on the one hand, and the actual revenue capabilities of the authorities, on the other.

The major arguments against granting the sub-national administrative bodies with broad fiscal autonomy are based on the increase in the risk of creating inter-regional or inter-municipal disproportions in the economic development, and also in weakening of the control over the macro-economic situation on the part of the central government. The simplicity of administering and retrenching by cutting down on the scale of fiscal administering are also listed among the arguments voiced by the proponents of centralized tax systems.

Besides, the importance of the problem of choice between the centralized and decentralized systems of tax regulating is also determined as some research-

ers have emphasized⁷³, by the impossibility to argue that the burden of a tax introduced at the national level is equivalent to the burden of a tax introduced at the sub-national level together with a delegation to the sub-national authorities of the right to change the tax rate. Similarly, the influences on the efficiency and equality of taxes regulated by different levels of authority will be of a different scope.

The simultaneous delegation of the right to exact various taxes to several levels of state authority gives rise to the problem of optimal distribution of tax assignments among particular levels.

Two major approaches to the solution of the problem of distributing tax assignments between the national and the sub-national levels of authority can be singled out. According to the traditional model of tax assignment distribution⁷⁴, the personal tax base (i.e. the base of taxes which can be regulated at a particular level) of the sub-national authorities will always be smaller than the spending liabilities faced by the sub-national authorities in accordance with the same traditional approach. The vertical misbalance of the budgetary system resulting from such a discrepancy has to be leveled by means of inter-budgetary transfers. Within the traditional analysis it is recognized that any delegation of the majority of tax prerogatives to the sub-national level results in emergence of distortions in the inter-territorial distribution of resources, and that the purpose of a effective distribution of tax assignments is to minimize such distortions. In this case much attention is also drawn to creating a system of inter-budgetary transfers that can be effective from the point of view of leveling the discrepancies.

The second approach to the solution of the problem rests in an analysis from the point of view of social choice⁷⁵. According to the models of thus type, when a

⁷³ See McLure, Charles E., Jr. "The Interstate Exporting of State and Local Taxes: Estimates for 1962" // *National Tax Journal*, vol.20, #1, 1967 and McLure, Charles E., Jr. "Market Dominance and the Exporting of State and Local Taxes" // *National Tax Journal*, vol. 34, #4, 1981

⁷⁴ See Richard Musgrave (1983), Roger H. Gordon (1983), Wallace Oates "Federalism and Government Finance" // *Economics of Fiscal Federalism and Local Finance*, ed. by Wallace E. Oates, Cheltenham, U.K.: An Elgar Reference Collection, 1998, John Norregaard (1997), Charles McLure "The Tax Assignment Problem: Ends, Means and Constraints" // *Australian Tax Forum*, Vol. 11, pp.153-183

⁷⁵ See Mancour Olson "The Principle of Fiscal Equivalence: The Division of Responsibilities Among Different Levels of Government" // *American Economic Review*, Vol. 59, 1969, pp. 479–487; Walter Hettich and Stanley Winter "A Positive Model of Tax Structure" // *Journal of Public Economics*, Vol. 24, pp. 67–87; Walter Hettich and Stanley Winter "Democratic Choice and Taxation", New York: Cambridge University Press, 1999; Geoffrey Brennan and James Buchanan "Normative Tax Theory for a Federal Poli-

state have a multilevel budgetary system it is necessary that the rule of correspondence of the revenue potential and the spending obligations be observed. It is also argued that in the majority of countries, tax prerogatives are distributed among the levels of state authority through a political process and not on the basis of economic calculations. In accordance with this approach, the sub-national administrative bodies must have the powers for taxing the most mobile factors, because in this case an inter-territorial competition will make it possible to avoid negative effects; besides, it is necessary to distribute tax assignments in such a manner that they would correspond to the spending obligations.

Let us consider the most important principles of tax assignment distribution among the levels of state authority in accordance with all these approaches to the solution of this problem. First of all, we are going to analyze the main points of the traditional approach to the distribution of tax assignments expostulated in detail by R. Musgrave⁷⁶.

1) *The state bodies of the middle and especially the lower level must have the authority to tax the least mobile types of the tax base.* A federal (multilevel) state must solve the problem of the most efficient utilization of resources at the national level to the necessity to eliminate the distorting effects of the inter-territorial differences in tax rates upon the distribution of resources. When the authority to exact income taxes (the base of which is comparatively mobile) is delegated to the lower levels of power, such a degree of efficiency will be achieved only when the income is taxed on the principle of the jurisdiction of its recipient, i.e., in the administrative-territorial entity where the latter is resident.⁷⁷ As it was mentioned above, the application of this principle requires substantial and not always productive expenditures on tax administering, primarily manifested in the «search» for those incomes of a juridical person or an individual that are obtained outside the territory of their registration and their subsequent taxation.

The solution to this problem consists in setting uniform tax rates (and, if possible, tax rebates) throughout the territory of the country, despite the fact that such a decision lowers the degree of centralization of the state. The lower levels of administration should be given the right to collect those taxes whose base is least susceptible to inter-territorial fluctuations. Such a distribution will be efficient not only from the point of view of national interests but also of the interests

ty: Some Public Choice Preliminaries" // *Tax Assignment in Federal Countries*, ed. Charles E. McLure, Canberra: Centre for Research on Federal Fiscal Relations, Australian National University, 1983

⁷⁶ These rules were suggested by Richard A. Musgrave (1983)

⁷⁷ See Roger H. Gordon (1983)

of the local authorities, because a non-mobile tax base reduces the possibility of its outflow into other administrative-territorial entities.

Thus, from the standpoint of the criterion under consideration, it is advisable to regulate income taxes as well as consumption taxes at the national level of the budgetary system. The authority to regulate consumption taxes as well as payroll taxes can be delegated to the middle sub-national administrative level, while property and real-estate taxes can be regulated most effectively at the sub-national levels which does not decrease the efficiency of resource distribution at the national level.

2) *Progressive personal income taxes can be set at sub-national level only when it is possible to administer the «global» tax base at the level of a territorial entity.* As previously mentioned, in order to prevent distortions in the inter-territorial distribution of resources, personal or corporate incomes must be taxed in accordance with the rates and regulations of the territorial entity the subject belongs to (that is the tax base is to be «global» - irrespective of the territory where the income is obtained). If the income has been obtained on the territory of other regions or municipalities, the taxpayer residing in the given territorial entity is entitled to a tax credit because his income is also subject to taxation elsewhere.

The precondition of tax base «globalization» is difficult to achieve as far as administering of corporate taxes is concerned, but is achievable in case of taxation of personal incomes provided that the administrative-territorial entities are large enough, firstly, to guarantee adequate resources for administering the incomes of non-residents on the given territory and the incomes of non-residents on other territories; and secondly, to prevent serious distortions in inter-territorial distribution of resources if the goal of «globalization» is not achieved and this type of administering is not possible.

3) The powers for regulation progressive taxation in order to achieve tax distribution must be delegated to the federal) national) level of authority. This rule proceeds from the principle that the authority to regulate progressive taxation in general should belong to the national government. If the goal of the federal government is to pursue a policy of income redistribution at the national level irrespective of whether an individual is registered in a particular territorial entity, the rules of progressive taxation asserting this purpose must also be uniform throughout the territory of the state.

When the authority to pursue a policy of income redistribution is delegated to the sub-national level it will be inevitably accompanied by an emergence of jurisdictions more or less favorable to population groups with different incomes. In this case every individual will tend to choose a place of residence according to

the particular policy of income redistribution that is practiced there. Such a situation will significantly increase the cost of achieving efficiency and consequently lead to an abandonment of any attempts at income redistribution.

4) *The powers for tax regulation capable of performing a stabilizing function must be assigned to the federal authorities, while the sub-national taxes must be cyclically stable.* The use of fiscal policy instruments for the purposes of achieving economic stabilization represents a predominant function of the national government. Applying stabilizing mechanisms at the sub-national level within a multilevel system of state authority leads to substantial losses thus minimizing any control over the aggregate demand. The national government also enjoys a priority in the use of mechanisms of credit and loan policy. Thus, effective sub-national taxes are those that can yield revenues stable against cyclical fluctuations (property taxes, consumption taxes), while the taxes with inherent adaptability to cyclical fluctuations (personal and corporate income taxes) must remain a priority for the national government.

5) If the tax base is unevenly distributed across the territory of the country, the powers for taxation thereupon must belong to the national government. It is clear that a substantial richness in natural resources can make it possible for the sub-national authorities to provide public services at low «tax prices» (i.e. due to a relatively low level of taxation), which can result in inefficient use of resources.⁷⁸ Therefore, the powers for taxing national resources unevenly distributed across the territory of the country must belong to the central government, even if it is contrary to the first of the discussed above rules of revenue assignment according to which the powers for taxation should be delegated to different levels of administration depending on the mobility of respective tax bases.

6) Special taxes imposed on the consumers of social benefits, as well as payments for the use of social benefits, are applicable at all levels of state authority. The powers for regulating these types of taxes and payments must be delegated to the various levels of state authority according to the distribution of the recipients of particular social benefits across the population.

The afore-listed rules regulating the distribution of tax assignments among the various levels of power demonstrate that the same taxes can be introduced by several levels, and it can be possible that the same taxes will be exacted simulta-

⁷⁸ See Peter Mieszkowski "Energy Policy, Taxation of Natural Resources and Fiscal Federalism" // *Tax Assignment in Federal Countries*, ed. Charles E. McLure, Chapter 6, Canberra: Centre for Research on Federal Fiscal Relations, Australian National University, 1983, pp. 129-145

neously by the authorities of different levels. There are several ways of simultaneous tax regulation by the authorities of different levels.

Firstly, the simplest solution consists in a joint use of the same tax base. When tax regulation is reasonable, the joint use of the tax base will considerably simplify tax administering thus reducing associated costs. However excessive taxation of one and the same base can result in dead-weight losses exceeding those typical of a more leveled tax system. For example, uncoordinated use of incremental tax rates can produce a situation when marginal rates might exceed 100%.

Secondly, in order to achieve the desired efficiency of tax exaction by different levels of administration, it is possible to introduce a deduction of the tax already paid at the one level of administration from the tax base calculated at another level. Thus, the taxable base will be determined as the income minus the taxes already paid at a lower level. In case when there exist two territorial entities A and B and the central authority C, the aggregate tax rates for the administrative-territorial entities A and B (t_A^* и t_B^* , respectively) will be as follows:

$$\begin{aligned} t_A^* &= t_A + t_C(1 - t_A) \\ t_B^* &= t_B + t_C(1 - t_B), \end{aligned}$$

where t_A , t_B and t_C — are the respective personal tax rates in the territorial entities A and B, as well as the tax rate of the central government.

In case of an established deduction of the tax already paid, the highest tax rate cannot exceed 100%. Besides, such a regime reduces the inter-territorial differentiation of tax rates and consequently reduces also any distortions of the inter-territorial choice, because

$$t_A^* - t_B^* = (1 - t_C)(t_A - t_B) < t_A - t_B.$$

It should be also noted that the application at the national level of the rule providing for the deduction of a tax paid at the sub-national level will result in reducing the incrementality of a sub-national tax, which is also favorable from the point of view of the rules of tax assignment.

Thirdly, in order to regulate a simultaneous collection of similar taxes by different levels of administration, it is possible to apply a method which is alternative to that of deducing the paid tax from the tax base. The point is the possibility of granting a credit equal to the amount of the paid tax. The application of this method envisages on the part of the authorities the deduction from the taxpayer's liabilities of the amount of tax paid by him into the budget of a lower

level. It is clear that in such a situation the authorities of the lower level would find it profitable to increase their own tax rate while the tax rate of the authorities of a higher level would simply represent the upper limit to which the authorities of the lower level would boost their tax rate.

At the same time, the crediting fixed at the level of the paid tax represents an effective instrument neutralizing the distortions of inter-territorial choice when it is used in horizontal relationships among the authorities of one and the same level.

The review of the international experience demonstrates⁷⁹, that taxes and levies assigned to the sub-national administrative bodies would differ from country to country. In the majority of countries (both industrially developed and newly developing ones, as well as federal and unitary) several sub-national taxes are collected. In general, it can be argued that revenues from personal income tax are more important for the sub-national budgets of the developed countries than for those of the developing ones, though in the Anglo-Saxon nations the role of property taxes is also very significant.

Below we are going to deal with the major problems that emerge when the authority to regulate specific taxes is distributed among the levels of the budgetary system, and to the ways of solving them in compliance with the standpoints of the traditional approach to taxation in a federal state.

Before we start to analyze the variants of tax and revenue assignment among the level of state administration as well as their economic implications, let us present a short description of the possible methods of tax assignment as distributed between the national and sub-national authorities. As a rule, the following major variants are singled out.⁸⁰

1. *Total centralization of tax and tax-revenue assignment.* In this case, the national government possesses all the powers for regulating the system of tax collection, while all the tax receipts are included in the national budget.

2. *Tax revenue division.* When the revenues are divided, control over tax collection remains the responsibility of the national government, though some share of the tax revenues would be allocated to the budgets of the sub-national level. The amount of tax assigned to a regional budget can be assessed in accordance with various principles: firstly, it can be a tax-share uniform for all the sub-

⁷⁹ See Tanzi V. "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects", Washington: World Bank, 1995

⁸⁰ See Charles E. McLure, ed. "Tax Assignment in Federal Countries", Canberra: Centre for Research on Federal Fiscal Relations, Australian National University, 1983

national formations; and secondly, the amount of tax assigned to a regional budget can be assessed in compliance with a certain formula aimed at distributing tax revenues according to the criteria of the income origin, the distribution of shareholders, the indices of the regional potential of taxation, population size, etc.

3. *Centralized division of tax assignments* envisages a division of the tax base and consequently a division of certain prerogatives among the national and the regional authorities, though nevertheless, there remains a high degree of uniformity as far as the national and local rules of tax collection are concerned. In particular, this variant envisages that the system of determining the tax base and the taxable income, as well as the rest of major elements of tax legislation must rest with the national authorities which are also responsible for tax collection, while the competence of sub-national administrative bodies must include the setting of tax rates.

4. *Decentralized tax assignment*. When the degree of decentralization is high, the state can use a decentralized system of tax assignment distributing the respective powers between the national and sub-national administrative bodies, when the role of the national government is reduced to determining the general framework within which the regional tax legislation can be changed, while the sphere of competence of the regional authorities significantly expands. When tax assignment is decentralized there can emerge a necessity to create certain independent regional taxation bodies, because when the rules of determining the taxable bases differ from region to region the national taxation bodies encounter difficulties in tax collection across a multitude of regions each of which has different rules regarding the determination of the taxable base, different tax rebates, etc.

5. *A unified and decentralized tax assignment*. Sometimes there can emerge a situation when tax assignment is formally decentralized but a number of regions (or all) would agree to unify their tax legislation. In this case, such a tax assignment will not differ (unless only formally) from tax revenue assignment.

6. *Fiscal autonomy of the sub-national authorities* is achieved when the sub-national administrative bodies possess all the powers for regulating and collecting taxes. The regions' autonomy is limited only by the constitutional guarantees stipulating the freedom of business activity and free circulation of goods and capital within the country. At the same time, the national authorities can introduce taxes that will be considerably different from similar regional taxes as far as the rules of their collection are concerned.

Let us consider the major problems emerging during the distribution of the powers for regulating the corporation income tax and indirect taxes among the levels of state authority and the budgetary system. These taxes are chosen for

thorough consideration mainly because most of the remaining widespread taxes according to the principles of the traditional approach are to be regulated by a certain level of state authority, as it is more or less definitely attested to by the international experience. At the same time, both in literature and in real life, there exists a disagreement concerning tax assignment as regards the corporation income tax and indirect taxes (the sales tax, the value added tax, and the excises).

The Corporation Income Tax. First of all, it should be noted that the potential of the corporation income tax as the instrument of the policy of income redistribution and economic stabilization is sufficiently strong. That is why, as it has been already mentioned, a delegation of considerable powers for its regulation to the sub-national level does not look effective from the viewpoint of the rules of tax assignment. On the other hand, the regional authorities are capable to a certain extent to perform the function of resource reallocation: first of all it deals with rendering the local public services, exacting the fines for damaging the environment, and eliminating tax-induced distortions of resource allocation. From such a viewpoint, the powers for regulating and collecting the corporation income taxes can be delegated to the sub-national level to the extent which corresponds respectively to the benefits from the reception of public services, the damage to the environment, etc.; or, they will simply represent a neutral means for the acquisition of incomes at the sub-national level.

It can be proved that none of the above-mentioned requirements are inadequately fulfilled as far as the corporation income taxes are concerned. In particular, there are no reasons to believe that the corporation equity income (the amount of economic profit plus the return on the invested capital), in opposition to sales taxes and the VAT, have any relation to the advantages received by the consumers or producers from the social benefits rendered to them. That is precisely why no regional corporation income taxes can be used for financing government expenditures in order to achieve the efficiency according to *Tiebout* as far as resource allocation among the regions is concerned⁸¹. All this remains true, for example, when the tax collected from the incomes of a corporation active on the territories of several regions is distributed among their budgets in accordance with the place where the income has been obtained - even in such a case the income tax cannot be considered as a benefit tax⁸².

⁸¹For more details concerning the character of income taxes in the regional aspect, see. Charles E. McLure, Jr. "State and Federal Relations in the Taxation of Value Added" // *Journal of Corporate Law*, Vol.6, 1980, pp.127-139

⁸² A simplified definition of the term "benefit tax" implies that the advantages of consumption of public benefits will correspond to the amount of the paid tax. In case of in-

Corporation income tax also does not look feasible as a source of financing the environment protection because no relation exists between the degree of danger to the environment represented by the activity of an enterprise, on the one hand, and its income, on the other. That is why the said incomes cannot be used as an ecological compensation either on the sub-national or national level.

In order to answer the question of whether the corporation income tax creates distortions of resource allocation among the regions, it is necessary to analyze the nature and the types of distortions caused by a particular tax. Let us consider the various types of corporation income tax collection and all the corresponding distortions.

When the corporation income tax is collected at the place of their registration, any delegation of the powers for tax regulation to the sub-national authorities appears unreasonable. It is evident that when the sub-national authorities possess extensive powers for taxation, the place of registration will be chosen by the enterprises mainly for the reasons of optimization of their tax payments, and the simplest way to achieve such an optimization will be to register in the regions with the most favorable conditions of taxation of companies-intermediaries whose primarily goal is profit accumulation. At the same time, the taxation bodies will face the problem of combating transfer pricing and tax exemption. One of the most negative consequences of tax assignment to the sub-national level that can be encountered under this variant of income tax will be the general reduction of tax revenues received by the budgetary system caused by the inter-regional competition aimed at attracting the taxpayers.

The foregoing problems can be avoided by collecting the corporation income tax provided that the revenues will be allocated to the budget of the region where the actual source of income is located. There are two methods of collecting such a tax: firstly, it is possible to treat the enterprises' subdivisions on the territory of the region as independent taxpayers. But this approach will produce numerous problems dealing with the assessment of transfer prices and the determination of the taxable basis for in-house goods delivery and rendering of services (when fiscal accounting is carried out by isolated subdivisions, the resulting picture of the subdivision's contribution to the total gains of the enterprise can be incorrect). The second method of registering tax revenues at the place of the emergence of the tax base is to allocate the tax base to the regions harboring the

come taxes, the principle of benefit taxation is violated to the extreme - the producers and consumers can use social benefits, while the enterprise can get no profits at all and therefore to pay no tax.

isolated subdivisions of the taxpaying enterprise; this allocation is to be carried out according to a special formula. As a rule, this formula would determine the region's share in the aggregate amount of the tax base according to the share of the isolated subdivision's wages fund, fixed assets and sales volume as reflected in the aggregate indices of the activity of the whole enterprise⁸³.

When the corporation income tax is paid according to the place where the income has been obtained, inter-territorial distortions of resource allocation will be eminent. Fiscal accounting conducted by the isolated subdivisions of a corporation will result in distortions of decision-making in the area of investing due to the impetus given to capital outflow from the regions with high taxation level to the regions with more lenient tax regulations. At the same time, there remains essential the problem of profits accumulation in the regions with lenient tax regulations involving transfer pricing. Such distortions can be avoided only through tax assignment centralization and a unification of regional tax regulations.

The distortions of inter-regional resource allocation are also caused during the distribution of the tax base among the regions in compliance with the formula. The regional profits tax can be considered in such a case as being also a tax on the factors included into a particular formula; its rates will reflect both the general level of the company's profitability and the regional tax regulations. If such factors are represented by the wages fund, the fixed assets and the company's sales volume, this income-oriented tax distribution (if tax regulation is decentralized) will have a negative effect on the rate of employment as well as on the investments and sales in the regions with higher tax rates⁸⁴. As in the previous case, the delegation of substantial powers for tax assignment to the sub-national level, and the absence of inter-regional unification of tax regulations, it is certain that the corporation income tax would distort the inter-territorial resource allocation.

One of the variants of corporation income tax collection in a federal state includes the combination of tax collection at the place of registration of isolated subdivisions and at the place of obtaining the income. Under such regulations, the tax is collected at the place of the company's registration, but the company obtains the right to a tax credit in favor of the regions where the company's in-

83 For example, different SU states apply different formulae to allocate the tax base to corporation incomes according to the places of activity of isolated subdivisions (both the engaged indices and their shares are singled out). In Russia, allocation pertains not to the tax base but to the revenues from the corporation income tax assessed proportionally to the mean value of the wages fund and the fixed assets of the isolated subdivisions as expressed in the similar indices for the enterprise as a whole.

84 See Charles E. McLure (1980)

come has emerged. In this case, the foregoing distortions of the interregional resource allocation will come into being; and the character of the distortions will depend on the size of the tax credit, that is on the ratio between the amount of taxes collected at the place of registration and the amount of taxes collected at the place of the income's emergence.

The neutrality of the corporation income tax to the inter-territorial resource allocation can be achieved only through integrating the former with the personal income tax (which means such a treatment of corporation incomes that would exclude any double taxation of dividends). In this case, neutrality results from the fact that the integration of the corporation income tax with the personal income tax is impossible without the coordination of national and sub-national tax regulations, as well as without the coordination of tax regulations at the sub-national level. If one should assume that the completely integrated corporation income tax will be collected with a deduction from the taxable personal income at the place of residence, while the money will be allocated to the region where the source of income is located, the regional authorities will not be interested in fiscal competition carried out by the lowering of tax rates. The only distortions to be possibly caused by this variant of the corporation income tax will be those of the natural person's choice of the place of residence.

The Value-Added Tax and the sales Taxes. Most of the theoretical studies on tax assignments from the viewpoint of the traditional approach indicate that the most effective form of the value-added tax (or the general sales tax) is the national VAT encompassing the opportunity to divide the tax revenues between the national and sub-national budgets⁸⁵. As a rule, this argument will be focused on the following standpoints⁸⁶: The growth of the administrative costs and the compliance costs which follows the assignment of tax to the lower levels of the budgetary system; the problem of taxation arising in the course of inter-regional economic relations; the uneven allocation of the tax base, etc.

Nevertheless, some researchers would put forward a number of arguments against the total centralization of tax assignment regarding the regulation of the

⁸⁵ See, for example, Charles E. McLure *"The Brazilian Tax Assignment Problem: Ends, Means and Constraints"* // A Reforma Fiscal no Brasil, Sao Paulo: Fundacao Instituto de Pesquisas Economicas, 1993; Alan A. Tait *"Value-Added Tax: International Practice and Problems"*, Washington: IMF, 1988

⁸⁶ See Richard Bird *"Federal-Provincial Taxation in Turbulent Times"* // Canadian Public Administration, Vol. 36, pp. 479–496; S. Sinelnikov et al. *"Reforma nalogovoi sistemy v Rossii: tendentsii, problemy, rekomendatsii"*, Moscow, Institute of the Economy in Transition, 2000

VAT⁸⁷. Firstly, within the current tendency towards decentralization of the spending obligations, some corresponding decentralization of tax assignment has become necessary. Secondly, the sales taxes are the only stable sources of income where the economy is either developing or in transition, and where the role of income taxes is not too important. Thirdly, in a number of economically developed countries the sub-national sales taxes remain a significant source of budget revenues. An analysis of the existing practice of collecting the VAT and sales taxes reveals several methods of the corresponding tax assignment among the levels of state authority.

1. Regulation and collection of the sales tax or the VAT at the regional level. At present, this system is used only in a small number of countries, primarily in the USA and Russia where the sales tax is collected at the regional level. Some analysts note that the EU fiscal system can be interpreted as a delegation of the powers for regulating the VAT to the sub-national level⁸⁸.

2. The VAT can be a national tax. The federal states which collect the VAT include the FRG, Switzerland, China and Russia. The national sales tax is collected in Australia, Brazil, India, Canada and Argentina at the national and sub-national levels, while only Brazil and Canada collect the VAT at both levels. It is often pointed out that the FRG experience (revenues from the VAT are distributed among the regional budgets in accordance with the formula or in proportion to the population size) is optimal as far as federal states are concerned⁸⁹, though formally such a system does not require the powers for tax regulation to be delegated to the sub-national administrative bodies, representing just another method of allotting transfers to the regions.

3. The existence of dual VATs and/or sales taxes cannot be excluded. Such a solution looks extremely expensive both from the viewpoint of fiscal administering and of possible distortions, though a number of researchers note that such might be the cost of the benefits created by a federal system and the independence of the sub-national authorities, particularly due to a more complete assessment of the population's preferences at the regional level⁹⁰.

⁸⁷ See, for example, Albert Breton *"Competitive Governments: An Economic Theory of Politics and Public Finance"*, New York: Cambridge University Press, 1996

⁸⁸ See Richard M. Bird and Pierre-Pascal Gendron "Dual VATs and Cross-Border Trade: Two Problems, One Solution?" // *International Tax and Public Finance*, Vol. 5, 1997 pp.429-442

⁸⁹ See Alan A. Tait (1988)

⁹⁰ See Richard Bird (1993)

4. The sub-national and national levels of administration can collect their own VATs, while reducing the costs of tax administering due to the unification of tax regulations. At present, such process can be observed within the EU.

5. A compromise variant between the division of tax revenues and the introduction of personal taxation at the national or sub-national levels can consist in the joint regulation of the VAT. Such a system of taxation would permit the national and sub-national levels to conduct a joint determination of the tax base and other substantial factors of taxation, while preserving their right to change the tax rate.

The Excise Taxes. As far as the excises are concerned, it should be noted that most of the associated studies tend to place this type of taxes within the competence of the sub-national authorities.⁹¹ Firstly, the excises represent a «politically acceptable» tax from the point of view of the sub-national authorities; secondly, they are sufficiently simple in administering at the regional level; and thirdly, an inter-regional differentiation of the tax rates becomes acceptable provided that the excises are introduced. Moreover, when the excises are collected on the principle of the region of allocation, no distortion will be caused by such a tax. Delegation the excise-regulating powers to the sub-national level is reasonable from the point of view of an agreement between the spending obligations and the assignment of the taxing powers: the degree of responsibility for service-rendering in health care and road construction on the part of the regional authorities must correspond to the scope of the prerogative to regulate the excise taxes on tobacco, alcoholic beverages, cars, and fuel, respectively.

After completing our discussion of the traditional methods of analysis dealing with the distribution of the taxing powers among the levels of administration, I should be noted that such an approach has a number of faults, the most serious ones being listed below⁹².

Firstly, the analysis presupposes that the economy can function efficiently in the absence of taxes, and the main goal of the tax policy is to minimize the distor-

⁹¹ See Charles McLure *Vertical Fiscal Imbalance and the Assignment of Taxing Powers in Australia*, Stanford, California: Hoover Institution, Stanford University, 1993

⁹²For more details on the comparative analysis of the traditional approach and the application of the public choice theory to the analysis of the distribution of the taxing powers among the levels of state authority see in Richard M. Bird *Rethinking Subnational Taxes: A New Look at Tax Assignment*, IMF Working Paper #WP/99/165, Washington: IMF, December 1999

tions caused by taxation. Though such a supposition makes a formal analysis easier, it contradicts the real goals of the authorities⁹³.

Secondly, the precondition of many traditional models is the strict hierarchy of the goals pursued by the administrative bodies of different level. For example, as it was already stated earlier in the text, the goal of the national government is (or should be) redistribution of revenues inside the country; whereas, despite the presence in those models of the precondition of a democratic state structure, strict distribution of tasks between the levels of state authority has little in common with the principles of constitutional federalism⁹⁴.

Thirdly, the traditional analysis leaves outside the study framework the extra-economic aspects of the relationship of the authorities in a federal state. That is, political processes, resolution of conflicts arising between the administrative bodies, etc. In respect of most states the statement that the principal goal of the authorities as representatives of the median voter is to efficiently and successfully provide public services does not sound correctly.

Fourthly, the drawback of the traditional approach to the analysis of national and sub-national tax assignments is its purely normative character and poor ability to provide any explanation of the ways of tax assignment distribution encountered in reality⁹⁵. It should be noted that the powers for regulating the most «productive» taxes as well as corresponding revenues in many countries are concentrated at the national level by no means due to theoretical speculations on the efficacy of such an order. Rather, this results from a factor that is overlooked in the traditional analysis: striving to obtain maximum political power.

For the reasons described above, to follow the recommendations developed as a result of the traditional normative analysis of the problems associated with taxation may create a large gap between the volume of revenues and the spending obligations at all levels of the budgetary system. Therefore, despite the im-

⁹³ See, for example, John G. Head *"Public Goods and Public Policy"*, Durham, North Carolina: Duke University Press, 1974.

⁹⁴ This contradiction is dealt with in detail in Richard M. Bird *"Central-Local Fiscal Relations and the Provision of Urban Public Services"*, Canberra: Center for Research on Federal Financial Relations, Australian National University, 1980.

⁹⁵ many researchers note that for the provisions of the normative theory of the distribution of the taxing powers to be implemented in practice, it is necessary to satisfy all its preconditions, including those three listed above. See Wallace E. Oates "Taxation in a Federal System: The Tax-Assignment Problem" // *Public Economics Review*, Vol. 1, pp. 35-60; J.Norregaard *"Tax Assignment" // Fiscal Federalism in Theory and Practice*, ed. T.Ter-Minassian. – Washington, IMF, 1997.

portance of these recommendations for developing a strategic program for reforming the system of public finances, to implement these proposals in the present situation may lead to unwanted economic and political consequences.

Let us consider the problem of tax assignment distribution between the levels of state authority from the point of view of the public choice theory. Our analysis will be based on the work by *Brennan and Buchanan (1983)*, where the basic provisions of this approach are presented most completely. As it was already mentioned before, the traditional approach to taxation in a federal system basically means minimization of the distortions that appear because of the necessity to delegate a part of the tax assignments to the sub-national level. Deviating from the traditional approach, the researchers that apply an analysis based on the theory of public choice proceed primarily from the decision-making process at the levels of the national and sub-national administrative bodies and the results of this process from the point of view of the distribution of the spending obligations and the tax assignments.

In particular, *Brennan and Buchanan*, through constructing a simple public choice model where the administrative bodies at the national and the sub-national levels act in the interests of the median voter, come to the conclusion that in case of inter-territorial differentiation of the voters' preferences the voting process based on the majority rule must lead to political decentralization of the state structure. At the same time, if the benefits of a certain public service involve the population of a limited number of territories, by means of a legally established centralization of powers, voting will result in providing this particular service at the same level on all the territories. Judging by the results of applying this model, the authors offer the following conclusions concerning the distribution of tax assignments between the levels of authority⁹⁶.

Firstly, any political decentralization of the state must be followed by a decentralization of the powers both for spending and for revenues. When the powers for tax regulation are assigned to the national administrative bodies which means that revenues are distributed to the lower levels of the budgetary system in the form of grants, the interconnection between the expenditures of the authorities on public services and their revenues disappears.

⁹⁶See Geoffrey Brennan and James Buchanan "Normative Tax Theory for a Federal Polity: Some Public Choice Preliminaries" // *Tax Assignment in Federal Countries*, ed. Charles E. McLure, Canberra: Centre for Research on Federal Fiscal Relations, Australian National University, 1983, p.59

Secondly, in the case of distributing tax assignments between the administrative bodies at several levels, the population of the territory must bear the burden of taxation in the same degree as it receives the benefits of the public services provided by the national government.

The outcome of applying another model where the administrative bodies maximize their own utility but do not respond to the preferences of the median voter have led to the conclusion that decentralization of both tax assignments and spending powers results in a closer correspondence of the public services provided on a given territory to the consumers' preferences. Besides, the sub-national administrative bodies (depending on the costs of migration between the territories) attract taxpayers to territory either through their taxation policy or through providing public services. Thus, sub-national taxes should be imposed primarily upon a mobile tax base so that inter-territorial competition may lead to increased efficiency of the tax system.

The common conclusion from applying the public choice theory to the problem of tax assignment distribution is the statement that it is necessary to decentralize the majority of public services (at least those that do not have external and «pouring over» effects) and to delegate correspondingly the tax assignments.

Thus it follows from the public choice theory that in reality the decisions made by the administrative bodies on imposing particular taxes result from political and not economic calculations⁹⁷. The competition for the taxation base can arise only to the extent it may influence the probability of a certain representative to be reelected for another term. This means that those taxes regarding which the regulating powers can be delegated to the lower levels of state authority may fall into one of the three categories: firstly, the revenues generated by the taxes can be too small, secondly, the costs of administering and collecting the taxes can be too great for the higher authorities (for example, the property tax), and, thirdly, these taxes can be both too complicated to administer and unattractive in terms of revenues (usually this refers to the local taxes on business).

Bearing in mind the traditional approach to tax assignment, and with regard to the analysis of this problem based on the principles of the public choice theory, it is possible to formulate two major rules of tax assignment to be oriented to in the process of decision-making⁹⁸.

⁹⁷ Walter Hettich and Stanley Winer "A Positive Model of Tax Structure" // *Journal of Public Economics*, Vol. 24, pp. 67-87

⁹⁸ Charles E. McLure "The Tax Assignment Problem: Conceptual and Administrative Considerations in Achieving Subnational Fiscal Autonomy", paper presented at the seminar on Intergovernmental fiscal relations and local financial management organized by the

1. The sub-national administrative bodies must possess tax-regulating powers as far as the taxes forming their budget revenues are concerned in order to carry out effective decentralized control over budget expenditures.

2. The term «tax-regulating» means here the ability of sub-national administrative bodies to influence the amount of tax revenues up to a certain extent by taking unbiased decisions on the fiscal policy, particularly by changing the tax rate. If it is expected that the behavior of the sub-national authorities will be responsible, these bodies must be able to use all the available instruments at their disposal in order to influence the amount of tax revenues provided that the possible consequences are also taken into account.

The foregoing standpoints mean, firstly, that tax assignment strongly depends on the distribution of the spending obligations, and secondly, that the real problem of tax assignment consists not in the delegation of the right to introduce or abolish taxes and to completely determine the tax base, etc. to the sub-national level, but in delegating to this level of authority the right of decision-making within the limits set by the national legislation.

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Chapter 5. Review Of Research Activities And Policy Advice Done Within *The CEPRA* In Order To Provide Recommendations For Maximum Efficiency In Interbudgetary Relations In The Russian Federation

In order to analyze the current interbudgetary system in the Russian Federation and to provide recommendations for maximum efficiency in the distribution of tax authority and expenditure responsibilities between the federal and regional administrations, as well as for the development of federal financial support to the regional budgets, a new project was carried out within the consortium on the economic problems (in) research applications (CEPRA). The investigations on the following problems were launched within the project:

1. The research in the history of the interbudgetary system in Russia.
2. The review over theoretical aspects concerning the distribution of tax authorities and expenditure responsibilities between budget system levels in a country with a multibudgetary structure.
3. The analysis of the legislation within interbudgetary system functioning in the Russian Federation inclusive of the distribution of tax authorities and expenditure responsibilities among different budget system levels and the structure of financial support to the budgets of lower levels.
4. The analysis of the misbalance in the Russian budget system.
5. The analysis of financial support provided for the budgets in the Russian Federation.
6. The analysis of measures pursued by the authorities in Russia within budget and tax policy in 2000 and their impact upon the budgets of the RF subjects, the distribution of tax revenues between the federal budget and those of the RF subjects.
7. The forecast of the possible consequences caused by the activities within the program of mid-term measures undertaken by the RF Government regarding their impact upon the RF subjects' budgets as well as upon the distribution of revenues among the budget system levels.

8. Short-term recommendations based upon the current and other projects within CEpra in the sphere of budget and taxation policy aimed at maximum efficiency of the tax authority distribution among budget system levels.
9. The establishment of the basic principles with regard to the distribution of transfers provided by the fund of financial support to the regions on the basis of fiscal capacity and expenditure needs of the RF subjects estimated within corresponding CEpra project.

A short review over the results achieved within the project for technical details, which were required for the recommendations given within budget and tax policy and are not of any scientific importance on their own.

Efficiency increase in the distribution of tax revenues, tax authorities and expenditure responsibilities between the federal and regional levels of administration in the Russian Federation

In order to work out some recommendations for the distribution of tax authorities between the federal and regional levels of administration, it is necessary that some data about the financial situation of regional budgets and the correlation between their revenue capacity and expenditure responsibilities be provided. In order to accomplish this task while formulating recommendations for the efficiency increase in the distribution of tax authorities and expenditure responsibilities, the following kinds of research were done:

- general analysis of regional budget execution in the Russian Federation within the last years;
- the analysis of the gap between revenue capacity and expenditure responsibilities of consolidated budgets of the RF subjects (the investigation of the misbalance within Russian budget system);
- the analysis of the impact caused by the activities within practical application of «the 2001 Federal budget for Act», a special part of the RF Tax Code, which is already taking effect, the Plan of the RF Government activities within social policy and economic modernization for 2000-2001, as well as of our suggestions within tax and budget policy (inclusive of those comprising «Basic long-term perspectives of social-economic policy pursued by the RF Government», which was regarded as the main document of the Plan for 2000 mentioned above) upon the budget system balance. Besides the documents mentioned, some other suggestions advanced by the experts of CEpra and the RF Government and included both in the project «Basic medium-term perspectives of social-economic policy pursued by the RF Government» and into the

new version of «Basic long-term perspectives of social-economic policy pursued by the RF Government», which is currently being prepared, were also analyzed.

The recommendation for the efficiency increase in the distribution of tax authorities and expenditure responsibilities in the Russian Federation during these years were formulated on the basis of the analysis and calculations done, as well as relying upon the results of other projects within CEPRA. Some results of this research were used by the RF Ministry of economic development and trade while launching a project «Basic medium-term perspectives of social-economic policy pursued by the RF Government», as well as by the RF Ministry of Finance while drafting the 2001 Federal budget Law and basic suggestions for the 2002 Federal budget Act and while drawing up a project of the Program of budget federalism development in the Russian Federation for 2002-2004.

The analysis of RF subjects' consolidated budgets

In order to work out some recommendation for the redistribution of tax authorities and expenditure responsibilities between the federal and regional levels of the budget system, an analysis of the correlation between revenue and expenditure rates for the budgets of different levels in 1997 and 1999 was made.

For the Russian Federation as a whole, total deficit of regional budgets was reduced from 1,24 % GDP (7,2% of total for expenditures) in 1997 to 0,02 % GDP (0,2% of total for expenditures) in 1999. Alongside with that, while in 1997 budget subsidies received from the upper budget (0,66% of GDP), as it was mentioned above, were the main sources to make up for the deficit, in 1999, the calculation done for these subsidies was in favor of the federal budget (with balance of – 0,1% of GDP) and funds were spent only within «Other inner loans».

One of the reasons for financial improvement of regional budgets in 1999, if compared to 1997, consisted in the decrease of the expenditure pressure exerted upon the regional budgets: while in 1997 total regional expenditures accounted for 17,3% of GDP along with 16% of GDP revenue, in 1999 the budget expenditures of the RF subjects were reduced to 14,28% GDP along with the decrease in revenues, which accounted for 14,25 % GRP, i.e. in general, regional budgets proved to be balanced.

Nevertheless, the decrease in the number of regions with formal excess of expenditures over revenues does not really mean any improvement in the budget situation. On the one hand, there exists budget credit debt reflected in the budget

statistics⁹⁹ but on the other, in 1999, the relations between regional authorities and their creditors completely changed. While in 1997 federal budget transfers provided for the RF subjects gained positive balance, which accounted for 14,35 bln. roubles (2,5% of total expenditures for regional budgets or 3,4 % of the transfer-recipients' expenditures), in 1999, the balance of the federal budget transfers received by the regions proved to be negative, i.e. the sum of subsidies paid off exceeded the sum of subsidies available for 2,2 bln. roubles. Analogous changes took effect within the market of regional and municipal securities. While in 1997 the funds required accounted for 6 bln. roubles, in 1999, the RF subjects' payments for the securities accounted for 2,2 bln. of roubles.

Thus, according to the principles of the budget classification (loan payments are reflected within «Deficit Coverage» of the report on budget execution), such a change in the balance of attracted and repaid funds must exert some influence upon the difference in the regional budget revenues and expenditures. Consequently, most regions, either paying to the federal budget for budget subsidies received or having settled the debt for other creditors, performed the excess of revenues over expenditures.

While analyzing budget execution of the RF subjects in 1997 with regard to the regions, it can be concluded that almost all consolidated budgets of the RF subjects were explicit to show the excess of expenditures over revenues. Favorable balance (consolidated budget net revenues) was achieved only by three RF subjects (Nenetz Region, Voronezh Region and Moscow), among which Moscow proves to be the leader (in 1997, debit balance between revenues and expenditures in Moscow accounted for 4 % of expenditures, while most regions performed budget deficit, which accounted for 20 % of expenditures). In respect to gross regional product, the deficit proves to be high for such traditional recipient-regions as the Koryak AR (-36% of GRP), the Republic of Tyva (-36% GRP), the Chukotski AR (-20% GRP). Other regions were balanced to the deficit not more than 13 % of GRP. Moscow keeps the leading position in this respect for its profit accounted for 0,59% of GRP.

In 1997, the deficit of regional consolidated budgets for most all the RF subjects accounts for a considerable amount. It was the reason for careful research of all main sources for regional budget deficit coverage inclusive of the balance of

⁹⁹ In case budget accountability were based upon budget liabilities, regional budget expenditures would be higher and would result in the corresponding budget deficit increase. In particular, the expenditure excess would equal credit debt, though it should be noted that some of the budget liabilities are not considered in budget debt rate (see the results of the research carried out within CEPRA "Debts in Russia").

loans received from federal budget, the balance of public (municipal) securities, as well as other sources of financing. In 1997, loans received from the federal budget proved to be a significant source of budget deficit coverage for regional consolidated budgets, the balance of which (the difference between received and redeemed loans) was favorable for all regions. It might result from the payroll campaign pursued for budget officials, within which, in November to December 1997, regional budgets received as loans about 10 bln. rubles or 60% of total amount for federal budget loans.

Alongside with other sources of regional deficit coverage, inclusive of bank credits, privatization, and budget balances, the importance of the funds received through regional (municipal) securities must be noted. As it was mentioned above, other sources of financing make for considerable part of deficit coverage of most regional budgets. Practically in all cases the considerable amount of such funds was determined by a large amount of bank and other credits received by regional authorities.

Further analysis of the RF subjects' consolidated budget balance shows that in 1999, the situation undergoes radical changes if compared to 1997. The number of regions with exceed of expenditures over revenues is decreasing, i.e. the favorable balance between revenues and expenditures of RF subjects' consolidated budget in 1999 was gained by most of the regions. In ruble value, the Khanti-Mansiysk AR and the Republic of Tatarstan gained the largest debit balance. Yamal-Nenets AR demonstrated the largest negative balance between revenues and expenditures of the consolidated regional budget in 1999. The deficit of most budgets accounts for less than -17% of the budget expenditures. With regard to GRP, the deficit of all regions but four accounts for less than -2,5%.

Thus, it can be concluded that though budget execution rates of the RF subjects have improved, if compared to 1997, Russia is still affected by considerable interbudgetary differentiation of budget balance, while budget loans received from the federal budget still prove to be the most significant source of financing depressive or recipient-regions. However, it should be noted, that neither deficit nor profit of the RF subject's budget is the only criterion for the estimation of actual financial situation in the region, for some part of the RF subjects' consolidated budget expenditures is covered by the transfers and other kinds of financial support provided from the federal budget, the absolute and relative amount of which might vary for different regions.

The analysis of the gap between budget own-source revenues and expenditures of the RF subjects

In order to analyze the interregional differences in the budget situation, the investigation of the gap between budget own-source revenues and expenditures was carried out. It was assumed that the redistribution mechanism currently actualized through the federal budget be absent. During the research we are interested in the correlation (gap) between regional budget revenues gained under such conditions (under the former tax legislation) and regional budget expenditures (covered according to the current legislation as well). The gap range calculated in this way makes it possible to estimate the degree of support provided from the federal budget, while the correlation of the rates calculated for different regions allows to estimate the degree of budget misbalance to the same extent it is reflected in account of the RF subjects' budget execution.

The analysis of calculation results for 1997 and 1999 showed that, in general, the expenditure share covered by the federal financial support within the Russian Federation was reduced in 1999. Thus, in 1997, the negative gap between own-source revenues and expenditures accounted for 16% of total expenditures for the budgets of the RF subjects (2,9% GDP), and in 1999, its amount decreased to 6,4 % of total expenditures (1,1% GDP). Nevertheless, as it was demonstrated above, this tendency can't be accounted for by the reduction of the interregional differentiation. It is more reasonable to assume that it resulted from the increase in the latter, in particular, from disproportional growth of budget security for the regions with most favorable financial situation if compared to highly subsidized regions.

Moreover, in 1999, the number of regions highly dependent upon financial support provided from the federal budget was decreasing. While, in 1997, there were 24 regions with a negative gap between own-source revenues and expenditures accounting for 30% or less of total expenditures, in 1999, there were only 17 regions of such kind. Alongside with that, in 1999, there were two regions in Russia with zero range (Moscow and the Khanti-Mansiysk AR), which did not receive the federal funds to cover their expenditures, and one region (Lipetz region), which gained a positive value of the range (0,2% of the expenditures), i.e. if this region had appropriated its funds to cover the expenditures, which were not connected with the federal budget settlements, it could possibly have increased its expenditures for 0,2 per cent.

In 1999, the interregional differentiation in the dependence upon the federal financial aid also increased. The standard deviation from the gap between own revenues and expenditures for 1997 accounted for 8 per cent. But the amount of

financial aid provided from the federal budget for the regions in 1999 decreased. While in 1997 the gap range was more than 5 % GRP for 48 regions, in 1999, it was reduced to 28 subjects of the Russian Federation.

The calculations of the gap range between revenues and expenditures under the condition of 100% tax revenues collected in the region for the budget of the RF subject showed that, in 1997, 33 regions failed to cover their expenditures by own-source revenues without any support provided from the federal budget (i.e. the amount of tax revenues raised on the territory of the regions for the regional budget regardless of the federal aid proved to be less than actual regional budget expenditures).

In 1999, the situation strikingly changed: the number of the regions with the negative gap between revenues collected on the territory of the region (exclusive of the federal aid) and actual expenditures was reduced to 24. It should be noted that, in general, the gap range didn't change a lot within the whole country: while in 1997 it accounted for 6,43% GDP, in 1999, it accounted for 6,67% GDP. But on the other hand, the correlation of total positive and negative gap changed: while in 1997, total amount of positive gaps exceeded negative ones (in the absolute value) by 10,8 times, in 1999, it grew up to 30,3 times.

On the basis of the results evaluated, it might be concluded that federal financial support is not required to overcome vertical misbalance of the budget system but to redistribute funds among the regions in order to equalize the vertical misbalance. The comparison of the gap between the regional budget revenues and expenditures in 1997 and 1999 under the condition of total for taxes collected by the regional budget is explicit to show that the total positive gap range between revenues and expenditures exclusive of any financial relations with the federal budget exceeds total negative gap range. Such a result proves to be natural, for, as it was mentioned above, the distribution of federal budget expenditures among the budgets of the RF subjects was not regarded within our calculations. That's why it can't be assumed that the revenues of all the regions are able to cover all the expenditures, for regional budgets do not shoulder the burden of, e.g. the expenditures for national defense, which totally refer to the federal budget responsibility.

Another result of the research that must be also noted is that 10-12 regions with the largest gap range are able to compensate not only the difference between revenues and expenditures of recipient regions but also some part of the federal budget expenditures even under the condition of the tax being totally raised by the regional budget.

Thus, on the basis of the calculations done for the gap between total revenue amount received on the territory of the RF subject and actual expenditures it might be concluded that, even in case all tax revenues collected in the region are raised by the regional budget, there are still some subjects of the Federation, which require additional financing and with most regions this gap range accounts for more than 20 per cent of their expenditures. Alongside with that, the increase in standards for tax revenues collected for the regional budget, which fails to decrease the number of the RF subjects dependent upon the federal financial support, results in a disproportional increase in the number of the regions with the considerable excess of the revenues over the expenditures, e.g. the revenues in 19 regions exceed the expenditures for 40 or more per cent, besides, in such regions as Moscow or Samara the positive gap range accounts for 100 % of their expenditures. As a result, it might be concluded that the budget system misbalance in Russia proves to be horizontal and the possibilities to equalize it by means of redistributing tax revenues are limited.

The analyses of the gap between own-source fiscal capacity and expenditure responsibilities of the RF subjects.

While pursuing a research on the degree of the Russian budget system misbalance, it must be considered that an acute problem in the Russian Federation consists in tax dodging, first of all, and, secondly, in incomplete financing provided for some expenditure needs by different levels of government. With regard to budget execution it means accruing debts of both taxpayers to budget system (tax and fee arrears) and budget system to budget funds recipients (budget credit debt). As soon as the amount of such debts proves to be considerable, it is provided that both actual budget revenues and expenditures and regional budget's arrears, as well as credit debts for the responsive period, be considered while analyzing regional budgets. The ratio calculated on the basis of this principle will be determinant for the budget system misbalance in Russia from the viewpoint of revenue capacity and expenditure liabilities to the extent they are reflected in budget accounts, rather than from the viewpoint of actual revenues and expenditures.

The calculations done showed that the gap range between own-source revenue capacity and expenditure responsibilities of the RF subjects is characterized by a larger degree of interregional differentiation than corresponding ratio calculated regardless debt amount, e.g., while the gap between regional own revenues and expenditures ranged from -80% to - 0,1% of expenditures, the analogous

ratio calculated on the basis of liabilities ranged from -78% to 21% of expenditure responsibilities.

While analyzing the results, one should pay attention to the positive value of the gap range providing that liability rate is introduced into the calculations, i.e. regional actual tax liabilities to the regional budget exceed expenditure responsibilities of the RF subject for the same period. It results from the misbalance of budgetary credit and debit debt dynamics (the latter proves to be tax and fees arrears). It is obvious that tax arrears growth might not equal budgetary credit debt increase and positive balance between arrears growth and regional budget credit debt might exceed federal financial support excluded from regional budget revenues, which, in its turn, results in the positive value of the gap considered.

The comparison of the gap range calculated on the basis of tax arrears and expenditure debts with the former calculations done regardless of any debts is explicit to show that positive gap rate is growing and negative is decreasing. It proves that in the whole country tax arrears growth exceeds the increase in credit debt of regional budgets. It should be also noted that the sign of the gap is changing for some regions as well. It means that even in case all tax arrears are collected, regional authorities will fail to cover all expenditure liabilities accrued during the year without federal center support, though credit debts accrued for this region would be more than enough to assume all expenditure liabilities.

The analysis of the gap range proved that the number of regions with negative budget gap in its absolute value exceeding 20% is large enough (to be more precise their number accounts for 14). But nonetheless, the number of such regions is less than that of the gap range calculations done regardless of debt rates. Moreover, none of the regions has the gap between revenue capacity and expenditure responsibilities for more than 50% of expenditures.

The range of positive gap rate in regard to GRP is not so large; Moscow has the largest one (23%). It proves, that budget sector share in the regional economy is considerably larger for recipient-subjects of the Russian Federation, in some of them this sector equals GRP, as well as in well-to-do regions, in spite of their considerable contributions into the federal budget, the share of budget sector is not so large.

Analyzing the gap range between total revenue capacity of the RF subjects regardless of the federal financial support and regional expenditure responsibilities it might be assumed that, in general, within the Russian Federation, the gap range in its absolute value is less than the one calculated regardless of tax arrears and expenditure debts, which can be explained by the fact that total tax arrears accrual proved to be higher than credit debt accumulation.

At the same time it is evident that the gap between revenue potential and expenditure responsibilities of the regions in 1999 was reduced in its absolute value if compared to 1997. The relative improvement in regional budgetary system in 1999 was caused by general improvement of the financial situation in Russia, which might take effect due to the following factors: by the growth of tax liabilities determined by economic revival and the lack of budget payments indexation on a large scale. The former factor causes revenue capacity growth for the budgets at all levels and the latter results in the reduction of budget credit debt increase.

But it must be noted that while total gap between regional budget revenues and expenditures is increasing along with calculations done on the basis of debit and credit debts (the improvement in general situation of equalizing revenues and expenditure responsibilities), the interregional gap differentiation is still considerable, which entails redistribution of the funds. Alongside with that, it must be mentioned that the improvement in financial welfare of the regions while calculating revenue capacity and expenditure responsibilities does not necessarily mean the possibility of any practical application of such improvement. Firstly, as it was stated above, credit debts of regional budgets might not include all the expenditure liabilities adopted by the law, and, secondly, the fact that all the arrears could be paid off seems to be problematic as long as the claim for credit payments submitted against regional budgets in legal form seems to be probable.

* * *

Analyzing the correlation between the budget revenues and expenditures of the RF subjects and the research on the correlation between the revenues (revenue potential) provided by the region and expenditures (expenditure responsibilities) of the RF subjects' budgets, we can arrive at the following conclusions.

Firstly, the analysis revealed a considerable horizontal misbalance of Russian budgetary system, which manifests itself, both in high degree of interregional differentiation of budget deficit values and in the structure of financial resources used to cover the deficit. For some regions it is urgent that budget loans and other credits be provided to cover current expenditures as long as other regions either do not have any budget deficit at all or cover its small amount by obtaining credits in the open market.

Secondly, the horizontal misbalance of the Russian budgetary system is better revealed though the analysis of the correlation between regional budget revenues and expenditures carried out under the condition that regional budget receives total amount of tax revenues raised on the territory of the region and the federal center does not provide any financial support. The research showed, that

about one third of the regions fail to cover their own expenditures within current tax system as long as the revenues of another one third considerably exceed regional expenditures. In other words, keeping to the current tax and budget legislation entails intensive interregional redistribution of the funds pursued through the federal budget in order to equalize the horizontal misbalance of the budgetary system.

Thirdly, although total gap range was reduced, as soon as revenue potential and expenditure responsibilities rates were introduced into the analysis of regional budgets carried out under the condition that regional budget receives total amount of tax revenues raised on the territory of the region and the federal center does not provide any financial support, the degree of interregional differentiation still proves to be high, which results from the lack of maximum fiscal efforts made in the regions (maximum tax revenues raised by the budget in case all other conditions being equal) to offset all regional budget expenditures adopted by the legislation.

Then, no direct conclusions can be drawn from the vertical misbalance of Russian budgetary system but it might be assumed that, the federal financial support being provided to almost all subjects of the Russian Federation, there occurs certain misbalance between revenues and expenditures in all the regions, i.e. vertical misbalance.

There are several ways to reduce the degree of the budgetary system misbalance. The easiest one is to reduce the difference between the regional revenues and expenditures by means of corresponding redistribution of tax authorities and tax revenues. But, still it would fail to cause considerable reduction, it could result in slight reduction of vertical misbalance of budgetary system, and in case of wider scope of authorities received, it might cause the distraction of federal funds allocated for equalization of horizontal misbalance. Alongside with that, the calculations done prove that even under the condition that federal budget tax revenues raised on the territory of the region are received by the regional budget, the gap between budget revenue and expenditure rates for some regions still proves to be negative. It is provided that interregional redistribution of some tax revenues be pursued in addition to redistribution of tax authorities in order to increase fiscal capacity. Such redistribution could be carried out by differentiation between the rates of tax revenues received by the regional budget. Nevertheless, the second way of interbudgetary redistribution, that is providing equalization transfers to the regions, seems to be more effective, for differentiation between standards of tax revenues received by the regional budget can't be pursued on the basis of objective and formalized principles referred to any element of interbudgetary system.

The impact of the measures suggested within tax and budgetary system reform upon the budget structure of the rf subjects

It should be noted, that the main goal of the research undertaken within CEPRA project «The efficiency increase in interbudgetary relations in the Russian Federation» consists in the set of recommendations worked out for the authorities of Russia and aimed at the efficiency increase in interbudgetary relations at different levels in the Russian Federation. In particular, both the analysis of possible impact produced by the measures taken according to the RF Government plan concerning budget revenues and expenditure of the RF subjects, and the forecast made in respect to the probable impact produced by the measures «obligated» in the current tax and budget legislation upon region financial structure, as well as the estimation of the effect produced upon RF subjects' budgets, which was caused by the suggestions expressed within this project and considered in the program documents of the RF Government were pursued.

The Program of the Government considering the suggestions offered by the Strategy Planning Center was adopted as a resolution of the RF Government on «the Plan of the RF Government Activity in the Sphere of Social Policy and Economic Modernization for 2000-2001» issued on July 26, 2000. This document was based upon « Basic long-term Perspectives of social-economic policy pursued by the RF government» as well as upon the long-range program for economy modernization. Both documents were designed by the Strategy Planning Center on the basis of the recommendations worked out by the experts working within CEPRA. It should be mentioned that the documents assume that tax system reform will undergo two stages. In the calculations given below it was assumed that the first stage takes effect in 2001 and the second one will follow in 2002. While doing the calculations, the measures included in the project of «Basic medium-term perspectives of social-economic policy pursued by the RF Government», the document which is being currently prepared by the RF Ministry of Economic Development and Trade on the basis of the recommendations offered by the CEPRA experts, were also estimated.

While estimating the changes in the budgets of the RF subjects caused by the measures included into the plan for the activities performed by the Government, it was considered that the main part of the measures planned for the first stage of the program was adopted and took effect in 2001, therefore, three expected budget structures of the RF subjects are outlined below: the expected changes in regional public finance in 2001 (caused by the changes in the legislation, which have already taken effect), the expected effect produced by the measures within the first (in addition to the ones already taken) and the second

stages of the program and recommendations of the experts working under CEPRA. The calculations relied upon the expected gross regional product for 2001, which was outlined by the RF Ministry of Economy. Besides the estimation of the effect produced by the recommendations mentioned, this part also contains the recommendations for the medium-term perspective, worked out by the experts while putting the project into practice.

The impact of changes within tax and budget legislation upon regional financial structure.

Some decisions within the sphere of tax and budgetary policy made in 2000 could exert considerable influence upon the regional financial structure. The changes mentioned were introduced through the 2001 Federal budget Act, four chapters of the Second (special) part of the RF Tax Code and other legislative and standard acts. All these documents took effect on January 1, 2001. An attempt to estimate the impact of changed legislative base upon the balance between budget revenues and expenditures will be made below.

The calculations for the expected consolidated budget structure of the RF subjects in 2001 were done on the basis of the following changes (if compared to 2000), which would inevitably exert their influence upon the RF subjects' budget structure.

1. The introduction of the income tax along with the delegation of the authority to change the tax rate within 5 % range to the local administration (the total amount of the revenues raised is received by the municipal budgets). In case this right takes effect, the total rate of income tax will increase from 30% to 35%, from which 24% or 69% of the total revenue amount gained will be received by the consolidated budget of the RF subjects (under the condition of maximum tax rate setting at 19% and 5% respectively at the regional and municipal levels).

2. The changes in share distribution of personal income tax revenues between the federal budget and the budgets of the RF subjects. While in 2000 the regional budget share in the personal income tax revenues accounted for 84% of total amount, since 2001, the revenues raised by the RF subjects' budgets from personal income tax account for 99% of total amount collected in this region. Besides, since January 1, 2001, the flat rate, which accounted for 13%, was introduced instead of the progressive rate.

3. The changes in the share amount of value-added tax revenues distributed between the federal and regional budgets. Since January 1, 2001, the total amount of the revenues gained from value-added tax are collected by the federal

budget (in 2000, the share of the RF subjects' budgets for this tax accounted for 15% of total amount of the tax revenues raised in the region).

4. The elimination of the tax levied to support the housing fund and social-and-recreational building, as well as levies for educational needs, which took effect since January 1, 2001.

5. The introduction of the highway users tax rate, which accounts for 1%, on January 1, 2001. The former maximum rate for this tax together with the regional rate accounted for 3,75%. The elimination of car-owner's tax and car-purchase tax.

6. The increase in excise rates while introducing the Second Part of the Tax Code. In respect to the regional budgets, it means the increase in alcoholic excise, 50% of total amount of which is raised for the budgets of the RF subjects.

7. The formation of the fund for Compensation within the federal budget, which provides transfers (subsidies) to cover the expenditures of the RF subjects' budgets required for the implementation of «Federal subsidies to the Citizens raising Children» Act and the Act of «Federal support to the Disabled in the Russian Federation».

The goal of the calculations done consisted in the estimation of the effect produced by the changes in budget and tax legislation upon the correlation between the revenues and expenditures of the RF subjects' budgets.

The results of the calculations prove that the implementation of the measures mentioned above should cause the increase in the regional budget revenues in their absolute value from 1031 bln. rubles in 2000 (14,9% GDP) to 1121 bln. rubles in 2001 (14,4% GDP), and as a result, the expected deficit of the total RF subjects' budget would account for 0,6 bln. rubles (0,07% GDP), which is equivalent to 0,05% of the consolidated regional expenditures (according to 2000 data, the consolidated regional budget was consumed at 0,5% GDP profit). Thus, regarding the possible error in the forecast it can be assumed that on the accepted premises the changes within tax and budget legislation discussed do not exert an outstanding influence upon the balance between regional budget revenues and expenditure on the whole.

The expected effect, produced by the changes in the tax and budget legislation upon the budget revenues of the RF subjects in 2001 might be formulated as follows:

- the change in enterprise income tax rate caused the increase in the regional budget revenues at 1,72 % GDP,

- the change in the personal income tax rate as well as in the share for personal income tax revenue distributed among the budgets resulted in the increase in budget revenues of the RF subjects at 0,31% GDP,
- the accumulation of value-added tax revenues within the federal budget caused the decrease in regional budget revenues at 1,18% GDP,
- the elimination of the tax raised for the housing fund and social-and-recreational building support caused the reduction in budget revenues of the RF subjects at 1,07% GDP,
- the reduction in marginal highway users tax rate resulted in the regional budget loss, which was equivalent to 1,18% GDP,
- the change in transfer amount provided from the Fund of financial support to the regions, as well as the introduction of a new kind of financial aid provided by means of the transfers allocated from the Fund for Compensation caused the increase in the regional budget revenues at 0,83% GDP,
- the change in the alcohol excise rate resulted in the regional budget growth at 0,08% GDP.

The analysis of the expected budget structure for some RF subjects shows that the effect produced by the decisions made in 2000 upon the correlation between budget revenues and expenditures varies from one region to another. Alongside with that, the regions with positive value of the expected difference between budget expenditures and revenues in 2001 almost equal in number those with the negative one.

Considering the results achieved, it should be noted that the deficit forecast for most regions is justified and determined by the model for the forecast itself; firstly, the calculations were done regardless of the resources for deficit coverage within the budget of the RF subjects, and, moreover, the expenditures in their respect to the GRP were regarded at 2000 level, which causes the increase in actual budget expenditures along with the expected growth of actual GRP at 6%.

The measures taken will result in the expected redistribution of budget revenues from most well-to-do regions to the regions with a traditionally low fiscal capacity, but this tendency is not characteristic of all the RF subjects: while intensive growth of budget deficit value is the case for such regions as the Republic of Tatarstan and Bashkortostan, as well as the Kemerovo Region, the reduction in the deficit or the increase in the profit for more than 2 bln. rubles is the case for Moscow and St.-Petersburg, the Republic of Sakha, the Krasnoyarsk region, Primorsky Territory, the Altay Territory, Vologda, Lipetzk, and Chelyabinsk regions, the Republic of Dagestan, Mordovia and Kalmyk, Taimyr AT. The situa-

tion described resulted from the decisions made in 2000 within tax and budget policy. First and foremost, the fact that national republics of a special status (Tatarstan and Bashkortstan) are included into one whole tax and budget structure causes the withdrawal of some part from the budget resources of these RF subjects.¹⁰⁰ Secondly, the positive balance of tax revenues resulted from centralization of the VAT, the introduction of municipal income tax, the reduction in highway user tax, and elimination of the tax raised to support housing fund and social-and-recreational buildings proves to be the case for the regions with high economic activity, i.e. with larger revenue amount received by economic subjects. Then, the distribution of the transfers received from the Fund for Compensation according to the standard expenditure needs, as well as the changes introduced into the model for the distribution from the Fund of financial support to the regions aimed at further objectification of transfer calculations, provide for the setting of regional expenditures according to the expenditure needs but not financial capacity (which is usually higher in the regions of high fiscal capacity). Therefore, according to the changes in the interregional distribution structure of the financial support provided from the federal budget, some of the latter measures might result in the growth of budget revenues in the regions with low fiscal capacity, as well as in the reduction in the revenues of the regions, which formerly received large amounts of the federal financial aid.

But on the other hand, while analyzing the impact produced by these measures upon the correlation between regional budget expenditures and revenues in regard to the regional budget expenditures, it can be noted that the largest excess of the expected budget revenues over the expenditures reflected as percentage share against the expenditures is the case for the regions with low fiscal capacity.

It should be mentioned that, firstly, the introduction of the municipal income tax along with the elimination of the tax raised to support the housing fund and the units of the social-and-recreational sphere, and, secondly, the correlation between VAT extracted from the regional budget and the financial aid distributed from the Fund for Compensation proved to be the decisive factors determining the intensity of the budget revenues growth for the regional budgets in 2001. Thus, the most favourable «profit» is gained, on the one hand, by the RF subjects with large amount of enterprise benefit (and population revenues) got in 2000,

¹⁰⁰ For more detail of the changes in the policy pursued by the federal center in regard to Tatarstan and Bashkortostan, see “Russian Economy in 2000: tendencies and perspectives”, M., IET, 2001 (www.iet.ru)

and, on the other hand, by the regions with low VAT revenues but with a great need for «family» subsidies and funds provided under the Act of «Federal Support to the Disabled». For instance, a considerable revenue growth in Moscow was determined by the increase in income tax revenues, while major losses were caused by the reduction in the highway user tax and elimination of the tax raised to support the housing fund and social-and-recreational buildings (besides, Moscow received a large transfer from the Fund for Compensation, but its amount was less than the revenues gained from the latter taxes and accounted for 2 bln. rubles). Analogously, a large excess of budget revenues over the expenditures (with regard to the expenditures) expected in such regions as the Republic of Kalmik and Tyva, and Taimir AT is determined, first and foremost, by the additional funds provided through the subsidies from the Fund for Compensations and the increase in transfer amount received from the FFFSR. Alongside with that, the losses inflicted upon these regions by VAT centralization, the elimination of the tax raised to support the housing fund and socio-cultural units, the reduction in the marginal highway user tax rate, as well as profit gained by the introduction of municipal income tax and redistribution of personal income tax revenues prove to be minor to the increase in the financial aid resulted from the low tax base in these RF subjects.

Thus, the calculations done show that the decisions taken in 2000 in the sphere of tax and budget policy won't exert any important influence upon the correlation between regional budget revenues and expenditures within the whole country in case all the premises mentioned above are considered. But the analysis of the impact of the respective measures upon the budget structure in the regional section proves that the major effect produced by these decisions consists in redistribution of the recourses in favor of the recipient–regions mostly by means of distributing additional federal budget revenues gained from the centralization of value-added tax revenues through financial support and target transfers from the «newly born» Fund for Compensation.

The estimation of the effect produced by the measures taken at the first stage of the reforms.

The calculations of the deficit expected within the consolidated budget of the RF subjects in 2001 were done regarding the changes, which must take effect in 2001 and were discussed above, and considering the measures outlined within practical application of the CEPRA project and included into the program documents of the Government, which still prove to be in potential (see above). As such, it must be noted that the basic principles of the first stage of the program

aimed at the implementation of the measures analyzed above, which exert some influence upon the regional financial structure and the impact of which can be calculated, took effect in 2001 and have been already discussed. At the first stage of tax and budgetary reform we assumed it necessary that some more radical measures, if compared to the current ones, be taken. In particular, «Basic long-term perspectives for social-economic policy pursued by the RF Government» project, developed under the active participation by the authors of the present article, presupposed total elimination of highway user tax, the transition to accrual method of VAT charging, a more considerable increase in excises, the modification in amortization charge, and elimination of investment benefits for the company income tax, etc. But, major part of the measures exerting some influence upon consolidated budgets of the RF subjects (which might be calculated) do not undergo any considerable changes if compared to the expected changes in the regional budget structure in 2001, which might take effect according to the decisions made within tax and budget policy.

It's natural that tax reduction along with the same budget expenditures should reduce the profit value. Nevertheless, it is quite possible that relative changes in the regional budget structure be analyzed on the basis of the calculations done. While outlining recommendations for the reform in the interbudgetary relations and regional finances, two forecasts for regional budgets were designed: first, on the basis of budget execution accounts for 1999, and later, along with information provided, on the basis of 2000 data.

If to compare the results of the calculations done over the regional budgets after the first stage of the tax reform with those forecasts designed for 2001 on the basis of the decisions made (for both variants), it can be concluded that none of the significant changes took effect. It proves that, first and foremost, the measures suggested within recommendation in the sphere of tax reforms have already been reflected in the decisions made, inclusive of the adopted chapter of the Second Part of the RF Tax Code and the Federal Budget Act for 2001. Secondly, it might be assumed that some measures being in potential, touch upon the simplification of the tax system (in most cases the effect produced by such measures can't be calculated) and the elimination of some taxes, which add little to the total revenues collected.

As for the federal budget, it can be stated that after the first stage of the tax reform, the federal budget for 2001 being planned as non-deficit one and most measures, which are supposed to be taken, being included into the latter, the elimination of some more taxes, which provide low revenues, might result in a slight federal budget deficit (about 0,03% of total federal budget expenditures).

The estimation of the effect produced by the measures taken at the second stage of the reform.

The practical application of the measures suggested by us at the second stage (which were regarded while designing the project « Basic medium-term perspectives for social-economic policy pursued by the RF Government») presupposes the following modifications in tax and budget legislation, which might influence public finance in the regions (the modifications in the distribution of tax revenues and tax authorities among the levels of the federal power and budgetary system are provided in Supplement 1):

1. *Value-added tax.* It is planned that the reduced tax rate should be eliminated, the tax rate should be gradually scaled down to 16-18%, and the tax should be raised on the basis of the target-country principles within the relations with other countries of ICS for all kinds of the commodities and services traded.¹⁰¹ The reduction in the tax rate carried out under the program is performed as a measure taken along with benefits elimination, which might distort the economic system, so that total tax revenues would remain the same.

2. *Company income tax.* It is suggested that at the second stage of the program the municipal income tax be abolished, the order of amortization charge be modified, as well as the investment and some other benefits be eliminated.

3. *Payments to the federal social extra-budgetary funds.* The introduction of one common social tax comprising payments to the pension fund, to the medical and social security funds proved to be the major innovation introduced under the program put into practice in 2001.

4. *Highway taxes.* Within tax recourses provided for the highway funds, the program suggests that territorial highway funds should be consolidated within the regional budget, which should be followed by the elimination of the target structure of the funds, highway users tax should be abolished along with the compensation provided for the highway building by means of gasoline excise growth¹⁰², some new excises for other kinds of fuel should be introduced, use tax on automobiles as well as car-purchase tax should be abolished, regional transport tax should be introduced, highway users offset for heavy freight and extra-size means

¹⁰¹ Since July 1, 2001, the value-added tax raised within the relations with other countries is based upon the principles of the target-country in respect to all commodities and services exclusive of oil, oil-products, and gas.

¹⁰² It should be noted that highway users tax must have been abolished at the first stage of the program, considering the fact that it was not carried out in 2001, it became part of the second stage.

of transport should be adopted, highway user tax for the transport registered abroad as well as for heavy freight means of transport, should be introduced.

5. *Payments for natural recourse consumption and coal-mining industry taxation.* Within this kind of taxation it is assumed that payments for the reproduction of the mineral resource base should be abolished, the ecological tax should be raised instead of the effluent tax, the tax revenue shares collected from coal-mining industry should be redistributed. Alongside with that, it is suggested that resource consumption tax should substitute for the payments for reproduction of the mineral-recourse base, royalty, and the excise.

Currently natural recourse payment shares account for 30% to the local budget, 30% to the regional budget, and 40% to the federal budget. In case natural recourse production is carried out on the territory of an autonomous district, the revenue share of 40% usually collected for the federal budget is divided into two equal parts between the federal and the autonomous budget (i.e. 20 % for each one). It is suggested that the distribution of tax revenues collected from coal-mining industry should be modified and fixed at 20% for the local budget, 20% for the regional budget, and 60% for the federal budget. In case the coal-mining industry is located on the territory of an autonomous district, the local budget share will account for 20%, the autonomous district share will be fixed at 20%, the regional budget share at 10%, and the federal budget share at 50%. Besides, the taxes should be raised on the basis of the market price for the product.

As for the taxation for hydrocarbon output, it is suggested that the tax on additional income gained from hydrocarbon output should substitute for oil excises introduced for new layers and for some part of the royalty.¹⁰³

6. *Currency-purchase tax.* This tax should be abolished at the second stage of the program.

7. *Property tax, land tax.* The suggestion made under the program consists in the substitution of the current company property and personal property tax, as well as the land tax for the real estate tax. It is assumed that setting full cadastre of real estate along with the introduction of real estate tax at the second stage should result in fiscal revenue growth by almost 1,5 times, if compared to the total revenue amount gained by property and land taxes.

8. *Excises.* The program includes the excises collected at specific rates, the increase in gasoline, expensive cars', and luxury excises, etc.

¹⁰³ Due to the lack of data, the effect produced by the new tax in regional section couldn't be estimated.

9. *Sales tax*. This tax should be abolished at the second stage of the program.¹⁰⁴

The calculations show that while carrying out the tax reform tax burden on the economy will be reduced (according to the budget of extended government) from 36,25% GDP (in 2000) and 33,35% GDP (in 2001) to 32,88% GDP (by the end of 2004), or for almost 3,4% GDP in comparison with 2000. In particular, the consolidated budget will be reduced from 24,75% GDP to 23,37% GDP (almost at 1,4 %), the extra-budgetary amount from 11,5% GDP to 9,41% GDP (for more than 2%)

The re-distribution of tax revenues in favor of the federal budget at the RF subjects' expense will go on within the tax reform. Thus, while the federal budget share within consolidated budget accounted for 56,6% in 2000, in 2001 it accounts for 60,7%, in 2002 for 60,2%, and by 2004 it will have almost reached 67,6%.

The reform within the system of payments for natural resource consumption proves to be one of the most important problems connected with tax revenue redistribution exercised under the program, therefore, the taxation reform in hydrocarbon industry appears to be significant in the fiscal respect (to be more precise, it is oil production that should be reformed).

We calculated the share of oil- and gas- production companies in the total amount of revenues collected for natural resource consumption considering the location of natural resources among the regions. Besides, the fact that oil-production for 2000 on the whole accounted for 5,9% was also regarded in the calculations.

Should the expected regional consolidated budgets based upon the same initial data be compared, it would become obvious, that there were no considerable changes in the regional budgets at the second stage either.

The results of the calculations done in order to estimate the expected regional budget revenues for 2000 slightly differ from those done for 1999. The major difference in the results achieved by the measures taken at the first and the

¹⁰⁴ As for the sales tax reform, it should be noted that according to the Resolution of the RF Constitutional Court adopted on January 30, 2001, №2-П, it is obliged that the discrepancy between the RF Constitution and some items of "Tax System Base" Act, regulating sales tax, be eliminated. This tax would be abolished since January 1, 2002, unless tax legislation on the part of sales tax is correlated to the RF Constitution. According to the information we received, currently the RF Ministry of Finance hasn't suggested any law-project on the modifications in "Tax System Base" Act, as well as any project of the RF Tax Code chapter "on Sales tax" to the State Duma.

second stages consists in the order the regions would be put in, if they were arranged according to the deficit down-scale.

The difference in the forecasts for the two stages also consists in the fact, that the abolition of some taxes and the increase in some other payments could exert a dubious influence upon the regional budgets, though general modification, if it is compared to the first stage of the program calculated both on the basis of 2000 and 1999, proves to be significant for a small number of regions in case this modification is referred to the respective budget expenditures.

If we consider total deficit modification within all the regions, in money value it will account for –10 bln. rubles, which makes –0,84% of total expenditures within consolidated regional budgets (the forecast on the basis of 2000 data), which proves that, as long as a possible error is considered, in general, consolidated regional budgets practically do not change. On the basis of the calculation results, it is possible that some modifications in the following revenue sources, which might exert a considerable influence upon the expected budget deficit amount for the RF subjects, should be singled out:

1. The abolition of the highway users' tax must result in regional budget loss at 0,61% GDP.
2. The modification in the order of payments for natural resources consumption (in particular, the reform of oil-production taxation) must cause additional revenues collected by the federal budget with regional budget revenues being almost unchanged (according to our calculations they grow at 0,28% GDP).
3. The reform planned within real estate taxation should lead to the additional regional budget revenues, which account for 1,70% GDP.
4. Total elimination of payments made for education needs will result in the loss of revenues at 0,05 % GDP.
5. The abolition of car-purchase tax and the tax on automobile use must lead to the reduction in the regional budget revenues at 0,05% GDP and 0,06% GDP respectively (apart from transport tax).
6. The abolition of sales tax should result in revenue losses equal to 0,33% GDP.
7. The elimination of the payments made to reproduce mineral-resource base will cause the loss of the revenues at 0,30% GDP.
8. The abolition of currency-purchase tax should lead to the revenue reduction at 0,02% GDP.

The following factors play the main part in the modifications in RF subjects' consolidated budgets at the second stage of the program if compare to the first stage:

1. The introduction of real estate tax.
2. The elimination of the payments made to reproduce mineral-resource base and the abolition of sales tax.
3. The modifications in the taxation designed for natural resource consumption.

Property taxes prove to be an important revenue source for some regional budgets, therefore, the increase in revenues by 1,5 times (according to the expert estimate) resulted from the introduction of the real estate tax, will produce a positive impact upon most regional consolidated budgets, though not enough to cover budget losses caused by the abolition of some taxes.

Budget expenditures are another important factor, which exerts its influence upon the regional budgets. While the expenditure amount of the regional consolidated budgets is regarded as a solid share in GRP within the calculations, this rate largely depends upon the base year and the expected GRP growth. On the basis of the data of the regional budget execution in 1999 it could be concluded that budget expenditure growth is slowed down if compared to the intensity of GDP growth (for the whole country), and the increase in the expenditures of regional consolidated budgets according to the intensity of GRP growth could result in the excessive rate for budget expenditure growth, for the GRP forecast for 2001, which was regarded in the calculations, shows the misbalance in the rate growth among the regions. Thus, it is expected that in Nenetz AD the GRP for 2001 should increase by 1,94 times if compared to 1999, as long as, in general, among different regions this rate equals 1,7 times. The data calculated for 2000 showed that the forecast of budget expenditures outlined according to this model fails to be stable. Should we compare the budget forecast outlined in 1999 with that of 2000, they would correlate between 0,66 in the Kursk region and 1,80 in the Republic of Ingush. On the basis of such information it can be concluded that such an error in the forecast of budget expenditures would tell on the quality of the forecast as a whole.

In general, slight changes in the regional consolidated budgets after the two stages of tax reform program compared to the forecast for 2001 prove that the measures enrolled into «the Federal Budget for 2001» Act must bring (here, we mean budget revenues rather than budget expenditures for the latter were not investigated within this research exclusive of the modifications in the transfers provided by the Fund for Compensation and those received from the federal fund of financial support to the regions, which were included in the calculations) regional consolidated budgets practically at the same level of revenues as might be achieved provided that all the measures suggested for both stages of the reform in tax and budget system take effect.

Suggestions for growing better efficiency of Russia's tax and budgetary system.

It is notable, that launching the program of the measures we suggest taking will not inflict big losses upon the budgetary system on the one hand, whereas on the other hand, it is aimed at raising the efficiency of tax and fee system, as well as at the same target for the interbudgetary relations in Russia. Apart from the suggestions, designed in the course of the project performance period, which effect was adduced above, the following CEPRA-based recommendations for the further perfection of Russia's tax and budgetary system could be listed below.

In the course of CEPRA project execution, suggestions were worked out for the improvement of the tax and budgetary legislation, with regard to tax revenues allocation and tax authorities delegation between the State power and administration levels of the Russian Federation.

The major part of the suggestions rests within the domain of tax administration improvement and is not subject to quantitative estimates. It is also noteworthy, that the suggestions given below are of medium-term nature and they have also been made use of by the RF Ministry of Finance for drafting the Budget Federalism Development Program in the Russian Federation for 2002 to 2004.

Personal income tax. The revenues generated by this tax are to be assigned to the RF subjects' budgets in full, whereby, for the reasons of imparting stability to the interbudgetary relations, the guideline for the revenues distribution by the personal income should not be settled by the Federal Budget Act for a next fiscal year, but by the tax legislation (for instance, by means of ranking the tax with a number of regional taxes that share common rates and bases for all the RF subjects), or by the Budget Code, by way of treating the personal income tax revenues as part of the budget revenues by an RF Subject. A particular stress should be placed to emphasize the sheer impropriety admitted by entitling the RF Subjects authorities to change the tax rates and to issue tax remissions on their own, since regional tax residence control for paying personal income tax is not allowed in terms of tax administration, and its establishment might be fraught with complications with regard to the preservation of the federative unity.

On the other hand, the present structure of personal income tax revenues distribution seems inexpedient. It is recommended, that this tax' revenues be fully assigned to the RF Subjects' budgets, which procedure will ensure a compensation for part of losses that might be inflicted by the sales tax' possible abolition.

The tax legislation could settle the personal income tax revenues distribution between the RF Subjects' own budgets and those of municipalities. Such distribution could be dubious - by means of a division between rates, the latter assigning the revenues to the budgets of various levels or by way of setting a proportion for the tax revenues per capita distribution. In each of the two ways, both advantages and disadvantages are inherent. Thus, the tax revenue sharing by the regional and the municipal budgets, based on the rate criterion, is easy to manage (provided that the flat rate of the tax is retained); however, such a method will settle an uneven tax base allocation between the municipalities and thus will raise a problem of budgets' «surplus» fiscal capacity with some municipalities at the expense the budget revenue deficiency with some other municipalities. The second way of distribution is by far more complicated, however, it ensures better equitability by distributing the tax revenues between the municipalities, and, in fact, is easier to apply if collected at the progressive rate.

These two approaches to tax revenue distribution might be combined through fixing the minimum rate which accounts for assigning the revenues to the budgets of the municipal units, while some certain part of the remaining amount (the minimum for which should be settled by the federal legislation) is to be allocated between the municipal budgets.

Enterprises and Institutions Income tax. The present conditions, under which the municipal units are empowered to settle the rate for the tax directed to the municipal budgets within a 5% range, while the RF Subjects authorities are entitled to issue remissions within the bounds of their own tax revenues, transfer pricing being uncontrolled, an unfavorable tax competition could be brought along which could result in worsening social well-being. With regard thereto, the following measures should be taken:

- «passing» the 5% rate of the income tax to the federal level, all respective revenues being accrued to the Offset Fund for the purposes of financing all of the RF Subjects' budget expenditures associated with «Veterans» Act (should sales tax be abolished to make up for the regional budgets' dropped revenues, the retention of the municipal income tax would be possible with an allowance of unifying the tax rates by municipalities within the framework of an RF subject);
- imposing a restriction upon the RF Subjects' authorities for dropping the tax rate below 10%.
- imposing a restriction upon the RF Subjects' authorities for the settlement of tax remissions on their own except for those otherwise obliterated in the federal legislation (as a more moderate way, placing a ceil-

ing upon the privileged revenue amount against toughening the control over individual tax remissions might be applicable by the federal legislation);

- setting the following tax rates: 15% for the federal rate (10% as an alternative), 10% to 20% as an option for the regional rate (or adjoining the regional tax rate by the municipal one (10% to 25% as a result)).

Value added tax. The present situation should be settled by the tax legislation, whereby VAT revenues are fully accrued to the federal budget.

Vodka and strong drinks excises. To avoid confusion (like assigning the excise revenues to the budgets of the regions producing but not consuming the goods subject to excises) originating from the applying system of excises paying with respect to alcohol, associated with deriving alcohol sales revenues by the production-involved but not the consumption-involved regions, the excise revenue interbudgetary distribution system should be modified. A most reasonable way of reforming the excise revenue distribution system is the acceptance of an in-full transfer of such excise revenues into the federal budget. Such redistribution should possibly be carried out alongside of a simultaneous assignment of the amount equivalent to the excises' regional part to the Fund for Compensation for the purpose of financing the regional budgets expenditures for paying salaries to the public employees (education staff) within the limits of a Universal Tariffication pattern.

As a compromise on the excise revenues distribution, a decision might possibly be taken to enter 50% of the excises, paid throughout the producer-done sales, into the federal budget (which was the point of discussion while considering the «On Excises» Chapter of the RF Tax Code Section 2 draft), while for the period of the further alcohol wholesaling by the excise warehouse the remainder of 50% of the revenues should be directed to the RF Subjects' budgets.

Natural resource consumption payments. The present distribution system of payments for the consumption of natural resources is constituted in a way, that the payments coming from the autonomous okrug territories, in their turn included in the regional (krai) jurisdiction (krai), or in the regional (krai) budget are effected at the expense of a federal budget share. First of all, it should be noted, that a reasonable solution seems to consist in an in-full to-the-budget payment transfer for the consumption of the natural resources of an uneven distribution. However, regarding the big-scale political problems originating therefrom, it should be compromised on setting such distribution proportions of payments for the consumption of the natural resources (royalty), so that the in-payments to the budget of an RF subject within which the autonomous okrug is located, do not

reduce the federal budget share, which implies a reduction of the autonomous okrug's (or/and the region's) share in comparison with the applying ones. The adoption of this variant could be facilitated by a transition to tax payments calculation on the basis of the goods market value, which will stimulate the growth of the tax revenues directed to the regional budgets, thus making up for the relative shares decrease. Thereby, preventing a drastic rise of the tax load upon the extractive industry sector should be carried out through abolition of payments for the reproduction of the mineral resource base and oil excises.

Another strategy to reform the system of payments for the consumption of natural resources is passing the revenues generated by the payments for the generic natural resources consumption (the forestry fund, water facilities, environmental facilities, water biological resources and other payments), inclusive of land tax, to the budgets of the RF Subjects. It should be noted thereby, that for the purposes of growing these taxes' significance for the regional budget revenues the decision to direct the revenues to the regional level should be taken alongside of the commitment of indexing the above payments' rates.

Property taxes (real estate tax). According to the Tax Code second part draft, the real estate tax is ranked with local taxes. Property taxes as those having a less mobile base should obviously be ranked among local taxes, entitling the municipal authorities to settle the tax rate within the limits outlined by the Tax Code and also entering the tax revenues into the local budgets. However, the conversion of the property taxes into the category of local taxes might rise a problem of surplus budget fiscal capacity for some municipalities, within which domain big industrial enterprises of a high value of assets and industrial reserves are situated. Consequently, such municipal authorities will have incentives to setting reduced tax rates. In our opinion, the following solutions of this problem are possible.

First and foremost, it is possible to adjust the municipalities' budget supply by means of a negative equalization transfers system. This will require that significant modifications be introduced in the legal provisions since the authority of rendering financial aid to other municipal entities is not incumbent upon the municipal budgets. Neither are the local authorities in charge of the obligations to superior budgets for gratuitous allocations, which may make it difficult to impart a mandatory status to the negative transfers. Under these terms, an elaboration of the budget legislations items appears necessary, so that the order of such transfer calculation and the budget proceeds execution are strictly regulated.

The second way to offset the possible disparities, originating from the local tax status imparted to real estate tax, could be a possible uniting the region's ma-

major enterprises (selected on the basis of the annual average property value (subject to the average regional indices)) into a regional tax okrug. In this case the property tax revenues, generated by such enterprises, are earmarked to the regional budget and are used for the interbudgetary equalization purposes (for instance, on a per capita basis).

In the nearest future (before the real estate tax is introduced and prior to passing the enterprises' property tax to the sphere of local taxes), the municipal authorities might be empowered to increase the enterprise property tax rate by 3% (by 1 in addition to the regional tax rate, as a variant), the respective revenues assigned to the municipal budgets - in full or pro rata (by equal shares for both an RF Subject's budget and for the budget of the municipal unit).

Taxes paid by minor business subjects. Regarded in the abstract, minor business taxation and providing conditions for minor business development should be a responsibility resting with the local authorities, which preconditions the delegation of the respective tax authorities and tax revenues to the local level. However, the currently applying criteria of ranking enterprises to minor businesses (under the legislation in power, minor enterprises are understood as quite big economic agents) do not make it possible to pass the respective tax revenues and authorities to the municipal level. In this sense, introducing modifications to minor business taxation system appears necessary (for instance, by narrowing the minor business enterprises scope basing on the criterion, excusing an enterprise from being registered as VAT payer), whereas it's only afterwards, that the decisions on the respective tax authorities decentralization should be made.

Other kinds of taxes and dues. For the nearest period, it would be highly expedient to pass the revenues generated by gambling business to the budget revenues of the RF Subjects.

Tax authorities decentralization and tax administration. As is obvious, the majority of the tax system modifications proffered presupposes the contactation of the tax authorities delegated to the regional and, particularly, to the municipal power institutions (with an exception of net worth tax). At the same time, a gradual rejection of splitting the tax revenues into those for the budgets of various levels creates negative incentives for the federal tax institutions in terms of the collection of the taxes entering into the regional and local budgets. A possible entitlement of the regional and local authorities with the right of introducing taxes on their own may burden them with carrying out tax administration costs. The establishment of their own tax services by the RF Subjects is scarcely desirable for a number of political reasons and losses inflicted by the scale effect. In this respect, the evaluation of expedience by the elaboration of agent agreements

mechanism between the regional authorities and tax institutions in offsetting the expenditures of the regional and local tax institutions financing might be appropriate.

Recommendations for the field of the federal financial aid allocation to the budgets of the RF subjects.¹⁰⁵

In the course of processing the suggestions for the improvement of the federal system of financial support to the regional budgets, rising the efficiency of the inferior power levels budget support system was supposed to be a priority with the governmental activities. In the course of the reformations planned, the activities aspiring to perfect the federal support system should be carried on, their first stage having commenced upon the adoption of the RF interbudgetary relations reforming Concept for 1999 to 2001, approved of by # 862 Assignment of the RF Government dated July, 30, 1998. One of the results of the first measure implementation stage under the Concept consists in the improvement of the FFSR funds distribution mechanism and other kinds of the interbudgetary equalization in terms of their efficiency and equitability. Specifically, it is all about the transition to FFSR calculation on the basis of the RF subjects' fiscal capacity rate and objectivized expenditure needs, also, needs for the foundation of a Fund for Compensation aimed at financing part of the unsecured federal expenditure mandates and also for the perfection of the mechanism for distributing the federal north supply funds. However, maintaining the further perfection procedures for the sake of improving the system of financial aid allocated to the regions would require a number of measures to be taken within the below fields.

The federal financial support to the budgets of inferior levels should be based on 3 key financial aid types:

1) financial aid directed at the equalization of the RF power institutions in their capacities of providing public services - i.e. the minimum budget supply (transfers from the Federal fund for financial support to the regions);

2) the appropriations assigned to the RF subjects' budgets for the purpose of repaying the vertical inequity of the budgetary system, the basic source for which consists in the expenditure obligations that are incumbent upon the RF Subjects' budgets by the federal legislation and provided with no financing

¹⁰⁵ : the above recommendations of CEPRA experts were made use of while preparing the state policy in relation to the budget expenditures Concept, which was submitted to the Ministry of Finance and the Economic Analysis Bureau.

sources - these are grants and subsidies for financing specific expenditures (the transfers from the Fund for Compensation);

3) Other kinds of financial support delivered to the regions for the purpose of facilitating the regional development and providing incentives for the financial sanitation and the budget sector reforming processes (the transfers of the Fund for Regional development and Regional Finance development Fund), also inclusive of budget credits and loans.

A significant drawback of the present interbudgetary relations system is accounted for by the lack of the due legal base that would also regulate the financial aid distribution process, which deprives this budget proceeds filed of the appropriate stability and transparency. This requires an elaboration and adoption of a federal act that would administrate the relationships between the budgets of different levels within the Russian Federation. On the other hand, the legislative approval of such federal aid distribution principles as transfers from the Fund for Financial Support to the regions, the fund for Compensation and other funds sets forward a requirement for the elaborated and tried distribution mechanisms, which could apply for the accomplishment of the respective tasks with no need for any additional models and recalculations, when settled and normalized. The second condition for the long-term standard-act settlement of the financial aid distribution principles is the termination of the tax- and budget-reforming active phase, which would make it possible to apply the financial aid amount data, calculated as for the future fiscal years with no need of adjustment for the tax and budgetary legislation changes.

At the same time, it is already at present, that those items of the RF Budget Code definitely be specified, which are to regulate the generic issues of granting financial aid (also inclusive of budget credits and loans) to the RF subjects, to define the terms of earmarking the funds from the federal budget and to take control over the consumption of such funds as well as over the order of mutual interaction performance by the federal authorities and the representatives of the regional authorities for the course of the interbudgetary relationships implementation.

Besides the issues of financial aid distribution from the Federal budget to those of the respective regions, the federal legislation should give a better consideration to the relationships of the RF Subjects' budgets and local budgets for investigating the possibility to render financial aid from the budgets of the RF subjects. It is advisable, that the RF Budget Code items as well as those of «On financial bases of autonomous bodies in the Russian Federation» Federal Act be brought to final amendment from the perspective of the legal settlement of the

budget rights equality principle for all municipal units with regard to the mutual relations with the RF subject's budget, of providing a unified, transparent and objectivized (based on the fiscal capacity rate and on that of the objective need for the budget expenditures) approach to municipal units in the aspect of financial aid distribution and guideline settlement for regulating taxes assignments (as a kind of financial aid) to the budgets of the municipal units. The distribution of expenditure authorities between the RF Subjects' own budgets and local budgets should be normalized, as well as the very procedure of such distribution.

Thus, the activities aimed at perfecting the federal aid distribution system should be carried on and directed to the following targets which will all be taken into account while elaborating the RF interbudgetary relations perfection Concept for 2002 to 2005.

The Fund for Financial Support to the Regions. While drafting the RF Federal Budget Acts for 1999 to 2001 a new formula was designed and implemented to calculate the FFSR transfer amounts to be granted to the regions. It was based on the equalization of the RF Subjects' fiscal capacity (Gross Tax Resources) with regard to actual expenditure needs. The experience of this formula implementation illustrates, that it facilitates accomplishing the tasks of the capacity equalization for the regional authorities to provide public services and doesn't need a crucial change, however, the methods and procedures of Gross Tax Resources rates (fiscal capacity) and the budget expenditure ratio calculation (the objectivised expenditure needs) require extra improvement. To reach a better concept of both the region's fiscal capacity and the expenditure needs, the following measures should be taken:

1. A method should be worked out and settled by the Government to estimate gross tax resources, basing on the regional tax base analysis and on the evaluation of the efforts applied by the regional authorities in tax collection; also, a method should be developed to calculate the budget expenditure ratio basing on the analysis of the factors exerting an impact on the RF Subjects' need for budget services under the Legislation in power and with regard to the pros [ective strategies of the budget sector reforming.

2. The development of the above methods of gross tax resources estimation and the expenditure needs ration calculation is impossible without a sufficient statistic base. For the above reason, the main condition prior to commencing the work consists in obtaining a list of demographic, social-economic, financial rates and other data, mandatory for the correct accounting of the key factors having an effect on both the fiscal capacity amount and on the RF Subject's expenditure needs level. Subsequently, an Assignment should be adopted by the Government

addressing the RF State Statistics Committee and the Ministry for Taxes and Dues and also other ministries and institutions with a prescription to prepare and regularly submit the above data to the Ministry of Finance.

3. After the development and probation period of the methods estimating the gross tax resources, calculating the budget expenditure ratio and reflecting the FFSR transfer calculation in a formula, the data should be affirmed as an Assignment of the RF Government, and later - as part of the federal Act regulating the interbudgetary relations in the Russian Federation. The procedure of calculating a transfer should, first of all, be transparent and verifiable to all the participants of the process, and secondly, it should be of a stable and long-term nature.

4. The federal law, regulating the interbudgetary relations relations, should settle the conditions of granting the FFSR transfers to the Regions. In particular, special control should be established over the disposal of the budget funds and the budget undertakings management in the RF subjects highly dependent on the federal financial aid. It is highly necessary to develop and affirm the procedure of exterior financial administration for the regions highly dependent on the federal budget grants.

The Fund for Compensation. Since 2001, the financing obligations for the funding part of the budget expenditures of the RF subjects, introduced by federal acts and not provided with the funding sources, were taken by the federal budget. For this purpose a fund for Compensation was created, which transfers are allocated to all the RF subjects with no exception in accordance with the funding need. The creation of the fund for Compensation is but a partial solution of the non-funded expenditure mandates, since total for extra expenditure obligations coming both as direct payments and as the obligations of financing a variety of privileges tends to exceed the projected amount of the compensation transfer funds. With regard to the introduction of the Fund for Compensation, the following measures should be taken to solve the problem of the unsecured expenditure mandates.

1. Likewise to FFSR transfer allocation, a method shall be first affirmed by the Government, and then settled by the Legislation to define the need for funding for particularized targets, for which purpose preparing and submitting the respective statistical data is highly obligatory.

2. Apart from the perfection of the Fund for Compensation allocations procedure, an inventory of and restructuring the system of the expenditure authorities unsecured by funding sources shall be performed.

Fund for Regional Development and Fund for Regional Finance Development. In compliance with the RF interbudgetary relations system reforming

Concept, more activity shall be run for the development of the legal provisions for shaping and allocating the funds of the Regional Development Fund (RDF) and Fund for Regional Finance Development (FRFD).

In this respect it is highly recommended to take the following measures to raise efficiency in RDF and FRFD funds distribution.

1. The federal targeted programs recognized as expedient should be joined into the Regional Development Fund, while the proceeds of these funds distribution shall also be elaborated. The procedure of RDF funds distribution shall be worked out with regard to the fact, that the key application of the RDF funds consists in creating a social infrastructure, which is necessary at least for discharging the provisions set by the RF Constitution and the federal legislation.

2. It is also necessary to develop, and, consequently, to have a method settled by the Government according to which the FRFD funds will be distributed, the key goal of which is facilitating the reformations within the budgetary sector of the RF subjects. In accordance with the interbudgetary relations reforming Concept, the FRFD assignments, which are sourced from the credits provided by international financial organizations, are allocated on a repay basis and also as technical assistance for the preparation of measurements within the budget reforming field.

3. The shaping and disposal principles for the above funds are to be made part of the federal legislation, that would be in charge of regulating the interbudgetary relations in Russia.

Raising state funding efficiency for goods supply to the regions with a particular supply schedule¹⁰⁶. A basic expenditure item of the federal budget funds is constituted by the purposes of financial aid rendered to the budgets of the regions having a specific supply schedule (hereinafter referred to as «north supply»). These funds are aimed at financing the expenses of a pre-schedule supply of goods to the obliterated regions and territories, whereby 90% of the goods supplied are accounted for by fuel, supplied for housing and utilities and some institutions of the budgetary sphere. Since 2000, the transfers to the regional budgets for financing the «north supply» have been allocated on the basis of a unified method and are included in the FFSR transfers.

The applying system of the «north supply» being a specific kind of target support, it however inheres a number of disadvantages, the most significant of which are adduced below:

¹⁰⁶ For more detail on the problem of financial support to the northern regions, please, see the footnote referring to Radygin

1. The lack of effective control by the federal finance institutions over the tender performance for a strict funds distribution between the suppliers and the shipping agents.

2. The lack of control over the tariffication and pricing on the part of common utility suppliers. This brings along precedents, when the budget expenditures for the fuel, financed under «north supply» are dispersed within the costs of the utilities, whereby «the north supply» is paid twice by both the consumers and the federal budget.

To amend the shortcomings the following measures are to be taken:

The introduction of a reliable control system on the part of the federal authorities to be performed over the correctness of all the proceeds.

The affirmation of the tender end results for the distribution of the shipping orders at the federal level, whereby a refusal to grant an appropriation should be practised toward an RF Subject in case the tender results are argued.

The creation of a system of tariffic regulations for controlling the utility enterprises' activities, whereby the costs of the fuel obtained under «north supply» will be eliminated from the utility costs for a consumer.

Considering the fact, that the basis for the state financing of the «North supply» is constituted by extra budget expenditure obligations of the RF Subjects' locating hard-to-reach areas within their territories and associated with the necessity of preschedule goods supply, the «north supply» funding will be included in total for the federal aid to the RF subjects, allocated as FFSR transfers according to the rules unified for all the regions, with an objective respect to the budget expenditures.

Methods of transfer distribution from the Fund for Financial Support to the Subjects of the Russian Federation (basic items)

The research on Russia's interbudgetary system peculiarities and upon the impact exerted by the Program of the RF Government upon the regional finance status applied to the measures to be taken as projected by the experts, and to the analysis of the theoretical aspects of the interbudgetary relationships optimization as well as basing on the paper on estimating the fiscal capacity and evaluating the expenditure needs of the regional consolidated budgets, carried out under «The estimation of fiscal capacity and the budget expenditure needs of the RF subjects» CEPRA project, a number of suggestions were set forward for further perfection of the methods of FFSR transfer distribution.

On the whole, it can be assumed, that the basic items we are setting forward haven't undergone any changes regarding the principles of financial aid distribu-

tion: part of the Fund assets is allocated between the regions, for which the specific gross tax resources, drawn up to a comparable level, do not exceed the average value for Russia as a whole, proportionally to the deviation of the adduced tax resources from the average level for the RF subjects; another part is allocated in a way so as to bring the specific gross tax resources of the less prosperous regions (after the distribution of the first FFSR part) to one and the same level, which is the maximum possible one by the given FFPR level.

Of the modifications proffered, most comprised the principles of fiscal capacity and expenditure needs calculations for the RF Subjects, which are made use of while calculating the value of the transfer provided for the region. In contrast to the transfer distribution scheme currently applied, which hinges on the exogenous dependency of the rates calculated upon a number of factors having a wide scope of adjusting ratio, the given scheme of fiscal capacity and expenditure needs calculation is based upon the results of econometric modeling for regional tax revenues and budget expenditures. An approach like that seems to be the one meeting the interbudgetary equalization requirements to a major degree.

The formulae for gross tax resources calculation, which are subject to the factor values determinant for accruing major tax revenues of the RF subjects (value-added tax, income tax, personal income tax, etc.), are set forward within the scheme. The above tax revenues are calculated according to the formulae obtained by the regressive calculation of tax revenue dependency upon a number of factors. The factors determining a RF subject's per capita average for fiscal capacity embrace such values as the actual salary reduced by per capita debt growth value, per capita average cash revenues in the region, per capita gross regional product, and per capita enterprise and utility benefit. Table 1 depicts the variety of regional tax revenues, which lay the basis for fiscal capacity calculation, as well as the factors involved therein.

TABLE 1. FACTORS OF REGIONAL FISCAL CAPACITY DIFFERENTIATION.

| Tax revenues | Factors |
|------------------------|--|
| 1. Personal income tax | 1. Actual salary reduced by per capita debt growth value. |
| 2. Company income tax | 2. Per capita cash revenues. |
| 3. Other taxes | 1. Per capita revenues gained by enterprises and utilities |
| | 1. Per capita gross regional product. |

The scheme-based estimation of a region's expenditure needs for the sake of transfer distribution is constituted by eight key expenditure items: housing and utilities, health care, education, culture and arts, law-enforcement activities, transport, state administration, and social policy. The items in the expenditures of

the regional budgets, which are at the basis of expenditure need guideline calculations, and the factors involved therein are represented by Table 2.

TABLE 2. FACTORS OF REGIONAL BUDGET EXPENDITURE GUIDELINE

DIFFERENTIATION.

| Kinds of budget expenditures (per capita) | Factors |
|--|--|
| 1. Housing and utilities | 1. Actual budget revenues of the RF subjects. 2. Municipal share of the housing fund. 3. The number of enterprises and companies within the RF subject * 4. The urban population share of total for the population of the RF subject. 5. Living standard value for the RF subject. |
| 2. Transport and Communications | 1. Actual budget revenues of the RF subjects. 2. The urban population share of total for the population of the RF subject. 3. Passenger-miles for public buses in the RF subject. |
| 3. Culture and art. | 1. Actual budget revenues of the RF subjects. 2. Newspaper and magazine supply available for the population in the public libraries (the number of newspaper and magazines in the public libraries). 3. Living standard value for the RF subject. 4. The elderly people percentage of total for the population of the RF subject. |
| 4. State government | 1. Actual budget revenues of the RF subjects. 2. The urban population share of total for the population of the RF subject. 3. The total population of the RF subject. 4. Actual salary average for the RF subject. Living standard value for the RF subject. |
| 5. Education. | 1. Budget revenues of the RF subjects. 2. Schools available for the population in the RF subject. (the number of people per one school) 3. Living standard value for the RF subject. |
| 6. Health care | 1. Actual budget revenues of the RF subjects. 2. Medical-nurse staff available for the population (the number of medical nurses per capita). 3. Actual salary average for the RF subject. 4. Living standard value for the RF subject. 5. Sickness rate in the RF subject (per capita sickness rate) |
| 7. Social policy. | 1. Actual budget revenues of the RF subjects. 2. Living standard value for the RF subject. 3. Average city-size in the RF subject. Urban population against the number of cities in the RF subject) |
| 8. Juridical activity | 1. Actual budget revenues of the RF subjects. 2. Living standard value for the RF subject. |

* per capita.

To simplify the scheme application, aggravated by the representative inconsistency of the indices calculated, the standard expenditures for each item are de-

fined as a multiplication of co-efficient adjusting to the factor value deciding for the budget expenditures within this item For these purposes, the adjustment factors' values were tabulated for each expenditure item.

SUPPLEMENT 1. THE MODIFICATIONS IN BOTH TAX REVENUE DISTRIBUTION AMONG THE LEVELS OF THE BUDGETARY SYSTEM AND TAX AUTHORITY DISTRIBUTION AMONG THE LEVELS OF STATE GOVERNMENT ACCORDING TO THE PLAN OF THE RF GOVERNMENT ACTIVITY.

| Tax | The distribution of tax revenues among the budget system levels,% | | | The level of state government responsible for... | | |
|--|---|--------------------------------|---------------|--|------------------|------------------|
| | The Federal budget | The budgets of the RF subjects | Local budgets | Tax introduction | Tax base outline | Tax rate setting |
| Federal taxes | | | | | | |
| Company income tax (the federal share ranges at 11%-10% rate) | 100 | 0 | 0 | Φ | Φ | Φ |
| Personal income tax | 1 / 0 | 99 / 100 | 0 | Φ | Φ | Φ |
| Gambling tax (federal share) | Min. Federal rate | 0 / 100 | | Φ | Φ | Φ / P |
| Value-added tax | 100 | 0 | 0 | Φ | Φ | Φ |
| Excises for commodities and some mineral raw materials produced on the territory of the Russian Federation | 100 50 / 100 | 0 50 / 0 | 0 0 | F | F | F |
| Excises for commodities imported into the Russian Federation | 100 | 0 | 0 | F | F | F |
| Currency-purchase tax | 60 / 100 | 40 / 0 | 0 | F | F | F |
| Legacy and gift taxes | 0 | 0 | 100 | F | F | F |
| Security transfer taxes | 100 | 0 | 0 | F | F | F |
| Severance tax | | | | F | F | F |
| - for hydrocarbon raw material output | 40 (20) [†] / 80 (70) | 30 (50) / 20 (30) | 30 / 0 | F | F | F |
| - for other natural resources output (rare natural resources) | 25 (12,5) / 60 (50) | 25 (37,5) / 20 (30) | 50 / 20 | F | F | F |
| - for common natural resources output, taxes raised for the exploration and development of the lands rich in natural resources | 0 | 0 | 100 | F | F / R | F / R |
| - for federal sea resources | 60 | 40 | 0 | F | F | F |
| - for coast sea- shelf | 100 | 0 | 0 | F | F | F |
| - for underground water output | 40 / 0 | 60 / 100 | 0 | F | F | F / L |
| - for mineral resource base reproduction | 30 / 0 | 30 / 0 | 0 / 0 | F / - | F / - | F / - |

| Tax | The distribution of tax revenues among the budget system levels,% | | | The level of state government responsible for... | | |
|--|---|--------------------------------|---------------|--|------------------|------------------|
| | The Federal budget | The budgets of the RF subjects | Local budgets | Tax introduction | Tax base outline | Tax rate setting |
| Foreign trade and overseas business taxes | 100 | 0 | 0 | F | F | F |
| State tax | | | | F | F | F |
| License and registration fees | 100 | 0 | 0 | F | F | F |
| Highway taxes | 100 | 0 | 0 | F | F | F |
| Regional taxes | | | | | | |
| Regional share of company and enterprise income tax (within the range from 19/20% (25%) for banks, stock-exchanges, etc.up to 27%) | 0 | 100 | | F | F | R |
| Casino business tax (exceeding minimum federal rate) | 0 | 100 | 0 | F | F | R |
| License and registration fees collected by the RF subject's budget | 0 | 100 | 0 | F | F | F |
| Sales tax | 0 | 40 / 0 | 60 / 0 | F / - | F or R / - | R / - |
| Single tax for total small business revenues | | | | R | F and R | F and R |
| Single tax for company revenues | 25 to FB + 25 to | 50 | | R | F and R | F and R |
| Single tax for private business revenues | 25 in ББФ | 75 | | R | F and R | F and R |
| Company net worth tax | 0 | 50 | 50 | F | F | R(F) |
| Forest taxes | 0 | 100 | 0 | F | F | R |
| Use tax on water | 0 | 100 | 0 | F | F | R(F) |
| Standard and substandard pollution tax | 0 | 100 | 0 | F | F | R |
| Local taxes and fees | | | | | | |
| Personal property tax | 0 | 0 | 100 | F | F | L(F) |
| Land tax | 30 / 0 | 20 / 50 | 50 / 50 | F | F | R and L (F) |
| Health resort tax | 0 | 0 | 100 | L | L | L |
| Target personal, company, and enterprise tax | 0 | 0 | 100 | L | F | L(F) |
| Commercials tax | 0 | 0 | 100 | L | F | L(F) |
| Alcohol and beer license fee | 0 | 0 | 100 | L | F | F |
| Other license and registration fees collected by local budgets | 0 | 0 | 100 | L | L and F | L |
| Other local taxes and fees | 0 | 0 | 100 | | | |

Notes: the levels of authority: F- federal, R – regional, L – local. R(F) and L(F) mean that the administration activity is possible only within federal restrictions.

Mark: “current situation/the order suggested”

- in brackets – the budget share in case there is an autonomous district within the RF subject.

Chapter 6. Fiscal Federalism in Germany

A. Federalism in Germany: the Constitutional and Political Context

The Federal Republic of Germany established in 1949 has firm historical roots in the earlier experience of the German Empire (1871-1918), the Weimar Republic (1919-34), the failure of the totalitarian centralization of the Third Reich (1934-45), and the immediate postwar influence of the allied occupying powers. In 1949, the eleven Länder of West Germany became the Federal Republic of Germany. Thirty-one years later, the reunification of Germany in 1990 provided for the accession of five new Länder from what had previously been the Democratic Republic of Germany. The federation, therefore, now consists of sixteen Länder with a total population of over 80 million. The population of the German federation is linguistically homogeneous, although there remains considerable economic disparity and difference in political cultures between the former West and East Germanies.

A notable characteristic of the German federation, by comparison with the Canadian and United States federations, is the extensive constitutional and political interlocking of the federal and state governments. The federal government has a very broad range of exclusive, concurrent (with federal law prevailing) and framework legislative jurisdiction. But the Länder in turn have a mandatory constitutional responsibility for applying and administering most of these federal laws. While the legislative powers of the federal government are much more extensive than in Canada or the United States, another significant feature of the German federation is that the Länder are more directly involved in decision-making at the federal level than the states or provinces in virtually any other federation. This is achieved through the constitutional requirement that the second chamber, the Bundesrat, is composed of Land first ministers and senior ministers serving as *ex officio* delegates of their Land governments. The Bundesrat possesses an absolute veto on all federal legislation affecting the Länder. In practice about 60 percent of federal legislation falls in this category and therefore the voice of the Länder through the Bundesrat is highly influential in federal policy-making. Thus, the Bundesrat is a key institution in the interlocking federal-state relationship and the extensive joint decision-making that occurs within the German federation including those on financial interrelationships.

Both the Federal and Land institutions are organized on the principle of parliamentary responsible cabinets, with the Chancellor at the federal level and a Minister President in each Land as the heads of government accountable to their legislatures. In addition there is a formal head of state with largely ceremonial powers, the President of the Federal Republic, who is elected by an electoral college consisting of the Bundestag and an equal number of members elected by the legislatures of the Länder.

Fiscal federalism in the German federation is of particular interest because of the way they relate to the closely interlocked legislative and administrative powers of the two orders of government, and because of the unique way in which the Länder participate in federal decision-making through their representation in the Bundesrat. This makes the Bundesrat a key institution in the highly integrated legislature, administrative and financial interdependence of the two orders of government.

1. Constitutional Status of Various Orders of Government

The Federal Republic of Germany consists of a federal (Bund) government, 16 Land (state) governments, and numerous municipal (or local) governments. All of the federal and Land governments are organised on the basis of the parliamentary system. There is a formal, indirectly elected head of state, the President of the Federal Republic.

The Federal and Land Legislatures

The fusion of legislative and executive branches of government within the federal and Land legislatures effectively transfers legislative power to the executive branch of government. However, unlike in the majoritarian Westminster model of parliamentarism, German governments are at both levels frequently composed of a coalition of two or more political parties. Therefore, government positions represent a compromise arrived at through a process of inter-party bargaining within the governing coalition.

One of the most distinctive features of the German system of government is the Bundesrat, the Upper House of the federal legislature. The membership consists of *ex officio* delegates of the Land governments each Land delegation voting as a block under direction from its government. Thus, the governments of the Länder are directly involved in the federal decision-making process. The Bundesrat holds an absolute veto on all legislation affecting the Länder; in practice about sixty percent of all federal legislation falls into this category because the Länder

are responsible for administering all federal legislation in areas of concurrent jurisdiction. The Bundesrat has a suspensive veto on all other federal legislation. The institutional position of the Bundesrat produces what is commonly referred to as an 'interlocking' relationship between the Federal and Land orders of government.

The Bundestag, the Lower House of the federal parliament, is elected via a mixed electoral system. The voter casts two ballots, one for a constituency member, and one for a political party. Constituency members are elected on a first past the post basis, while the party list members are elected on a proportional basis. The result is that the party membership of the Bundestag very closely matches the party vote distribution. A party must, however, receive at least five percent of the vote or win at least three constituency seats in order to be represented in the Bundestag; this rule discourages a splintering of the vote.

Following an election where, as is often the case, no party emerges with a majority, there is a period of inter-party bargaining as parties negotiate the terms of agreements to form a governing coalition. The leader of the party with the most seats becomes the Chancellor, or in the Länder Minister President; cabinet posts are allocated among the parties to the coalition as negotiated in the coalition agreements. While there is frequently ongoing inter-party tension within the governing coalition, parties have honoured their coalition agreements and thus stable governments have been the norm.

Land legislatures are unicameral, with the exception of bicameral Bavaria. The relationship between the executive and the legislature (Landtag) is the same as it is in the federal Bundestag. In the three historic free cities (Berlin, Bremen, and Hamburg) the Landtag is also the city council, and the mayor is head of the government.¹⁰⁷

The Courts

The Federal Constitutional Court is established under the constitution, and has comprehensive jurisdiction over all questions of federal constitutional law. It is not, however, a court of general appeals as are the Supreme Courts of Canada and the United States, but rather only determines constitutional questions. It is assigned the following functions: the judicial review of legislation, the adjudication of disputes between Land and Bund political institutions, the protection of individual civil rights as constitutionally guaranteed, and the protection of the

¹⁰⁷ Daniel Elazar, *Federal Systems of the World: A Handbook of Federal, Confederal and Autonomy Arrangements* (Harlow, Essex, UK: Longman, 1991), 105

constitutional and democratic order against groups and individuals seeking to usurp it.¹⁰⁸ Half the members of the Constitutional Court are appointed by the Bundesrat on behalf of the Länder and half by the Bundestag. In both cases two-thirds majorities are required.

With the exception of seven national courts of appeal, all regular tribunals are Land courts, established and administered by Land statutes.¹⁰⁹ However, they apply a unified national legal code.

Constitutional Status of the Federal and Land Governments

The Basic Law explicitly states that all state authority emanates from the people, and that the organs of government are simply the means via which the people exercise their authority.(Article 20(2) As well, the federal nature of the German state is guaranteed by the Basic Law: the so-called ‘eternity clause’ of the Basic Law prohibits amendments which would abolish the Länder.(Article 79(3)

Two fundamental features of the distribution of powers are worthy of note. First, the Basic Law allocates legislative jurisdiction on the basis of an exclusive list of federal powers and a list of concurrent powers, with the residual power remaining with the Länder.¹¹⁰ Exclusive federal legislative power is granted in areas which include foreign affairs and defence, citizenship and immigration, rail and air transport, criminal policing, and foreign trade.(Article 73) An extensive list of areas of concurrent legislative jurisdiction includes such areas as civil and criminal law, the regulation of nuclear energy, labour relations, environmental protection, and road transport.(Article 74)

There are also two additional special categories of concurrent powers in the Basic Law. First, the federal government may under its ‘framework’ powers restrict the exercise of Länder legislative authority, to a limited extent, in certain fields.(Article 75) In these fields, the federal government has the right to enact framework legislation aimed at providing a degree of uniformity of action across the federation; within these parameters, the Länder have the right to enact customized, detailed laws. Framework legislative fields include areas such as higher education, nature conservation, and regional planning. Second, there is a consti-

¹⁰⁸ David P.Conradt, *The German Policy* (5th ed.; New York: Longman, 1993), 183

¹⁰⁹ Conradt, 181

¹¹⁰ Ronald L. Watts, *Comparing Federal Systems* (2nd ed.; Montreal and Kingston: McGill-Queen’s University Press, 1999), 37-39.

tutional provision for the federal and Land governments to carry out 'joint tasks' together. These areas include university construction, regional policy, agricultural structural policy and coastal preservation, education planning, and research policy.

A second notable feature of the German division of powers relates to the distribution of administrative authority. In the Anglo-American federations, the general principle is constitutionally mandated legislative-administrative coincidence.¹¹¹ That is, the order of government that has legislative jurisdiction over a policy area also has administrative responsibility for that area. In the German federation, by contrast, the Land governments are largely responsible for the administration of legislation, whether that legislation originates at the federal or Land level. Thus it is possible to have a relatively high degree of legislative centralization, while retaining a high degree of administrative decentralization. Constitutional protection of the administrative role of the Länder serves as a bulwark against thorough-going centralization of the federation.

Local Governments

Local government autonomy is constitutionally guaranteed.¹¹² The local government bodies which carry out many of the administrative tasks attributed to the Länder thus have their status protected, even to the degree of raising legal questions concerning that status before the Federal Constitutional Court. However, the organization and supervision of local governments falls within the legislative sphere of the Länder.

2. Constitutional Allocation of Revenue and Expenditure Responsibilities and Provisions Related to Intergovernmental Transfers

The German constitution is quite specific in regard to issues of fiscal federalism. Separate articles of the Basic Law assign competency for legislation, for administration, for revenue-raising, and for expenditure among orders of gov-

¹¹¹ Ronald L. Watts, "German Federalism in Comparative Perspective," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification* (London: Pinter, 1999), 272.

¹¹² Uwe Leonardy, "The Institutional Structures of German Federalism", in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 12.

ernment.¹¹³ In general, legislative power lies at the federal level, administrative responsibility primarily at the Land level, and revenue-raising and expenditure powers are shared. As regards the federal legislative power, however, the role of the Bundesrat in federal decision-making must be borne in mind.

Constitutional Allocation of Revenue

As assignment of tax revenue is determined by the constitution, only minor adjustments in these assignments can be made by legislation, while major adjustments require constitutional amendments.

While the Basic Law distinguishes between the right of each layer of government to legislate on specific taxes, and the right to appropriate the proceeds of taxes, in practice the two are tied together. The exclusive federal power to legislate on taxes is restricted to customs duties and fiscal monopolies.(Article 105 (1))The power to legislate on all taxes the revenue from which is shared is concurrent; in practice, this means that the Länder can use the federal Bundesrat as their vehicle for shaping federal tax legislation.¹¹⁴

The major feature of German revenue-raising arrangements is constitutionally-mandated sharing of tax revenues. All of the most important revenue sources are shared. Together, the wage and assessed income taxes, the corporation income tax, and the general sales, or value added tax (VAT), make up about three-quarters of total tax revenue, and the proceeds of all are shared.¹¹⁵

Personal Income Taxes

The constitution mandates that the proceeds of the personal income tax are shared among the Bund, Land, and local orders of government.(Article 106(3)) The federal and Land orders of government each receive 42.5 percent of the proceeds, with the remaining 15 percent accruing to local governments.

Corporate Income Taxes

Corporate income tax is constitutionally mandated to be shared equally between the Federal and Land governments.(Article 106(3))

Sales Taxes

The proceeds of the VAT are constitutionally mandated to be shared between the Bund and Land orders of government, but the respective shares are

¹¹³ Paul Bernd Spahn and Wolfgang Föttinger, "Germany," in Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington: International Monetary Fund, 1997), 239.

¹¹⁴ Leonardy, "Institutional Structures", 15.

¹¹⁵ Spahn and Föttinger, 229.

determined by federal legislation. The ratio is reviewed every two years, and adjusted if necessary in light of changing financial needs; this provides an important element of flexibility in fiscal arrangements. At present, the allocation ratio is 56:44, for the Federation and Länder respectively.

Constitutional Allocation of Expenditure Responsibilities

The relatively centralized system of revenue-raising is counterbalanced by a relatively decentralised system of expenditure. Land administration of both Federal and Land legislation means that the vertical division of legislative competences is not reflected in the distribution of administration and hence of expenditures among orders of government.¹¹⁶ Thus, expenditures for areas as varied as social policy and investment in infrastructure are made by all orders of government.

Constitutional Provisions Related to Intergovernmental Transfers

Intergovernmental transfers in Germany flow both from the Federal government to the Länder, and among the Länder. These transfers fall into two broad categories: specific grants, and equalization transfers.

Specific grants flow from the Federal government to the Länder for projects under the 'joint tasks' category, for reimbursement of Länder for federally mandated expenditures, and for specific projects related to the creation of uniformity of living conditions. These payments are made in accordance with Articles 91a and 104a. These are dealt with in details in section C below.

Equalization transfers consist of two elements.¹¹⁷ First, there is an interstate revenue pool into which richer Länder pay and from which poorer Länder draw according to specified criteria and a set formula. The criteria are set, under Article 104a, as the necessity to avert disturbance of overall economic equilibrium, to equalize economic capacity, or to promote economic growth. Second, there are federal supplementary payments made to the poorer Länder based on a fixed percentage of the VAT(Article 106(3),(4); Article 107).

¹¹⁶ Ibid., 228

¹¹⁷ Ronald L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston:Institute of Intergovernmental Relations, 1999), 27.

3. Constitutional or Other Spending Power Provisions

The constitutional allocation of expenditure responsibilities to the federal government is explicit, but limited. The Federal government is permitted to spend in certain areas of Länder jurisdiction.¹¹⁸ The Federal government may participate in the areas of the 'joint tasks' provided that this participation is relevant to the community as a whole and that such participation is necessary to improve living condition.(Article 91a(1)) As well, where the Länder are obliged to expend funds to meet the requirements of a federal law, the Federal government is obliged to provide compensation.(Article 104a(2))

There are, however, legal limits on the power of the federal government to spend in areas of Land jurisdiction.¹¹⁹ First, specific projects to be undertaken under the 'joint tasks' provision must be defined in detail in federal law. Such legislation must gain the consent of a majority of votes in the Bundesrat. Second, any transfer payments authorized under Article 104a also require the Bundesrat's consent.

4. Politics and Legal Dynamics- Including the Role of Law and Role of Politics in the Decision-Making Processes

The German federal constitutional system attempts to achieve a balance between diversity and unity by utilising a federal structure, but with the societal goal of uniform living conditions across the federation.

The achievement of a common standard of living throughout the country has been a stated goal in the Federal Republic of Germany since federation.¹²⁰ Indeed, the achievement of 'uniformity of living conditions' was a principle entrenched in the Basic Law until 1994. It was considered a guiding tenet of the West German state that, although it was organised federally, all institutions should be oriented toward uniformity.¹²¹ The primary impetus behind this philosophy was the belief that the general population, regardless of their territorial position, had essentially undifferentiated demands and expectations in regard to social conditions. Uniformity became a powerful norm permeating all relation-

¹¹⁸ Ibid., 25

¹¹⁹ Ibid.

¹²⁰ Uwe Leonardy, "German Federalism Towards 2000: To be Reformed or Deformed?," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 297.

¹²¹ Hartmut Klatt, "Forty Years of German Federalism: Past Trends and New Developments," *Publius* 19 (1986), 186-87.

ships between, and actions of, both orders of government. This contrasts sharply with the traditional greater emphasis in the United States upon state autonomy and individual initiative as higher values.

Adjustments in the balance between the achievement of uniform living conditions and the maintenance of a federal system are accomplished by means of constitutional amendment, intergovernmental relations, and judicial review. Amendment of the German constitution requires only special majorities in the two houses of the federal parliament; it must be noted, however, that because the Bundesrat is composed of *ex officio* delegates of the Land governments, this process in effect entails agreement of a special majority of the Land governments. This process has proved relatively flexible, allowing 46 amendments during the first 50 years of the federation. These amendments have included the strengthening of the Bund's legislative and financial roles in the period 1967-9, and the reunification of Germany in 1990.

In the aftermath of reunification in 1990 there was a felt need to further adjust the constitutional basis of the federation. The western Länder believed that the addition of the economically-dependent eastern Länder and the ongoing process of European Union (EU) integration put them in danger of losing ground to the federal government.¹²² The Constitutional Reform Act of 1994 was the answer to these concerns. Among the changes were the strengthening of the Bundesrat's role in German policy-making in relation to the EU, the placing of a greater onus on the federal government to justify its use of its concurrent and framework legislative powers, additions to the administrative powers of the Länder, and expansion of the areas over which the Bundesrat has veto powers.¹²³ While the effects of these changes are complex, it appears that the position of the Länder, especially in regard to their institutional privileges as represented by the Bundesrat, was further enhanced.¹²⁴

While Germany has been relatively successful in using incremental constitutional amendment as a means of adjustment in the federation, however, the particular characteristics of the German distribution of powers necessitate intensive and ongoing coordination among orders of government. Thus, an extensive sys-

¹²² Hans-Peter Schneider, "German Unification and the Federal System: The Challenge of Reform," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 69-70.

¹²³ Werner J. Patzelt, "The Very Federal House: The German Bundesrat," in Samuel C. Patterson and Anthony Mughan, eds., *Senates: Bicameralism in the Contemporary World* (Columbus Ohio, USA: Ohio State University Press, 1999), 75-79.

¹²⁴ *Ibid.*, 78.

tem of intergovernmental relations is a prominent feature of the German political decision-making processes.

Intergovernmental relations occur in the context of a tension between parliamentary government and federalism. During periods when there are differing party majorities in the Bundestag and Bundesrat, the second chamber sometimes acts as an alternative opposition. Parallels are sometimes drawn with the U.S. pattern of 'divided government'. This can complicate the processes of intergovernmental relations.

Role of Law in the Decision-Making Process

The two processes noted in the previous section have played a large role in the resolution of issues affecting both the overall federal system and the fiscal arrangements within that system. These include the processes of incremental constitutional amendment, and the non-constitutional processes of adjusting of responsibilities according to the principle of concurrency and the intricate bargaining processes of intergovernmental relations. The courts have also played a role in the evolution of German federalism.

Political life in Germany takes place to a high degree within, or with significant reference to, a legal framework. There is a tendency to attempt to frame actions within legal norms, to justify political actions with reference to constitutional or legal bases, and to seek to achieve binding conflict resolution via legal means. The decisions of the Federal Constitutional Court should be understood in this context.

The Federal Constitutional Court has provided a general support for federalism via the promulgation of the principle of federal comity.¹²⁵ This principle, advanced in one of the Court's earliest decisions, was held to create, for the Federal government in its relations with the Länder, and for the Länder in relations with each other and with the Federal government, a constitutional duty to cooperate sincerely in reaching common understandings. The principle covers not only the substance but also the style of conduct, and extends beyond the legal to the political sphere.¹²⁶ The effect is to oblige political actors to conduct political negotiations in a way which does not violate or weaken the federal nature of the German system of governance.

¹²⁵ Philip Blair and Peter Cullen, "Federalism, Legalism and Political Reality: The Record of the Federal Constitutional Court," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*. (London: Pinter, 1999), 132-33.

¹²⁶ Leonardy, "Institutional Structures", 20.

Given the wide area of concurrency in the division of powers, the Court has been important as a protector of Land jurisdiction; i.e., had the Court adopted a broad interpretation of federal power, the competences of the Länder would have been seriously compromised. The Court has chosen, however, to stress the importance of Articles 70 and 83 of the Constitution, which provide the residual power to the Länder and provide for Länder administration of federal law, respectively.¹²⁷ While the Court has sometimes been generous to the Federal government in cases concerning economic matters, even in this area the interpretation has been sufficiently narrow to protect Land privileges.

In general, the pattern of decision-making by the Court seems to indicate a desire to maintain a balance in the federal system, but with a tendency to protect the position of the Länder.

Reference Procedures

The Federal Constitutional Court has a broad power to consider referred cases.¹²⁸ The so-called 'abstract review of norms' allows the Court to determine if a norm of federal or Land law is in conformity with the Basic Law, and whether Land law is in conformity with federal law. References can be directly initiated by the federal government, a Land government, or by request of one third of the members of the Bundestag, without reference to a concrete case (Article 93).

It is not necessary for the issue in question to directly affect the party requesting the adjudication. Thus, it is relatively easy for governments to seek a judicial opinion on legislative provisions to which they object, even if the issue is not strictly a federal one. While this ease of access can be abused by governments or political parties for partisan purposes, this has not been seen as a major problem in the German system.

Appointments to the Courts

The federal principle in Germany extends to the selection of judges for the Federal Constitutional Court. One-half of the sixteen judges are selected by the Bundestag, and the other half by the Bundesrat. In each case, there is a requirement for a two-thirds majority vote to confirm a selection.

In practice, a special judicial selection committee of the Bundestag, composed of elite members of the political parties in proportion to their strength in

¹²⁷ Blair and Cullen, 123.

¹²⁸ *Ibid.*, 120.

the chamber, makes the Bundestag's selections. The Bundesrat's judiciary committee makes nominations to a plenary session of the Bundesrat. As Land delegations to the Bundesrat must vote on instructions, the Land governments retain a direct influence on the selections.

A procedure similar to that for the Federal Constitutional Court is used to select judges for all other federal courts.

Role of Politics in the Decision-Making Process

As noted, the peculiarities of the distribution of powers in the German system necessitates extensive intergovernmental coordination. This system of intergovernmental relations may be conceived of as having three levels.¹²⁹ The first is the level of the 'whole state' (*Gesamstaat*). This level comprises institutions in which both the Federal government (Bund) and the Länder are represented on terms of equal status. Decisions at this level must be made unanimously, via a process of accommodation and compromise; thus, discussions may end with only an agreement to disagree. The function of this level is to provide consultation and cooperation in all fields, but in particular in overlapping fields of competence.

The top institution in this category is the Conference of the Heads of Government of the Federation and the Länder. Meetings of this group occur about every four months. Agreements reached among Heads of Government may require the further approval of Federal or Land legislatures.

The second level of intergovernmental relations are those of the 'federal state' (*Bundesstaat*). This level comprises the constitutionally organised structure of interrelationships between the Federal and Land institutions. Decisions at this level are subject to simple or special majority decision-making rules. The subject matter of decisions made at this level must fall within the federal legislative field or, as in the case of 'joint tasks', be subject to federal procedures. The function of this level is to provide coordination and preparation for voting on legislation.

The Bundesrat is the key institution at this level. Its plenary sessions occur every third week, but committee work leading to these sessions is ongoing. An entire network of bodies supports the work of the Bundesrat, ranging from permanent advisory councils, to missions of the Länder staffed by Land civil servants. The latter provide a conduit for information flow between orders of government.

While decision-making via majority voting is the constitutionally-mandated rule in the Bundesrat, there has developed an institutional culture which puts a

¹²⁹ Leonardy, "Institutional Structures", 20.

premium on consensus. There is extreme reluctance on the part of the Länder to pass legislation over the serious objections of even a single Land.¹³⁰ There is thus a norm of negotiation to find a unanimously acceptable compromise, even if this means that agreement can only be achieved on the basis of the lowest common denominator. While such a norm may have questionable policy consequences, it conforms to the general culture of federal comity.

The 'third level' of intergovernmental relations consists of cooperation among the Länder, excluding the federal government. This level consists of institutions in which the Länder are represented on terms of equal status. Decisions must be unanimous, and may require the approval of the federal or Land legislatures. Matters discussed may fall within either or both of Federal and Land areas of legislative jurisdiction. The function of this level is to provide coordination not only in the preparation of legislation but also on processes of administration.

The highest ranking institution at this level is the Conference of Minister-Presidents of the Länder. The Conference convenes formally once per year, but informally almost monthly. Parallel meetings among ministers and officials with the same area of functional responsibility (i.e., health, justice, etc.) are ongoing.

Even this brief account should make it clear that intergovernmental relations are a prominent feature of the German system of governance. Political decision-making routinely entails complex processes of intergovernmental bargaining and compromise.

The Differences Among the Länder

Large differences in area and population existed among the Länder even before unification; in 1988 the city-state of Bremen, area 400 km² and population 650,000, had the same constitutional status as Bavaria, area 70,500 km², and North Rhine-Westphalia, population 16.8 million. The ability of such disparate economic units to bear symmetrical constitutional responsibilities, especially in the context of the goal of uniform living conditions, was often questioned. In the 1980s, increasing disparities in economic development among the Länder put financial pressure on the poorer Länder, and placed greater strain on inter-Länder bargaining over financial equalization.¹³¹ In the post-reunification period, the

¹³⁰ Fritz W. Scharpf, "the Joint-Decision Trap: Lessons from German Federalism and European Integration," *Public Administration* 66 (1988), 246.

¹³¹ Roland Sturm, "Party Competition and the Federal System: The Lembruch Hypothesis Revisited," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 201.

difficulties were made even more salient: economic disparities deepened, and were compounded by cultural differences among the former western and eastern Länder.

While initial transitional financial arrangements were made in the wake of reunification, and subsequent long-term adjustments made in the financial equalization system, differences in size, population, and level of economic development continue to generate disagreements among the Länder. The result has been a growing unease with the equalization system. The recipients believe the system is inadequate to their needs, as it aims mainly to equalize revenues from shared taxes, but does not take into adequate account the higher per capita expenditure requirements of the poorer Länder. Meanwhile, the contributors believe the system subsidises economic and financial mis-management among the poorer Länder, and penalises the Länder that are better economic managers.

Superimposed on these issues are concerns on the part of the richer Länder that the Federal government will exploit the weak position of the poorer Länder to gather more power to itself. They fear the Bund will use the 'golden leash' of supplementary funding to convince the poorer Länder to cede responsibilities to the Federal government. The result has been calls for the further reform of German federalism

5. Transparency and Accountability

Revenue and Expenditure Responsibilities of Governments

Despite the extensive constitutional specification of legislative, administrative, revenue-raising, and expenditure responsibilities, the German system of fiscal federalism exhibits a degree of complexity which is inimical to accountability and transparency.

The Länder are responsible for the most important administrative functions in German federalism, including the implementation of federal law. While there are provisions for the federation to provide financing of activities mandated by its legislation, and such legislation must pass through the Länder-controlled Bundesrat, it remains the case that Länder are consistently left with uncompensated administrative costs. For example, the Länder are responsible for the costs when they execute federal law as a matter of their own concern, (Article 83) and it is their responsibility to cover the administrative costs incurred by local govern-

ments in implementing legislation.(Article 104a(5))¹³² Only in situations in which the Länder are acting as agents of the Federal Government, as in some capital construction, are the costs covered by the federation, and even then ongoing administrative costs are a Länder responsibility. In addition, for some categories of co-financed projects, the Bundesrat has a veto only if one-quarter or more of the costs, excluding administrative costs, are to be met by the Länder(Article 104a(3)). Overall, the net result is that accountability is decreased, as the Länder ‘foot the bill’ for some federally mandated initiatives.

Beyond the accountability problems involved in the shifting of administrative costs from one order of government to the other, transparency is decreased by the complexity of the entire fiscal federal system. The interdependent network of shared taxes, equalization transfers, expenditure responsibilities, and even decision-making institutions renders it practically impossible for voters to identify which government is taxing or spending for particular purposes. Thus, in Germany the principles of subsidiarity, economic efficiency, and revenue equalization have largely trumped accountability.

B. A Summary of Federal and State Budgetary Relations in Germany

This section contains a description of the stylized facts and the relative magnitudes of federal and state (including local government) responsibilities and how they have evolved over time. This includes the shares of federal and state governments in public spending and revenue allocation as well as the importance of transfers between and among levels of government. Of particular significance is the impact of German unification on federal-state and state-state fiscal relations. Not only did the integration of the former east German states into the Federation seriously strain the extant system of intergovernmental fiscal relations, it also resulted in dramatic shifts in flows, especially federal-state flows through the allocation of the Unification Fund.

The German system of budgetary relations is dominated by the uniformity-of-living conditions principle noted in Section A of this report. This is articulated in Articles 72 and 106 of the Basic Law. Article 72 [Concurrent legislation of the Federation] reads:

¹³² Uwe Leonardy, “German Federalism Towards 2000: To be Reformed or Deformed?,” in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 295.

1. On matters within the concurrent legislative power, the Länder shall have the right to legislate so long as and to the extent that the Federation has not exercised its legislative power by enacting a law.
2. The Federation shall have the right to legislate on these matters if and to the extent that the establishment of equal living conditions throughout the federal territory or the maintenance of legal and economic unity renders federal legislation necessary in the national interest.

Article 106 [Apportionment of tax revenue] lists federal taxes, state taxes, and common (joint) taxes. As noted in Section A, most of the major tax sources are placed in the third category involving a constitutionally-mandated sharing of specific tax revenues. Of particular relevance here, Article 106(3) specifies that shares in the VAT shall be determined based on the following principles:

1. The Federation and the Länder shall have an equal claim to funds from current revenue to cover their necessary expenditures. The extent of such expenditures shall be determined with due regard to multi-year financial planning.
2. The financial requirements of the Federation and the [Länder] shall be coordinated in such a way as to establish a fair balance, to avoid excessive burdens on taxpayers, and ensure uniformity of living standards throughout the federal territory.

In many ways, German federalism emulates the unitary state. Intergovernmental fiscal relations are largely ruled by the so-called financial constitution, comprising Articles 104-115 of the Basic Law. Revenue apportionment is roughly commensurate with expenditure responsibility. In this regard, the balancing role of shares in VAT is particularly important.

Equal per capita distribution of VAT implies a fully equalized revenue source—so-called first-tier equalization. However, state-state equalization of income tax revenues—so called second-tier equalization—places an important function of the federal government in the context of federal systems such as Canada instead in the hands of the German states. Moreover, this operates as a net scheme.

Federal and State Shares of Total Public Spending and Government Revenues

Table B.1 provides data indicating the shares of federal and state governments in total public sector spending. These data include federal supplementary grants; that is, transfers in the form of supplementary grants to states are included as a component of federal spending. The provision in 1969 for negotiated chang-

es in federal and state shares of VAT in light of shifts in relative expenditure responsibilities obviated the need for supplementary grants to poorer states which had previously accommodated vertical fiscal imbalance. Following unification in 1990, however, allocation of the federally controlled German Unity Fund again increased the federal share in spending. As the former east German states have been integrated into state-state equalization, the federal share has again fallen. By the same token, the states' share in spending has risen.

Table B.2 provides data indicating the shares of federal and state governments in total public sector revenues. These data include federal supplementary grants. Again, transfers to states dropped with the 1969 arrangements on VAT allocation, increasing the states' share of revenues. Transfers to states increased in 1990 with the introduction of the German Unity Fund, financed in part through a federal income surtax¹³³ but also through a reallocation of VAT revenues in favour of the states, which increased the states' share.

TABLE B.1. FEDERAL AND STATE GOVERNMENTS SHARES (PERCENTAGES) OF TOTAL EXPENDITURES INCLUDING TRANSFERS (FEDERAL SUPPLEMENTARY GRANTS)

| Year | Federal | State | Year | Federal | State | Year | Federal | State |
|-------------|----------------|--------------|-------------|----------------|--------------|-------------|----------------|--------------|
| 1950 | 40.9 | 59.1 | 1974 | 36.7 | 63.3 | 1988 | 37.6 | 62.4 |
| 1955 | 40.5 | 59.5 | 1975 | 38.9 | 61.1 | 1989 | 37.7 | 62.3 |
| 1962 | 41.8 | 58.2 | 1976 | 38.8 | 61.2 | 1990 | 37.5 | 62.5 |
| 1963 | 41.6 | 58.4 | 1977 | 38.8 | 61.2 | 1991 | 41.6 | 58.4 |
| 1964 | 40.8 | 59.2 | 1978 | 39.0 | 61.0 | 1992 | 36.0 | 64.0 |
| 1965 | 41.2 | 58.8 | 1979 | 38.5 | 61.5 | 1993 | 36.4 | 63.6 |
| 1966 | 40.9 | 59.1 | 1980 | 37.6 | 62.4 | 1994 | 36.8 | 63.2 |
| 1967 | 43.2 | 56.8 | 1981 | 38.5 | 61.5 | 1995 | 36.7 | 63.3 |
| 1968 | 41.8 | 58.2 | 1982 | 39.1 | 60.9 | 1996 | 36.8 | 63.2 |
| 1969 | 41.6 | 58.4 | 1983 | 39.2 | 60.8 | 1997 | 36.6 | 63.4 |
| 1970 | 39.8 | 60.2 | 1984 | 39.1 | 60.9 | | | |
| 1971 | 38.7 | 61.3 | 1985 | 38.6 | 61.4 | | | |
| 1972 | 39.1 | 60.9 | 1986 | 37.8 | 62.2 | | | |
| 1973 | 38.0 | 62.0 | 1987 | 37.8 | 62.2 | | | |

Note: State governments are considered to be the sum of Länder (state) governments, local (gemeinden) governments and special-purpose associations (Zweckverbände).

Source: Author's calculations using data from Statistisches Bundesamt (Federal Statistical Office). Fachserie 14. R 3.1. 1997

¹³³ The German Unity Fund is discussed in detail in section C, p. 38.

TABLE B.2: FEDERAL AND STATE GOVERNMENTS SHARES (PERCENTAGES) OF TOTAL REVENUES AFTER THE DISTRIBUTION OF SHARED TAXES AND INCLUDING TRANSFERS (FEDERAL SUPPLEMENTARY GRANTS)

| Year | Federal | State | Year | Federal | State | Year | Federal | State |
|-------------|----------------|--------------|-------------|----------------|--------------|-------------|----------------|--------------|
| 1950 | 40.2 | 59.8 | 1974 | 36.7 | 63.3 | 1988 | 35.2 | 64.8 |
| 1955 | 45.3 | 54.7 | 1975 | 36.1 | 63.9 | 1989 | 36.8 | 63.2 |
| 1962 | 41.8 | 58.2 | 1976 | 36.4 | 63.6 | 1990 | 36.8 | 63.2 |
| 1963 | 41.5 | 58.5 | 1977 | 36.4 | 63.6 | 1991 | 39.3 | 60.7 |
| 1964 | 41.9 | 58.1 | 1978 | 36.6 | 63.4 | 1992 | 35.3 | 64.7 |
| 1965 | 42.7 | 57.3 | 1979 | 36.8 | 63.2 | 1993 | 34.5 | 65.5 |
| 1966 | 42.0 | 58.0 | 1980 | 36.4 | 63.6 | 1994 | 35.8 | 64.2 |
| 1967 | 41.4 | 58.6 | 1981 | 36.7 | 63.3 | 1995 | 35.9 | 64.1 |
| 1968 | 40.8 | 59.2 | 1982 | 37.2 | 62.8 | 1996 | 34.4 | 65.6 |
| 1969 | 41.7 | 58.3 | 1983 | 37.4 | 62.6 | 1997 | 34.6 | 65.4 |
| 1970 | 41.5 | 58.5 | 1984 | 37.3 | 62.7 | | | |
| 1971 | 40.7 | 59.3 | 1985 | 37.4 | 62.6 | | | |
| 1972 | 39.0 | 61.0 | 1986 | 36.7 | 63.3 | | | |
| 1973 | 38.3 | 61.7 | 1987 | 36.2 | 63.8 | | | |

Note: State governments are considered to be the sum of Länder (state) governments, local (gemeinden) governments and special-purpose associations (Zweckverbände)

Source: Author's calculations using data from Statistisches Bundesamt (Federal Statistical Office), Fachserie 14. R3.1, 1997

Transfer Payments from the Federal to State Governments

Table B.3 shows transfers from the federal government as a percentage of revenues by state. The message is clear: the states rely on the federal government for only a small percentage of their revenues; for the former east German states, however, these transfers are of considerable significance. Indeed, the data also show a marked increase in the significance of the federal government since reunification and the dramatic impact of federal supplementary grants on some states revenues.

Table B.3(b) shows state-state transfers as a percentage of revenues by state.

What is notable from the table is the relatively small percentages of revenues involved in explicit state-state transfers.

TABLE B.3(A) SHARE OF FEDERAL TRANSFER PAYMENTS IN STATE TOTAL REVENUES
(PERCENTAGES)

| Year | Baden- Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg- Vorpommern | Niedersachsen | Nordrhein- Westfalen | Rheinland- Pfalz |
|------|-----------------------|--------|-------------|--------|----------------------------|---------------|-------------------------|---------------------|
| 1975 | 0 | 0.54 | | 0 | | 1.42 | 0 | 1.52 |
| 1980 | 0 | 0.61 | | 0 | | 1.58 | 0 | 1.79 |
| 1985 | 0 | 0.56 | | 0 | | 1.45 | 0 | 1.72 |
| 1990 | 0 | 0 | | 0 | | 2.78 | 0.00 | 2.50 |
| 1992 | 0 | 0 | | 0 | | 2.70 | 0.01 | 2.77 |
| 1993 | 0 | 0 | | 0 | | 2.90 | 0.01 | 3.16 |
| 1994 | 0 | 0 | | 0 | | 3.09 | 0 | 3.42 |
| 1995 | 0 | 0 | 11.81 | 0 | 12.10 | 2.07 | 0 | 3.69 |
| 1996 | 0 | 0 | 11.55 | 0 | 11.75 | 2.19 | 0 | 3.43 |

| Year | Saarland | Sachsen | Sachsen- Anhalt | Schleswig- Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|--------------------|------------------------|-----------|--------|--------|---------|
| 1975 | 1.57 | | | 1.58 | | 0 | 0 | 0 |
| 1980 | 1.78 | | | 1.77 | | 0 | 0 | 0 |
| 1985 | 2.94 | | | 1.86 | | 0 | 0 | 0 |
| 1990 | 5.33 | | | 2.97 | | 0 | 4.10 | 0 |
| 1992 | 6.00 | | | 2.86 | | 0 | 9.42 | 0 |
| 1993 | 6.17 | | | 3.01 | | 0 | 9.97 | 0 |
| 1994 | 20.81 | | | 2.43 | | 0 | 22.90 | 0 |
| 1995 | 21.95 | 10.76 | 11.87 | 1.81 | 12.00 | 9.85 | 24.12 | 0 |
| 1996 | 21.40 | 10.61 | 11.76 | 1.83 | 12.03 | 10.60 | 24.24 | 0 |

Source: Author's calculations using data from Statistisches Jahrbuch 1998, tables 20.1.3 and 20.1.4.

TABLE B.3(B) SHARE OF HORIZONTAL EQUALIZATION PAYMENTS IN STATE TOTAL REVENUES (PERCENTAGES)

| Year | Baden-Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg-Vorpommern | Niedersachsen | Nordrhein-Westfalen | Rheinland-Pfalz |
|------|-------------------|--------|-------------|--------|------------------------|---------------|---------------------|-----------------|
| 1975 | -2.26 | 1.13 | | -1.17 | | 3.43 | -0.88 | 2.71 |
| 1980 | -3.29 | 0.82 | | -1.14 | | 2.36 | -0.11 | 1.57 |
| 1985 | -2.65 | 0.05 | | -2.23 | | 2.15 | 0.11 | 2.00 |
| 1990 | -3.61 | -0.05 | | -3.52 | | 4.13 | -0.06 | 2.18 |
| 1992 | -1.92 | 0.06 | | -3.83 | | 2.37 | 0.00 | 2.54 |
| 1993 | -1.24 | -0.01 | | -4.25 | | 1.79 | 0.02 | 2.91 |
| 1994 | -0.50 | -0.69 | | -3.61 | | 1.68 | 0.12 | 2.44 |
| 1995 | -3.39 | -2.51 | 3.91 | -4.31 | 4.72 | 0.79 | -2.50 | 0.11 |
| 1996 | -3.02 | -2.88 | 4.58 | -6.12 | 5.10 | 0.94 | -2.24 | 0.83 |

| Year | Saarland | Sachsen | Sachsen-Anhalt | Schleswig-Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|----------------|--------------------|-----------|--------|--------|---------|
| 1975 | 5.97 | | | 3.14 | | 0 | 1.71 | -7.22 |
| 1980 | 6.47 | | | 2.80 | | 0 | 4.49 | -3.06 |
| 1985 | 6.63 | | | 4.16 | | 0 | 7.07 | -3.20 |
| 1990 | 5.34 | | | 3.49 | | 0 | 10.25 | -0.05 |
| 1992 | 5.52 | | | 2.02 | | 0 | 6.93 | 0.00 |
| 1993 | 5.36 | | | 0.90 | | 0 | 8.91 | 0.68 |
| 1994 | 4.63 | | | 0.34 | | 0 | 6.21 | 0.36 |
| 1995 | 1.94 | 4.24 | 4.64 | -0.65 | 4.65 | 11.16 | 6.37 | -0.64 |
| 1996 | 2.51 | 4.64 | 5.08 | 0.07 | 5.16 | 12.29 | 7.26 | -2.74 |

Source: Author's calculations using data from Statistisches Jahrbuch 1998, tables 20.1.3 and 20.1.4.

Vertical Fiscal Imbalances

The vertical fiscal imbalance (VFI) indicates an imbalance between federal (state) revenues and expenditure responsibilities. A large VFI indicates that the states rely heavily on the Federation for transfers to finance their expenditures. Since 1969, VFI has been only a transient issue in German federalism. Previously, special allocations had bridged the gap on an equalizing basis. As mentioned, the need for this system was obviated by the provision for periodic negotiation

between the Federation and the states of shares in value added tax (VAT) revenues, based on shifts in expenditure-revenue positions of the two tiers of government.

Table B.4(a) depicts the VFI for the federal and state governments. It is evident from the table that VFI became a more significant issue following unification. Generally, the data reflect the level of deficit financing, especially from the mid-1970s to mid 1980s. The Federal government, especially, was forced into deficit finance with the establishment of the German Unification Fund. Recall that this was to be financed partly through an income tax surtax and partly through debt, while the states' share of financing was partly offset by a transfer of shares in VAT revenues. Table B.4(b) depicts VFI by state. VFI is shown to be a significant problem for the former east German states.

TABLE B.4(A) VERTICAL IMBALANCES BETWEEN FEDERAL AND STATE GOVERNMENTS (PERCENTAGES)

*[(TOTAL EXPENDITURES - TOTAL REVENUES)/TOTAL EXPENDITURES]*100*

| Year | Federal | State | Year | Federal | State | Year | Federal | State |
|-------------|----------------|--------------|-------------|----------------|--------------|-------------|----------------|--------------|
| 1950 | 7.74 | 4.81 | 1974 | 7.75 | 7.62 | 1988 | 12.94 | 3.46 |
| 1955 | -16.11 | 4.45 | 1975 | 21.86 | 11.74 | 1989 | 6.85 | 3.35 |
| 1962 | 1.34 | 1.34 | 1976 | 17.14 | 8.29 | 1990 | 7.67 | 4.63 |
| 1963 | 4.24 | 3.87 | 1977 | 13.01 | 3.52 | 1991 | 13.10 | 4.37 |
| 1964 | 1.53 | 6.08 | 1978 | 13.86 | 4.76 | 1992 | 9.12 | 6.33 |
| 1965 | 2.92 | 8.98 | 1979 | 12.63 | 6.14 | 1993 | 14.48 | 7.03 |
| 1966 | 3.11 | 7.211 | 1980 | 12.70 | 7.90 | 1994 | 10.57 | 6.86 |
| 1967 | 11.81 | 4.93 | 1981 | 16.16 | 9.73 | 1995 | 10.31 | 7.13 |
| 1968 | 6.46 | 2.68 | 1982 | 15.28 | 8.32 | 1996 | 15.90 | 6.62 |
| 1969 | -1.44 | -1.24 | 1983 | 12.84 | 5.91 | 1997 | 13,17 | 5,37 |
| 1970 | -0.47 | 6.52 | 1984 | 11.28 | 4.35 | | | |
| 1971 | 1.16 | 9.26 | 1985 | 8.78 | 4.01 | | | |
| 1972 | 5.21 | 4.76 | 1986 | 8.83 | 4.48 | | | |
| 1973 | 2.26 | 3.46 | 1987 | 10.29 | 4.31 | | | |

Note: State governments are considered to be the sum of Länder (state) governments, local (gemeinden) governments and special-purpose associations (Zweckverbände)

Source: Author's calculations using data from Statistisches Bundesamt (Federal Statistical Office), Fachserie 14. R3.1, 1997

TABLE B.4(B) VERTICAL IMBALANCES OF STATE GOVERNMENTS (PERCENTAGES)
 $[(TOTAL EXPENDITURES - TOTAL REVENUES)/TOTAL EXPENDITURES] * 100$

| Year | Baden- Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg- Vorpommern | Niedersachsen | Nordrhein- Westfalen | Rheinland- Pfalz |
|------|-----------------------|--------|-------------|--------|----------------------------|---------------|-------------------------|---------------------|
| 1975 | 12.08 | 10.17 | | 15.17 | | 14.27 | 15.15 | 13.16 |
| 1980 | 8.81 | 4.34 | | 7.59 | | 8.86 | 13.31 | 8.26 |
| 1985 | 1.32 | 0.29 | | 2.43 | | 3.71 | 9.01 | 5.08 |
| 1990 | 2.97 | 3.53 | | 6.63 | | 5.95 | 5.63 | 5.88 |
| 1992 | 4.75 | 3.46 | 20.71 | 4.61 | 12.30 | 6.28 | 4.20 | 5.76 |
| 1993 | 3.64 | 2.05 | 21.02 | 5.16 | 15.09 | 8.04 | 6.28 | 7.08 |
| 1994 | 1.67 | 1.43 | 19.68 | 4.95 | 16.63 | 8.38 | 6.83 | 7.33 |
| 1995 | 5.99 | 2.63 | 12.30 | 7.23 | 12.68 | 9.55 | 6.92 | 7.66 |
| 1996 | 4.20 | 5.69 | 10.98 | 4.53 | 13.06 | 5.53 | 5.76 | 7.49 |
| 1997 | 2.77 | 5.28 | 7.75 | 5.66 | 9.34 | 5.82 | 7.87 | 8.74 |

| Year | Saarland | Sachsen | Sachsen- Anhalt | Schleswig- Holstein | Thuringen | Berlin | Bremen | Hamburg |
|------|----------|---------|--------------------|------------------------|-----------|--------|--------|---------|
| 1975 | 17.83 | | | 14.42 | | 7.68 | 23.65 | 11.51 |
| 1980 | 13.86 | | | 6.97 | | 4.71 | 20.30 | 6.41 |
| 1985 | 19.25 | | | 6.45 | | 1.10 | 14.59 | 5.17 |
| 1990 | 10.43 | | | 6.25 | | 5.47 | 10.91 | 6.87 |
| 1992 | 10.05 | 14.84 | 18.96 | 5.84 | 16.99 | 7.49 | 8.46 | 9.71 |
| 1993 | 12.45 | 11.87 | 18.23 | 6.24 | 16.54 | 13.72 | 15.96 | 12.06 |
| 1994 | -4.00 | 12.04 | 17.86 | 6.17 | 17.20 | 18.63 | -7.72 | 12.89 |
| 1995 | -1.84 | 7.63 | 13.74 | 7.82 | 10.86 | 22.73 | -0.73 | 7.94 |
| 1996 | -3.64 | 7.04 | 10.90 | 7.86 | 12.61 | 22.98 | 0.38 | 13.46 |
| 1997 | -4.40 | 5.00 | 12.89 | 6.57 | 9.79 | 9.00 | -1.18 | 7.33 |

Source: Author's calculations using data from Statistisches Jahrbuch 1998, tables 20.1.3

Horizontal Fiscal Imbalances

Different states have different fiscal capacities for delivering public services to their residents—that is, there are horizontal fiscal imbalances (HFIs). These can arise from both the expenditure and revenue sides of the budget. With respect to expenditures, the need for public services of different types can differ across states because of different demographic make-ups of the state populations. As well, costs of provision can differ. On the revenue side, different states have different tax capacities—that is, per capita tax bases will differ across states. This is the case in respect of both common taxes (distributed to states on an origin basis) and state taxes (including local taxes). Because of the uniformity-of-living-conditions principle as well as centralized tax legislation, these measures should be quite comparable across states.

HFI of State Expenditures

Table B.5 shows per capita state government expenditures as a proportion of the national average. Other than the city states, values range between 87% and 117% of the national average. For the city states, however the values are markedly different, in the neighbourhood of 40%-50% greater. These differences are substantial and indicate differences in need and cost across states.

HFI of Common Taxes

Table B.6(a) shows per capita revenues from common taxes by state as a percentage of the German average. The disparities are wide; although they appear to have lessened in recent years, this appears to be more a consequence of the high degree of HFI associated with the former east German states following unification.

HFI of State Taxes

Table B.6(b) shows per capita revenues from state taxes as a percentage of the German average. Most noticeable here is that the former east German states exhibit a lesser degree of HFI in respect of state taxes than is the case with common taxes.

HFI of Local Taxes

Table B.6(c) shows per capita revenues from local taxes by state as a percentage of the German average. Once again, the former east German states exhibit huge disparity in terms of HFI, tending to pull down the average.

HFI of State Revenues After Distribution of Common Taxes

Table B.7(a) shows per capita state revenues after distribution of common taxes as a percentage of the German average. These data are before state-state equalization. They reflect both the disparity in fiscal capacities in respect of common taxes and the implicit equalization associated with VAT distribution as well as the explicit component associated with supplementary equalization financed out of the VAT. Evidently, VAT distribution has dramatic impacts on states' relative fiscal capacities.

HFI of Local Taxes After Distribution of Common Taxes

Table B.7(b) shows per capita local revenues after distribution of common taxes as a percentage of the German average. They, too, reflect both the disparity in fiscal capacities in respect of common taxes. Evidently, personal income tax distribution has an impact on local governments' relative fiscal capacities, although less dramatically so than VAT distribution has on states' relative fiscal capacities.

HFI of State Revenues After Distribution of Common Taxes and Transfers

Table B.7(c) shows per capita revenues from all sources after distribution of common taxes and transfers as a percentage of the German average. There remains a marked degree of disparity between city states and others. Nonetheless, only one state exhibits a fiscal capacity below 90 percent of the national average. Other than with regard to the city states, the German system exhibits a remarkable degree of uniformity in fiscal capacities across states.

*TABLE B.5 STATE GOVERNMENTS PER CAPITA EXPENDITURES
AS A PERCENTAGE OF GERMAN AVERAGE*

| Year | Baden- Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg- Vorpommern | Niedersachsen | Nordrhein- Westfalen | Rheinland- Pfalz |
|------|-----------------------|--------|-------------|--------|----------------------------|---------------|-------------------------|---------------------|
| 1975 | 101.37 | 93.72 | | 104.93 | | 94.28 | 94.37 | 95.21 |
| 1980 | 106.49 | 92.64 | | 99.55 | | 94.82 | 95.37 | 92.35 |
| 1985 | 100.74 | 94.25 | | 101.47 | | 93.54 | 94.13 | 91.62 |
| 1990 | 101.03 | 96.49 | | 107.08 | | 94.03 | 93.66 | 88.97 |
| 1992 | 99.34 | 97.24 | 107.04 | 104.12 | 103.63 | 94.09 | 92.02 | 87.09 |
| 1993 | 97.16 | 94.65 | 110.82 | 104.15 | 109.44 | 93.00 | 92.49 | 86.01 |
| 1994 | 93.40 | 94.93 | 112.65 | 102.38 | 114.09 | 93.17 | 91.65 | 84.70 |
| 1995 | 95.65 | 97.22 | 111.34 | 100.77 | 114.75 | 91.43 | 93.21 | 84.08 |
| 1996 | 94.79 | 98.96 | 112.57 | 103.87 | 119.81 | 89.80 | 93.33 | 86.88 |
| 1997 | 94.32 | 98.49 | 113.00 | 101.77 | 116.60 | 89.29 | 94.17 | 86.84 |

| Year | Saarland | Sachsen | Sachsen- Anhalt | Schleswig- Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|--------------------|------------------------|-----------|--------|--------|---------|
| 1975 | 93.05 | | | 96.38 | | 183.10 | 136.77 | 138.26 |
| 1980 | 94.59 | | | 93.51 | | 186.70 | 140.36 | 130.00 |
| 1985 | 107.89 | | | 93.53 | | 201.65 | 140.29 | 142.60 |
| 1990 | 99.39 | | | 97.97 | | 177.33 | 143.65 | 136.28 |
| 1992 | 96.94 | 100.24 | 104.03 | 97.16 | 103.86 | 149.84 | 143.35 | 139.17 |
| 1993 | 96.58 | 101.90 | 109.19 | 95.70 | 108.47 | 154.28 | 145.17 | 130.83 |
| 1994 | 95.51 | 105.76 | 111.07 | 96.14 | 111.38 | 155.36 | 143.00 | 132.04 |
| 1995 | 93.96 | 110.86 | 114.43 | 96.87 | 109.75 | 158.10 | 144.27 | 129.63 |
| 1996 | 94.92 | 112.84 | 113.10 | 95.67 | 112.93 | 148.65 | 145.34 | 134.80 |
| 1997 | 95.73 | 104.51 | 117.86 | 95.90 | 112.59 | 152.36 | 147.97 | 136.60 |

Source: Author's calculations using data from Statistisches Jahrbuch 1998, tables 20.1.3

TABLE B.6(A) REVENUES PER CAPITA FROM COMMON TAXES AS A PERCENTAGE OF THE GERMAN AVERAGE

| Year | Baden-Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg-Vorpommern | Niedersachsen | Nordrhein-Westfalen | Rheinland-Pfalz |
|------|-------------------|--------|-------------|--------|------------------------|---------------|---------------------|-----------------|
| 1975 | 103.47 | 79.88 | | 103.41 | | 64.53 | 103.81 | 71.21 |
| 1980 | 103.21 | 83.94 | | 100.52 | | 68.42 | 101.72 | 70.19 |
| 1985 | 101.75 | 88.50 | | 105.58 | | 61.87 | 101.59 | 68.70 |
| 1990 | 124.58 | 105.12 | | 129.90 | | 73.08 | 142.45 | 84.80 |
| 1993 | 110.65 | 102.50 | 26.74 | 127.62 | 21.51 | 77.28 | 110.29 | 129.40 |
| 1995 | 105.39 | 100.05 | 36.78 | 122.45 | 29.14 | 73.23 | 111.18 | 119.17 |

| Year | Saarland | Sachsen | Sachsen-Anhalt | Schleswig-Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|----------------|--------------------|-----------|--------|--------|---------|
| 1975 | 75.29 | | | 64.74 | | 52.43 | 136.50 | 219.93 |
| 1980 | 72.85 | | | 63.50 | | 48.67 | 131.73 | 236.79 |
| 1985 | 70.07 | | | 58.90 | | 56.80 | 135.91 | 242.05 |
| 1990 | 90.06 | | | 80.27 | | 31.41 | 139.99 | 242.49 |
| 1993 | 79.91 | 24.50 | 23.85 | 80.70 | 21.01 | 73.64 | 136.29 | 230.77 |
| 1995 | 80.50 | 32.46 | 30.77 | 80.23 | 28.96 | 85.32 | 125.40 | 235.65 |

Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.
 Source: Author's calculation using data from Statistisches Jahrbuch. Various Editions.

*TABLE B.6(B) REVENUES PER CAPITA FROM STATE (LANDER) TAXES
AS A PERCENTAGE OF THE GERMAN AVERAGE*

| Year | Baden- Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg- Vorpommern | Niedersachsen | Nordrhein- Westfalen | Rheinland- Pfalz |
|------|-----------------------|--------|-------------|--------|----------------------------|---------------|-------------------------|---------------------|
| 1975 | 98.57 | 95.76 | | 95.36 | | 74.14 | 93.31 | 77.72 |
| 1980 | 95.99 | 93.78 | | 96.74 | | 78.85 | 95.35 | 79.48 |
| 1985 | 101.13 | 103.24 | | 100.63 | | 78.89 | 87.29 | 76.70 |
| 1990 | 128.88 | 124.15 | | 125.95 | | 93.36 | 117.59 | 85.34 |
| 1993 | 109.90 | 112.04 | 50.02 | 114.78 | 48.03 | 89.56 | 99.42 | 81.75 |
| 1995 | 107.70 | 110.48 | 59.14 | 105.55 | 51.55 | 84.97 | 101.24 | 76.77 |

| Year | Saarland | Sachsen | Sachsen- Anhalt | Schleswig- Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|--------------------|------------------------|-----------|--------|--------|---------|
| 1975 | 82.04 | | | 70.03 | | 106.33 | 114.68 | 156.85 |
| 1980 | 78.81 | | | 71.60 | | 105.92 | 104.17 | 153.46 |
| 1985 | 76.43 | | | 78.25 | | 112.88 | 95.72 | 131.11 |
| 1990 | 88.15 | | | 94.93 | | 73.58 | 112.84 | 169.71 |
| 1993 | 75.15 | 56.87 | 44.90 | 92.29 | 48.55 | 82.82 | 103.08 | 133.44 |
| 1995 | 75.66 | 64.05 | 50.16 | 90.10 | 52.04 | 91.53 | 96.85 | 136.25 |

Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.
Source: Author's calculation using data from Statistisches Jahrbuch. Various Editions.

TABLE B.6(C) REVENUES PER CAPITA FROM LOCAL TAXES AS A PERCENTAGE OF THE GERMAN AVERAGE

| Year | Baden-Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg-Vorpommern | Niedersachsen | Nordrhein-Westfalen | Rheinland-Pfalz |
|------|-------------------|--------|-------------|--------|------------------------|---------------|---------------------|-----------------|
| 1975 | 97.04 | 85.10 | | 104.41 | | 74.70 | 96.33 | 80.90 |
| 1980 | 103.36 | 92.20 | | 100.79 | | 84.16 | 90.95 | 87.34 |
| 1985 | 99.93 | 92.34 | | 105.59 | | 74.67 | 94.93 | 87.29 |
| 1990 | 122.68 | 111.34 | | 139.03 | | 90.74 | 125.91 | 103.45 |
| 1993 | 109.46 | 104.14 | 21.88 | 123.62 | 19.78 | 93.86 | 113.69 | 94.01 |
| 1995 | 104.25 | 100.49 | 32.29 | 120.17 | 29.01 | 88.00 | 113.62 | 91.76 |

| Year | Saarland | Sachsen | Sachsen-Anhalt | Schleswig-Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|----------------|--------------------|-----------|---------|--------|---------|
| 1975 | 62.22 | | | 70.44 | | 99./.-1 | 139.38 | 172.90 |
| 1980 | 70.92 | | | 71.48 | | 59.87 | 131.30 | 160.62 |
| 1985 | 62.23 | | | 60.40 | | 69.62 | 131.09 | 185.33 |
| 1990 | 85.73 | | | 78.69 | | 49.61 | 148.47 | 195.20 |
| 1993 | 77.32 | 25.39 | 20.96 | 83.47 | 19.26 | 90.87 | 141.96 | 185.96 |
| 1995 | 73.80 | 37.14 | 28.95 | 82.54 | 28.12 | 89.95 | 152.27 | 197.54 |

Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.
 Source: Author's calculation using data from Statistisches Jahrbuch. Various Editions.

TABLE B.7(A) STATE (LANDER) PER CAPITA TAX REVENUES AFTER THE DISTRIBUTION OF SHARED TAXES AS A PERCENTAGE OF THE GERMAN AVERAGE

| Year | Baden-Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg-Vorpommern | Niedersachsen | Nordrhein-Westfalen | Rheinland-Pfalz |
|------|-------------------|--------|-------------|--------|------------------------|---------------|---------------------|-----------------|
| 1975 | 99.72 | 86.89 | | 97.40 | | 82.85 | 95.85 | 82.40 |
| 1980 | 102.02 | 89.09 | | 97.70 | | 84.39 | 94.89 | 85.18 |
| 1985 | 101.45 | 93.44 | | 102.07 | | 52.28 | 91.98 | 84.28 |
| 1990 | 127.27 | 116.20 | | 127.20 | | 102.89 | 118.49 | 104.48 |
| 1993 | 106.44 | 103.86 | 52.13 | 114.85 | 50.88 | 92.34 | 101.23 | 89.80 |
| 1995 | 83.10 | 82.25 | 112.46 | 82.59 | 115.12 | 84.92 | 84.05 | 85.49 |

| Year | Saarland | Sachsen | Sachsen-Anhalt | Schleswig-Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|----------------|--------------------|-----------|--------|--------|---------|
| 1975 | 82.70 | | | 83.28 | | 73.20 | 110.45 | 147.96 |
| 1980 | 82.00 | | | 83.69 | | 72.56 | 105.44 | 132.13 |
| 1985 | 81.45 | | | 82.65 | | 81.05 | 99.02 | 135.21 |
| 1990 | 102.42 | | | 103.25 | | 52.20 | 115.14 | 155.24 |
| 1993 | 90.07 | 52.03 | 51.31 | 97.07 | 49.75 | 86.71 | 105.43 | 129.58 |
| 1995 | 126.67 | 111.60 | 113.73 | 88.15 | 113.39 | 130.73 | 184.91 | 111.05 |

Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.

Source: Author's calculation using data from Statistisches Jahrbuch. Various Editions.

TABLE B.7(B) LOCAL PER CAPITA TAX REVENUES AFTER THE DISTRIBUTION OF SHARED TAXES AS A PERCENTAGE OF THE GERMAN AVERAGE

| Year | Baden-Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg-Vorpommern | Niedersachsen | Nordrhein-Westfalen | Rheinland-Pfalz |
|-------------|--------------------------|---------------|--------------------|---------------|-------------------------------|----------------------|----------------------------|------------------------|
| 1975 | 95.96 | 85.90 | | 103.61 | | 76.98 | 96.75 | 80.39 |
| 1980 | 102.55 | 92.15 | | 99.»1 | | 84.19 | 92.76 | 86.66 |
| 1985 | 100.17 | 92.06 | | 104.0S | | 77.05 | 95.51 | 85.31 |
| 1990 | 123.97 | 113.23 | | 135.61 | | 93.63 | 124.63 | 104.37 |
| 1993 | 108.61 | 105.40 | 27.21 | 122.0S | 26.58 | 94.37 | 110.44 | 93.28 |
| 1995 | 102.73 | 100.11 | 46.61 | 116.69 | 39.74 | 89.75 | 108.80 | 89.96 |

| Year | Saarland | Sachsen | Sachsen-Anhalt | Schleswig-Holstein | Thüringen | Berlin | Bremen | Hamburg |
|-------------|-----------------|----------------|-----------------------|---------------------------|------------------|---------------|---------------|----------------|
| 1975 | 64.91 | | | 77.74 | | 83.28 | 131.25 | 164.97 |
| 1980 | 70.73 | | | 78.29 | | 54.67 | 124.13 | 149.94 |
| 1985 | 66.20 | | | 69.10 | | 65.83 | 121.97 | 170.07 |
| 1990 | 85.66 | | | 91.75 | | 41.48 | 139.05 | 184.86 |
| 1993 | 78.64 | 29.97 | 31.48 | 92.42 | 24.60 | 87.22 | 12.5.32 | 167.00 |
| 1995 | 78.34 | 45.76 | 38.84 | 91.55 | 38.67 | 92.20 | 130.06 | 167.93 |

Source: Author's calculation using data from Statistisches Jahrbuch. Various Editions.

TABLE B.7(C) STATE GOVERNMENTS PER CAPITA REVENUES, INCLUDING SHARED TAX REVENUES AND TRANSFERS, AS A PERCENTAGE OF GERMAN AVERAGE

| Year | Baden-Württemberg | Bayern | Brandenburg | Hessen | Mecklenburg-Vorpommern | Niedersachsen | Nordrhein-Westfalen | Rheinland-Pfalz |
|------|-------------------|--------|-------------|--------|------------------------|---------------|---------------------|-----------------|
| 1975 | 102.91 | 97.22 | | 102.78 | | 93.33 | 92.46 | 95.47 |
| 1980 | 106.82 | 97.48 | | 101.19 | | 95.06 | 90.94 | 93.18 |
| 1985 | 104.19 | 98.50 | | 103.76 | | 94.40 | 99.77 | 91.15 |
| 1990 | 103.48 | 98.27 | | 105.55 | | 93.36 | 93.30 | 88.40 |
| 1992 | 102.14 | 101.32 | 91.61 | 107.20 | 98.10 | 95.19 | 95.15 | 88.59 |
| 1993 | 101.96 | 100.97 | 95.33 | 107.57 | 101.21 | 93.14 | 94.40 | 87.04 |
| 1994 | 99.86 | 101.75 | 98.39 | 105.82 | 103.42 | 92.82 | 92.86 | 85.34 |
| 1995 | 98.03 | 103.20 | 106.45 | 101.92 | 109.24 | 90.15 | 94.58 | 84.63 |
| 1996 | 98.38 | 101.12 | 108.57 | 107.44 | 112.85 | 91.92 | 95.28 | 87.08 |
| 1997 | 98.16 | 99.85 | 111.57 | 102.77 | 113.15 | 90.01 | 92.87 | 84.83 |

| Year | Saarland | Sachsen | Sachsen-Anhalt | Schleswig-Holstein | Thüringen | Berlin | Bremen | Hamburg |
|------|----------|---------|----------------|--------------------|-----------|--------|--------|---------|
| 1975 | 88.28 | | | 95.24 | | 195.18 | 120.58 | 141.26 |
| 1980 | 89.62 | | | 95.68 | | 195.68 | 123.05 | 133.82 |
| 1985 | 91.31 | | | 91.70 | | 209.01 | 125.58 | 141.73 |
| 1990 | 93.98 | | | 96.96 | | 176.96 | 135.10 | 133.98 |
| 1992 | 94.11 | 92.14 | 91.00 | 98.74 | 93.06 | 149.61 | 141.63 | 135.62 |
| 1993 | 92.08 | 97.81 | 97.24 | 97.72 | 98.60 | 144.98 | 132.86 | 125.30 |
| 1994 | 108.01 | 101.16 | 99.20 | 98.09 | 100.27 | 137.47 | 167.49 | 125.08 |
| 1995 | 104.31 | 111.63 | 107.61 | 97.35 | 106.65 | 133.18 | 158.43 | 130.09 |
| 1996 | 106.58 | 113.64 | 109.18 | 95.50 | 106.93 | 124.03 | 156.86 | 126.38 |
| 1997 | 106.97 | 106.27 | 109.89 | 95.91 | 108.71 | 148.41 | 160.26 | 135.49 |

Source: Author's calculations using data from Statistisches Jahrbuch 1998, tables 20.1.3

C. System of Intergovernmental Transfers

The German system of intergovernmental transfers involves both federal-state transfers and state-state transfers. Federal-state transfers include both conditional grants and unconditional grants. Of these, some are focused on vertical imbalances, especially directed at constitutionally mandated areas of joint responsibility. Others are focused on horizontal imbalance, especially directed at the former east German states, but generally on states with below average fiscal capacities after VAT distribution and after interstate equalization.

Interstate transfers are constitutionally mandated and are both implicit and explicit. 75% of the states' share of VAT is distributed on an equal per capita basis, resulting in implicit transfers from those states with above average VAT yields to those with below average VAT yields. In addition, explicit interstate equalization is an important component of the allocation of income, corporate, and local taxation.

Nature of Programs Focused on Vertical Imbalances

Specific-Purpose Grants

Conditional grants from the Federation to the states are made in areas of so-called joint tasks and in the form of grants-in-aid. Joint responsibilities are listed under Chapter VIIIa of the Basic Law. Article 91a is prefaced as follows:

(1) In the following areas the Federation shall participate in the discharge of responsibilities of the Länder provided that such responsibilities are important to society as a whole and that federal participation is necessary for the improvement of living conditions (joint tasks).

The items listed are:

1. extension and construction of institutions of higher education including university clinics;
2. improvement of regional economic structures;
3. improvement of the agrarian structure and of coastal preservation.

Such joint tasks are constitutionally mandated, involving joint planning and decision-making, as well as sharing of responsibility and financing. Grants-in-aid are directed at correcting for regional disparities, stabilization motives, and promoting economic growth.

Article 91a continues:

(2) Joint responsibilities shall be defined in detail by a federal law requiring the consent of the Bundesrat. This law shall include general principles governing the performance of such tasks.

(3) The law ... shall provide for the procedure and institutions required for joint overall planning. The inclusion of a project in the overall plan shall require the consent of the Land in whose territory it is to be carried out.

Finally, Article 91a has language that specifies cost-sharing in areas of joint responsibility:

(4) In cases to which subparagraphs 1 and 2 of paragraph (1) of this Article apply, the Federation shall finance one half of the expenditure in each Land. In cases to which subparagraph 3 of paragraph (1) of this Article applies the Federation shall finance at least one half of the expenditure; and the proportion shall be the same for all Länder. Details shall be regulated by the law. The provision of funds shall be subject to appropriation in the budgets of the Federation and the Länder.

(5) Upon request the Federal Government and the Bundesrat shall be informed about the execution of joint responsibilities.

Article 91b relates to co-operation between the Federal government and the states in education and research:

Pursuant to agreements the Federation and the Länder may cooperate in educational planning and in the promotion of research institutions and projects of supraregional importance. The apportionment of costs shall be regulated by the relevant agreement.

Other Specific-Purpose Grants

Article 106a [Federal grants for local mass transit] reads as follows:

Beginning January 1 1996 the Länder shall be entitled to an allocation from federal tax revenues for purposes of local mass transit. Details shall be regulated by a federal law requiring the consent of the Bundesrat. Allocations made pursuant to the first sentence of this Article shall not be taken into account in determining the financial capacity of a Land under paragraph (2) of Article 107.

Nature of Programs Focused on Horizontal Imbalances

Article 107 of the Basic Law [Financial equalization] is directed at horizontal imbalances across states. It reads as follows:

(1) Revenue from Land taxes and the Land share of revenue from income and corporation taxes shall accrue to the individual Länder to the extent that such

taxes are collected by revenue authorities within their respective territories (local revenue). Details respecting the delineation as well as the manner and scope of the allotment of local revenue from corporation and wage taxes shall be regulated by a federal law requiring the consent of the Bundesrat. This law may also provide for the delimitation and allotment of local revenue from other taxes. The Land share of revenue from the turnover tax shall accrue to the Länder on a per capita basis; a federal law requiring the consent of the Bundesrat may provide for the grant of supplementary shares not exceeding one quarter of a Land share to Länder whose per capita revenue from Land taxes and from income and corporation taxes is below the average of all the Länder combined.

(2) Such a law shall ensure a reasonable equalization of the disparate financial capacities of the Länder, with due regard for the financial capacities and needs of municipalities (associations of municipalities). It shall specify the conditions governing the claims of Länder entitled to equalization payments and the liabilities of Länder required to make them, as well as the criteria for determining the amounts of such payments. It may also provide for federal grants to be made by the Federation to financially weak Länder from its own funds to assist them in making their general financial needs (supplementary grants).

Article 107 therefore prescribes two forms of federal legislation (requiring consent of the Bundesrat): The first is legislation governing state-state equalizing transfers of local revenue (revenue from Land tax and the states' share of revenue from the income tax and corporation tax); the second is legislation governing supplemental equalization payments, financed out of a 25% share of the VAT, to be made to states whose per capita revenue from income and corporation tax is below the national average.

Equalization and the VAT

As mentioned, 75% of the states' share of VAT revenues is distributed on an equal per capita basis across states. This, then, incorporates a significant element of implicit horizontal equalization, transferring revenues from those states with above average VAT capacity to those with below average VAT capacity. In fact, this implicit transfer is referred to as first-tier equalization in the German system. One implication is that the greater is the states' share of VAT, the greater will be the level of first-tier equalization, and, hence, the less will be the need for explicit (second-tier) equalization.

The remaining 25% of the states' share of VAT is used to fund a supplementary equalization scheme, directed at poorer states. Based on adjusted fiscal capacity for state taxes (defined below), states with fiscal capacities after equalization below the national average are eligible for a VAT grant. The grant pool is, of

course, restricted to 25% of VAT revenues. Hence, if aggregate entitlements exceed the size of the pool, all entitlements are pro-rated accordingly (on an equal proportionate basis). If aggregate entitlements fall short of the size of the pool, the surplus is distributed to all states on an equal per capita basis.

Interstate Equalization

State-state equalization operates as a net scheme—payments to receiving states are just covered by contributions from paying states. For each state, equalization entitlements are calculated in steps with graduated rates according to the difference between its adjusted fiscal capacity and its individual equalization standard. It is important to note that state-state equalization is, in fact, a second-tier equalization process. That is, states' fiscal capacities include revenues from the VAT which are already "equalized".

Adjusted fiscal capacity (AFC_i) is essentially aggregate state and local revenues (including shared taxes) with an adjustment for extraordinary expenditures for harbours. Aggregate state and local revenues include (a) state revenues as specified under Article 106(2), (b) state revenues from joint taxes as specified under Article 106(3), distributed on a residence basis, (c) state share of VAT, and (d) local taxes.

The equalization standard for each state (ES_i) is calculated as the average per capita fiscal capacity for all states, scaled up (or down) to reflect the higher (lower) revenue needs associated with larger (smaller) population densities, times population. For cities, weights used to scale average per capita fiscal capacity start with a value of 1.00 for cities with a population of 5,000 and move up by steps to a value of 1.35 for cities with populations in excess of 500,000. Population density is also taken into account in determining the overall weight for each state.

State taxes are weighted by a factor of 1.35 in city states to account for agglomeration diseconomies. Elsewhere the weighting factor is 1. For local taxes, weights rise progressively, based on population size.

TABLE C-1: WEIGHTING OF POPULATION

| Number of inhabitants of a municipality | Weight |
|--|---------------|
| The first 5,000 | 1.00 |
| The next 15,000 | 1.10 |
| The next 80,000 | 1.15 |
| The next 400,000 | 1.20 |
| The next 500,000 | 1.25 |
| All others above 500,000 | 1.30 |

Source: Extracted from Spahn (1997), 143.

Furthermore, states with more than 500,000 inhabitants receive additional points on their weighting factor according to population density. Those with between 1,500 and 2,000 inhabitants per square kilometre receive an additional 2 percentage points; those with between 2,000 and 3,000 inhabitants per square kilometre receive an additional 4 percentage points; and those with more than 3,000 inhabitants per square kilometre receive an additional 6 percentage points.

Those states with an adjusted fiscal capacity between 92% and 100% of their equalization standard are equalized to 37.5% of the difference. Thus, for such states, in symbols, equalization entitlements are calculated as:

$$E_i = 0.375(ES_i - AFC_i).$$

States for which AFC_i is less than 92% of their equalization standard are equalized at a marginal rate of 92% of the difference. Thus, for such states, in symbols, equalization entitlements (E_i) are calculated as:

$$E_i = (0.92ES_i - AFC_i) + 0.375(ES_i - 0.92ES_i)$$

States with adjusted fiscal capacities above their equalization standard are required to contribute to the equalization pool. If the difference is less than 1% (that is, if AFC exceeds ES by not more than 1%) they contribute 15% of the difference.¹³⁴ Thus, the contribution to the equalization pot is calculated as:

$$E_i = 0.15(AFC_i - ES_i).$$

States for which AFC exceeds ES by between 1% - 10% contribute 66% of the difference.¹³⁵ For such states, then, equalization entitlement is calculated as:

$$E_i = 0.15(1.01ES_i - ES_i) + 0.66(AFC_i - 1.01ES_i).$$

For differences in excess of 110% they contribute 80% of the difference, or:¹³⁶

$$E_i = 0.15(1.01ES_i - ES_i) + 0.66(1.1ES_i - 1.01ES_i) + 0.8((AFC_i - 1.1ES_i)).$$

Since wealthier states—those with relatively high fiscal capacities—tend to be those with relatively high population densities, the scaling process tends to lessen the level of equalization flows at the second tier.

Where aggregate equalization payments exceed (fall short of) aggregate equalization contributions, state entitlements are pro-rated accordingly.

¹³⁴ Prior to 1995, states with AFC less than 2% of ES were referred to as being in the “dead zone”—that is, they were not required to contribute to the equalization pot.

¹³⁵ Prior to 1995, states with AFC between 102% and 110% of ES were required to contribute 70% of the difference to the equalization pot.

¹³⁶ Prior to 1995, such states contributed 100% of the difference to the equalization pot.

The German Unity Fund

Incorporation of the former east German states into the Federation's fiscal equalization scheme would have completely distorted the historic outcomes. All but Bremen among the recipient states would have become contributing states and, as well, would have lost their federal supplementary allocations.¹³⁷ The 1990 Unification Treaty temporarily suspended the parts of the Basic Law relating to financial equalization (Article 107), providing a period to review the equalization question, as they would otherwise have applied to the new states through the beginning of 1995.

The German Unity Fund, co-financed by the Federation and the western states, was established as an interim program directed at raising fiscal capacities in the former east German states to levels comparable with those which would have prevailed had the temporary suspension not been implemented. Of the DM115 billion in this fund, DM20 billion was to be directly contributed by the federal government in respect of financial savings arising from unification. The balance was to be financed through debt, the responsibility for which was to be shared equally by the Federation and the Länder (including local governments). In 1992 an additional DM31 billion was added to the fund, financed partly through a one-point increase in the VAT rate (DM23 billion) and partly by the Federation (DM8 billion).

The Federation introduced an income tax surcharge in 1991/92 (7.5% on all income tax payments) to assist in paying for the Fund. In addition, they raised the mineral oil tax and the insurance tax.

States were partially compensated for the additional burdens they assumed by a reapportioning of the VAT—from 63/37% to 56/44%.

Former federal supplementary grants were to be replaced by two types of unconditional grants. Type A grants, payable to both east and west German states, are designed to raise per capita revenues (after horizontal equalization) to 90% of the national average. Type B grants are primarily directed at east German states in respect of infrastructure development.¹³⁸

¹³⁷ It was estimated that incorporating the former east German states into the fiscal equalization scheme would have increased flows from DM5 billion per year to a staggering DM25 billion per year (see Spahn, Paul Bernd, "Intergovernmental Transfers in Switzerland and Germany" in Ehtisham Ahmad ed., *Financing Decentralized Expenditures: An International Comparison of Grants* (Brookfield: Edward Elgar, 1997), 103.

¹³⁸ Also, Type C grants are available to compensate western states for undue hardship from integrating the eastern states into horizontal equalization, grants-in-aid to eastern

The fund was distributed among the new states based on population. In turn, states were obliged to pass on 40% of their grant to their local governments.

Participation in financial equalization (Article 107) was extended to the east German states in 1995. Changes, reflected in the discussion above, were made with respect to the terms of payment for contributing states.

In each state, state-local equalization schemes exist, based on the gap between need and fiscal capacity.

TABLE C-2: FISCAL EQUALIZATION AMONG STATES, 1995

| | Relative Fiscal Capacity Per Capita (Average = 100) | | | | Rank after equalization |
|-------------------|---|------------------------|--------------------------------|----------------------|-------------------------|
| | Without VAT | After VAT distribution | After inter-state equalization | After federal grants | |
| Hamburg | 157.5 | 133.9 | 102.3 | 93.4 | 15 |
| Hesse | 118.7 | 109.7 | 103.5 | 94.6 | 10 |
| Baden-Wu | 115.7 | 107.1 | 103.0 | 94.2 | 12 |
| N.Rhine-Wes. | 114.2 | 105.4 | 102.4 | 93.7 | 14 |
| Bavaria | 113.8 | 105.1 | 102.5 | 93.7 | 13 |
| Bremen | 111.7 | 103.0 | 96.4 | 141.4 | 1 |
| Schleswig-Hols. | 106.8 | 100.0 | 101.3 | 95.9 | 9 |
| Lr. Saxony | 96.2 | 94.2 | 97.8 | 92.9 | 16 |
| Rhineland-Pala. | 95.7 | 92.6 | 96.8 | 94.3 | 11 |
| Berlin | 93.3 | 93.4 | 95.0 | 111.0 | 8 |
| Sarland | 83.5 | 89.1 | 95.0 | 129.2 | 2 |
| Brandenburg | 56.4 | 84.4 | 95.0 | 118.6 | 6 |
| Saxony | 50.3 | 83.1 | 95.0 | 117.4 | 7 |
| Mecklenburg-W.Pom | 47.0 | 82.3 | 95.0 | 119.8 | 3 |
| Saxony-Anhalt | 44.5 | 82.7 | 95.0 | 118.8 | 5 |
| Thuringia | 43.7 | 82.6 | 95.0 | 118.9 | 4 |

Source: Extracted from Spahn and Föttinger (1995).

D. Systems of Tax Harmonization and Tax Collection

In section A-2 and A-3 above the constitutional allocation of revenue and expenditure responsibilities are set out. Since unlike Canada and the United States the German constitution sets out detailed provisions for tax harmonization

states to promote investment and economic growth, and additional grants to fiscally strapped states.

and collection, this section D sets out these constitutional provisions in further detail.

Article 106 [Apportionment of tax revenues] separates taxes into federal taxes, state taxes, common taxes, and municipal taxes. Section (1) of the article specifies federal taxes and reads as follows:

(1) The yield of fiscal monopolies and the revenue from the following taxes shall accrue to the Federation:

1. customs duties;
2. taxes on consumption in so far as they do not accrue to the Länder pursuant to paragraph (2) or jointly to the Federation and the Länder in accordance with paragraph (3) or to the municipalities in accordance with paragraph (6) of this Article;
3. the highway freight tax;
4. the taxes on capital transactions, insurance and bills of exchange;
5. nonrecurring levies on property and equalization of burdens levies;
6. income and corporation surtaxes;
7. levies within the framework of the European Communities.

Federal taxes account for roughly 17% of all revenues in Germany. The most significant among them are excise taxes—mineral oils tax, tobacco taxes, and alcohol taxes (excluding beer). There is provision for a federal surtax on both personal and corporate income taxes (the German Unity Fund).

Section (2) of article 106 specifies state taxes and reads as follows:

(2) Revenue from the following taxes shall accrue to the [states]:

1. the property tax;
2. the inheritance tax;
3. the motor vehicle tax
4. such taxes on transactions as do not accrue to the Federation pursuant to paragraph (1) or jointly to the Federation and the Lander pursuant to paragraph (3) of this Article;
5. the beer tax;
6. the tax on gambling establishments.

Exclusive state taxes account for 5% of all revenues in Germany. The most significant among these are the motor vehicle tax and the property (net worth tax).

Exclusive municipal (local) taxes account for 7% of all revenues in Germany. Principal among these are local business tax (trade tax), the property tax and utilities charges. Municipal revenues are, however, significantly tied up in revenue sharing arrangements specified in subsequent sections of the Article.

Joint taxes (or common taxes or shared taxes), as noted previously in Section A, are the income tax, the corporation tax and the value added tax (VAT). Joint taxes account for the bulk of revenues in Germany—71% of the total. Their distribution is specified in section (3) of Article 106. The income tax is shared between all three levels of government—that portion of the income tax which is not distributed to municipalities is to be shared equally between the federal and state governments. The corporation tax is shared equally between the federal and state governments. The distribution of the VAT is to be determined through negotiation and federal legislation subject to the consent of the Bundesrat, and subject to specified principle, particularly the uniformity-of-living-conditions principle mentioned previously.

Section (3) reads as follows:

(3) Revenue from income taxes, corporation taxes and turnover taxes shall accrue jointly to the Federation and the Länder (joint taxes) to the extent that the revenue from the income tax and the turnover tax is not allocated to municipalities pursuant to paragraph (5) and 5(a) of this Article. The Federation and Länder shall share equally the revenue from income taxes and corporation taxes. The respective shares of the Federation and the Länder in the revenue from turnover tax [VAT] shall be determined by a federal law requiring the consent of the Bundesrat. Such determination shall be based on the following principles:

1. The Federation and the Länder shall have an equal claim against current revenues to cover their necessary expenditure. The extent of such expenditures shall be determined with due regard to multi-year financial planning.

2. The financial requirements of the Federation and of the Länder shall be coordinated in such a way as to establish a fair balance, avoid excessive burdens on taxpayers, and ensure uniformity of living standards throughout the federal territory.

At present, 15% of income tax revenues is apportioned to the municipalities, leaving federal and state shares of 42.5% each.

Section (4) of Article 106 spells out the apportionment of the VAT. Vertical adjustments through shares of the VAT is the feature of the otherwise rigid German revenue sharing arrangements which provides the relief valve, ensuring that any vertical fiscal gap is consistent with constitutional principles. Section (4) reads as follows:

(4) The respective shares of the Federation and the Länder in the revenue from the turnover tax shall be reapportioned anew whenever the ratio of revenues to expenditures of the Federation becomes substantially different from that of the Länder. If a federal law imposes additional expenditure on or withdraws revenue

from the Länder the additional burden may be compensated for by federal grants pursuant to a federal law requiring the consent of the Bundesrat provided that additional burden is limited to a short period of time. The law shall establish the principles for calculating such grants and distributing them among the Länder.

Section (5) specifies that municipalities are to receive a share of income tax revenues, to be determined by federal legislation requiring the consent of the Bundesrat. Section (6) specifies (a) exclusive municipal taxes as well as revenue sharing arrangements concerning the business (trade) tax. Specifically, both the state and federal governments are accorded shares in business tax revenues, to be specified in federal legislation requiring the consent of the Bundesrat. At present, 80% remains with local governments, 15% is rendered to state governments, and 5 % is rendered to the federal government. (Note: This tax was to be replaced with revenue sharing from VAT.) The federal government shares a portion of its revenues from the mineral oil tax with the states in aid of regional public transport programs.

Sections (5) and (6) read as follows:

(5) A share of the revenue from the income tax shall accrue to the municipalities, to be passed on by the Länder to their municipalities on the basis of the income taxes paid by their inhabitants. Details shall be regulated by a federal law requiring the consent of the Bundesrat. This law may provide that municipalities may establish supplementary or reduced rates with respect to their share of the tax.

(6) Revenue from taxes on real property and trades shall accrue to the municipalities; revenue from local taxes on consumption and expenditures shall accrue to the municipalities or, as may be provided for by Länder legislation, to associations of municipalities. Municipalities shall be authorized to establish the rates at which taxes on real property and trades are levied within the framework of existing laws. If there are no municipalities in a Land, revenue from taxes on real property and trades as well as from local taxes on consumption and expenditures shall accrue to the Land. The Federation and the Länder may participate by virtue of an apportionment, in the revenue from tax on trades. Details regarding such apportionment shall be the subject of a federal law requiring the consent of the Bundesrat. In accordance with Land legislation, taxes on real property and trades tax as well as the municipalities' share of revenue from the income tax and the turnover tax may be taken as a basis for calculating the amount of apportionment.

Section (7) of Article 106 provides explicitly for revenue sharing between states and their municipalities of revenues from joint taxes. Otherwise, revenue sharing arrangements are at the discretion of individual states.

Section (7) reads as follows:

(7) An overall percentage, of the Land share of total revenue from joint taxes to be determined by Land legislation, shall accrue to the municipalities or associations of municipalities. In all other respects Land legislation shall determine whether and to what extent revenue from Land taxes shall accrue to municipalities (associations of municipalities).

Finally, section (8) provides for compensation to municipalities where federal requirements place a financial burden on municipalities.

Section (8) reads as follows:

(8) If in individual Länder or municipalities (associations of municipalities) the Federation requires special facilities to be established that directly result in an increase of expenditure or in reductions of revenue (special burden) to these Länder or municipalities (associations of municipalities) the Federation shall grant the necessary compensation if and in so far as the Länder cannot reasonably be expected to bear that burden. In granting such compensation due account shall be taken of indemnities paid by third parties and financial benefits accruing to these Länder or municipalities (associations of municipalities) as a result of the establishment of such facilities.

Article 108 of the Basic Law specifies the allocation of responsibilities for collecting, handling and spending taxes. States have the principal responsibility for tax administration. That is, while the federal government administers federal taxes, the states are responsible not only for administering state taxes, but also the common (i.e. shared) taxes.

There is provision to ensure uniformity in tax collection and auditing.

Article 109 requires that each level of government, while autonomous fiscal units, should take into account impacts of their budgetary policies on the other levels. This is achieved by requiring federal legislation be passed through the Bundesrat (representing the Länder) that, in effect, approves the budgets of all three tiers. State budgetary policies must, for example, be consistent with the broader goal of macroeconomic stability.

E. Analysis

1. ECONOMIC ASPECTS

1. Impacts on Economic Efficiency

The German system of federal-state fiscal relations is constitutionally anchored in the uniformity-of-living-conditions principle. Article 30 [Division of authority between the Federation and the Länder] confirms the paramountcy of states in the provision of government services. Equally, Articles 72 and 106(3)2 confirm the role of the federal government in ensuring fiscal equity (if that is what may be interpreted by uniformity-of-living-conditions). Constitutional provisions that promote horizontal equalization—both implicitly and explicitly—provide the “glue” that binds the system together. The end result is a high degree of uniformity in terms of public infrastructure and government services. In this respect the emphasis upon uniformity of living standards is much higher than in Canada or the United States.

The German system is decentralized on the expenditure side—that is, the states are primarily responsible for delivery of key social services. Equally, the system is highly centralized on the revenue side; the bulk of revenues are collected as common taxes with proscribed allocation between the orders of government and subject to federal legislation albeit usually requiring the consent of the Bundesrat representing the states. The allocation of the VAT between orders of government provides the relief-valve for any emerging vertical fiscal imbalance in the federation. Otherwise, the bulk of federal transfers to states are directed at alleviating the horizontal fiscal imbalance arising out of German unification.

Nonetheless, German states are, at the margin, accountable for the revenues used to finance the provision of public services. And this, combined with decentralized provision of public services, albeit with provision for joint decision-making with regard to general principles (Article 91a(2)), conforms to general notions of economic efficiency. Moreover, the significant degree of harmonization in the tax system and the general commitment to equalization principles mutes the standard criticisms of decentralized fiscal systems. Thus, for example, the commitments to the equalization principle on the revenue side and uniformity-of-living-conditions on the expenditure side ensure a degree of uniformity in net fiscal benefits (NFBs) across states, alleviating pressures for inefficient migration. Centralized tax systems preclude the possibility of tax competition among states.

It needs to be said, however, that the German system brings with it some potentially serious flaws. Equalization, for example, has caused the burden to fall disproportionately on a small sub-set of states. As might be expected, this has led to political tension. Moreover, in the post-unification era, pressure on the western states from proposed inclusion in the interstate equalization scheme has threatened support for pursuing the goal of fiscal equity. In turn, this has resulted in an increased federal role in promoting fiscal equity. Yet, this increased federal role has all but reversed the order of states in terms of fiscal capacity.

The German commitment to equalization and uniformity-of-living-conditions may result in a disincentive for states to pursue expansion of their own-revenue sources. Relatively rich states may not pursue economic development potential in view of the equalization implications.

Moreover, 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.

2. Impacts on Equity

Equity in federal systems is a central concern. Equity achieved through the provision of public services is consistent with the uniformity-of-living-conditions principle. Uniform public services conform with the equity objectives of equality of opportunity and economic security, for example. Moreover, the notions of both vertical and fiscal equity are well served by the German arrangements.

It is the emphasis upon the uniformity of living conditions principle, the revenue-sharing arrangements and the self-financing nature of the state-to-state equalization that truly distinguishes the German fiscal arrangements from those in Canada and the United States.

3. Equity and Public Services

Important public services such as education, health and social services are provided through the public sector essentially because their provision serves equity objectives. Otherwise, their provision could be left to the private sector. Decentralization to the states, as in the case of Germany, may be efficiency enhancing in that it permits better reflection of residents' preferences; equally, the federal government may have an interest in ensuring that some notion of national standards is satisfied. In the German case, maintaining some degree of vertical fiscal imbalance has been important in this process. Equally, the roles of both the

federal and state governments in ensuring fiscal equity have been clearly enunciated in the Basic Law, resulting in a significant degree of horizontal fiscal equity.

2. Political aspects

1. Impact on Stability

The process of intergovernmental relations and fiscal arrangements has been both a stabilizing influence and a source of conflict in Germany.

Areas of Consensus

Equivalence of Living Conditions: As noted in section A.4, the achievement of a common standard of living across the federation has been a goal of the Federal Republic of Germany since its establishment. Uniformity became a powerful norm permeating the German system of governance.

Post-unification, the Constitutional Reform Act of 1994 substituted the term ‘equivalence of living conditions’ for ‘uniformity of living conditions’.¹³⁹ It does not appear, however, that the modified constitutional wording is reflective of a serious diminution of the norm of uniformity.¹⁴⁰ Indeed, the enduring importance of the drive to create a common standard of living across the federation cannot be over-estimated. It remains a leading value of the system, and thus affects not only relations among governments, but also sets standards for the equal distribution of wealth throughout the country.

Areas of Dispute

Territorial Reform:

As we have noted, the ability of the Länder to bear symmetrical constitutional responsibilities has been questioned. Given their disparate territorial areas, population sizes, and, since re-unification, levels of economic development, it has been argued that territorial reform is necessary if the country is to achieve its goal of equivalence of living conditions. Any territorial reform of Land boundaries has had important motivations and major implications related to the financial position resulting from territorial modifications.

There are six specific arguments advanced for the necessity of territorial reform.¹⁴¹ It has been argued, first, that under the present boundaries, not all Län-

¹³⁹ Uwe Leonardy, “German Federalism Towards 2000: To be Reformed or Deformed?,” in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 297.

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*, 291.

der can fulfill their constitutional functions within the Federal Republic of Germany, and, second, nor can all fulfill the functions expected of them in relation to the European Union. Third, it has been argued that reorganization is necessary for the orderly economic development of urban areas which cut across Land boundaries. Fourth, it has been argued that the increased number of Länder post-unification presents a more difficult environment for intergovernmental coordination. Fifth, it has been argued that the economic disparities among the Länder leave the Länder open to 'divide and rule' tactics on the part of the Bund, and, sixth, that these disparities place the onus for the realization of the goal of equivalence of living conditions on the Bund, thereby subverting the federal nature of the German state.

Despite the strength of these arguments, however, the prospects for territorial reorganization are not bright. While such reorganization has been a matter of debate for the entire life of the Federal Republic of Germany, only the 1951 amalgamation of three small south-western Länder, into the new Land of Baden-Württemberg, has been successfully implemented.¹⁴² Two expert commissions, in 1955 and 1973, recommended territorial reorganization, but the governments involved proved both unwilling and unable to carry through with reforms. In 1990, the extreme political time pressures associated with the re-unification process meant that another opportunity for reorganization was lost; the eastern Länder were simply admitted to the FRG on the basis of the Land boundaries that had existed in East Germany prior to 1952. Finally, an attempted 1996 merger of Berlin with Brandenburg failed when the voters of the latter rejected it in a referendum.

Reform of the Fiscal Transfer System: As noted, while transitional financial arrangements were made in the wake of unification, and subsequent long-term adjustments made in the financial equalization system, differences in size, population, and level of economic development among the Länder continue to generate disagreements among them and between them and the federal government. One issue is the level of equalization payments.

The second stage of the equalization process, the award of supplementary federal allocations, now ensures income equalization at a level of 99.5 percent of the Länder average.¹⁴³ However, as expenditure needs are not taken into account,

¹⁴² Ibid., 287.

¹⁴³ Mackenstein, Hans, and Charlie Jeffery, "Financial Equalization in the 1990s: On the Road Back to Karlsruhe?," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 169.

the recipient Länder remain unsatisfied. The poorest Länder therefore continue to press the Bund for selective financial support. Meanwhile, the payee Länder feel that they are penalised for their effective economic and financial management; they believe they are being forced to subsidise Länder that have not made the hard choices necessary to improve their own positions. While cuts to the target level of equalization have been suggested, territorial reorganization may be the only long-term solution. In the absence of such reorganization, payee Länder may resort to constitutional litigation in an attempt to decrease their financial obligations to the poorer Länder.

A second issue is that of ‘unfunded mandates’. As we have noted above, the Länder, as administrators of federal policy, often end up footing the bill for costs incurred as a result of federal legislation. Proposals to remedy this situation have focused on the need for constitutional revisions which would provide that the order of government which legislates costs should be legally required to cover those costs, rather than shifting them to another order of government.¹⁴⁴ Such revision may be possible, given the history of constitutional amendment in Germany, but it will assuredly not be easy.

A third financial issue relates to the ‘joint tasks’. The Länder have regarded this as the area most open to abuse by the Bund. Both the difficulties, noted above, of the use of the ‘golden leash’ by the Bund, and of decision-making on the basis of the lowest common denominator, seem to occur most frequently in relation to the joint tasks. While further adjustment of the VAT allocation ratio, in favour of the Länder, may decrease somewhat the financial influence of the Bund, it is unlikely that this would be sufficient to remedy the difficulty entirely. The disparities in size and population of the Länder pose a structural difficulty which tinkering cannot cure; i.e., the smaller and poorer Länder will never be able to afford to provide the same levels of services in regard to the joint-task policy areas without special assistance from the Bund. Unfortunately, the long-term resolution of these difficulties depends upon territorial reorganization.

Ability to Adapt to Changes

Despite the areas of dispute noted in the previous section, the fact remains that the Federal Republic of Germany has proven itself remarkably adaptable over its first fifty years. Adjustments in the federal balance have been accomplished via constitutional amendment, intergovernmental relations, and judicial review. All three processes have proved relatively flexible. Partial revisions of the constitution have been common, with the major amendments having included

¹⁴⁴ Leonardy, “German Federalism Towards 2000,” 296.

the strengthening of the Bund's legislative and financial roles in the late 1960s, the reunification of Germany in 1990, and the post-unification reforms of 1994.

Intergovernmental relations in Germany have also proven a relatively successful method of adjustment in the federation. The German pattern of intergovernmental relations follows the 'executive federalism' model common to parliamentary federations. However, in Germany the intensive network of relationships, at the *Gesamstaat*, *Bundesstaat*, and 'third' levels, provide for systematic coordination among orders of government. This tightly interlocked relationship appears to offer a less conflictual model of executive federalism than is found in some other parliamentary federations.

This system of interlocked relationships has been criticized, however, for being an impediment to adaptation. An institutional culture which puts a premium on consensus can mean the indefinite postponement of difficult policy choices. This is the so-called 'joint-decision trap', identified by Fritz Scharpf, in which both policy decisions and changes to the rules via which such decisions are made are blocked by an institutional culture which prescribes unanimous agreement for virtually all major decisions. Finding the most effective balance between cooperation among orders of government and maintenance of each order's ability to act autonomously and flexibly in response to policy challenges has become a major issue within the German federation, although it is a problem not unknown to other federations.

Judicial review has been an important method of adaptation to changing circumstances, in part due to German societal norms which prescribe that political life take place with significant reference to a legal framework. The Federal Constitutional Court's balanced approach to jurisdictional disputes has meant that both orders of government have been able to use the Court to seek adjustments in the federation.

While the fiscal transfer system was showing some strain in the 1980s, overall it may be observed that prior to reunification it had proven a flexible instrument in the West German context. With special transitional provisions and adjustments in the allocation of VAT revenues, the system has survived reunification. However, the enduring disparities in economic development between the former West- and East-German Länder, and the consequent high levels of transfers, are severely straining the inter-Länder solidarity on which the system depends. Whether the wider system of intergovernmental relations will be sufficiently flexible to effect the necessary changes which would preserve the principles of the present system while adapting its details to the new economic realities is an open question.

2. Transparency and Accountability Considerations

As noted in section A.5, the highly integrated German system of fiscal federalism exhibits a degree of complexity which is inimical to transparency and accountability.

Transparency is decreased by the complexity of the system of fiscal federalism. The interdependent network of shared taxes, equalization transfers, expenditure responsibilities, and even decision-making institutions makes it difficult for citizens to identify which government is taxing or spending for particular purposes. Given the interlocking of German institutions, however, it is difficult to see how this situation could be remedied. Nevertheless, the issue of improving transparency and accountability has been receiving increased attention within Germany in recent years.

If accountability requires clear mechanisms for making executive action answerable to legislative control and supervision, then the German system cannot be said to exhibit high levels of accountability. The German system of legislative and administrative non-coincidence is a structural impediment to clarity in lines of accountability. As well, the evolution of the Federal Republic of Germany has reinforced the interlocked features of the federation. While this has aided governments in the efficient coordination of their activities, it has also further blurred the lines of democratic accountability.

3. Political Culture

Post-unification, German society remains relatively homogeneous, if less so than before, and the process of intergovernmental relations and fiscal arrangements reflects and reinforces this characteristic.

The quest to create a common standard of living across the federation, 'equivalence of living conditions' in post-1994 constitutional parlance, is emblematic of both the fact and the norm of homogeneity. It is in the context of the drive to create what has been termed "the unitary federal state"¹⁴⁵ that the operation of a number of the features of the German federal system are best understood. The division of legislative/administrative responsibilities, the wide area of concurrent legislative jurisdiction, and the constitutional provision for federal framework legislation, together provide a constitutional environment facilitative of uniformity. Federal framework legislation, for example, can provide a basic

¹⁴⁵ Hartmut Klatt, "Centralizing Trends in West German Federalism, 1949-89," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 42.

legislative standard across the country, while Land governments are allowed a certain latitude for customization of implementation via their administrative control.¹⁴⁶

The extensive system of financial equalization between richer and poorer Länder has also had its philosophical roots in the achievement of uniform living standards across the Federal Republic of Germany. It is true that the degree of equalization which should be pursued is now a matter of dispute among Länder. However, the principle of equalization payments as a means to achieve the goal of common living standards remains a matter of consensus. Indeed, even the proposals for territorial reform and changes to the fiscal transfer system are aimed not at undermining the goal of uniformity, but at facilitating its achievement. Thus, the highly integrated and interdependent characteristics of fiscal federalism in Germany largely grow out of and reflect its prevailing political culture.

¹⁴⁶ Ibid.

Chapter 7. Fiscal Federalism in the U.S.A.

A. Federalism in the USA: The Constitutional and Political Context

The United States of America became the first modern federation in 1789 following the failure of the previous confederal form of government established in 1781. At its origin the federation was composed of 13 states. Since then it has expanded across the continent and evolved into a federation of 50 states. The United States survived a devastating Civil War, 1861-1865, during the first century of its existence, but still operates under the original federal constitution of 1789. It is, therefore the longest-standing federation in the world, and it serves as an important reference point in any comparative study of fiscal federalism.

In comparative terms, the United States is moderately noncentralized. The major feature of the distribution of powers, which applies symmetrically to all 50 states, is the arrangement whereby the Constitution lists subject matters delegated to the federal government and leaves fairly substantial residual authority to the states. Those powers delegated to the federal government are mostly concurrent with federal law prevailing in cases of conflict with state laws. In a few areas the states are prohibited from legislating, thus making these matters in effect exclusively federal. While originally a more decentralized federation than Canada, the extensive exercise by the federal government of its authority in areas of concurrent jurisdiction, the broad interpretation of the doctrine of "implied powers" in the interpretation of federal powers by the courts, and the extensive use by the federal government of its spending power have resulted in a federation that is now considerably more centralized than the Canadian federation.

Within the institutions at both levels of government, the separation of powers between executive, legislative and judiciary is the prevailing principle, involving a system of checks and balances among these institutions. The federal Congress includes a directly elected House of Representatives with representation based on population and a directly elected Senate in which the states are each represented by two Senators. The President is also directly elected, state votes being allocated on the basis of an Electoral College. The lack of party discipline, resulting in part from the separation of powers, has generally given prominence to local and state views in congressional deliberations. The large number of states and the separation of powers within both levels of government has also

lead to a diffused, complex and relatively uncoordinated set of intergovernmental relationships.

Although there is no constitutional requirement for the federal government to cooperate with the states in carrying out policies in those areas in which it has legislative jurisdiction, in practice federal governments have chosen frequently to use state and local governments as administrative agents, sometimes leaving them considerable latitude of operation. To influence the application of its policies, the federal government has relied extensively on conditional grants to the state and local governments. This has given relations between governments in the United States federation a highly interdependent character.

1. Constitutional Status of Various Orders of Government

The United States of America consists of a federal government, 50 state governments, 2 federacies, 3 local home-rule territories, 3 unincorporated territories, over 130 Native American domestic dependent nations, and numerous municipal (or local) governments.¹⁴⁷ All of the federal and state governments are organized according to the principle of the separation of executive and legislative powers.

The Federal and State Legislatures

The separation of legislative and executive branches of government within the federal and state legislatures, combined with fixed terms of office, has allowed the legislative branch to maintain its independence from the executive. The Senate is the Upper House of the federal legislature. It is composed of two Senators from each state, who are directly elected on state-wide constituencies for six-year terms, one-third being elected each two years. The Senate has equal power with the House of Representatives, and in addition the power to ratify treaties and certain executive and judicial appointments. The prestigious position of Senators makes them rivals to the President for public attention.

The House of Representatives, or Lower House, is elected on the first past the post electoral system, with the number and distribution of seats based on population. The electoral term of the House is relatively short, two years, and the number of members relatively large, at 435.

¹⁴⁷ Ronald L. Watts, *Comparing Federal Systems* (2nd ed.; Montreal and Kingston: McGill-Queen's University Press, 1999), 21.

The separation of legislative from executive power encourages a regime of weak party discipline to prevail throughout the system. As a result members of both the House and the Senate are free to form *ad hoc* cross-party legislative coalitions on an issue-by-issue basis. In a custom referred to as ‘log-rolling’, members trade their support for legislation in which they have no crucial interest for support from other members on legislation in which they do have a critical interest.

Weak party bonds mean that members of both Houses are, to a great degree, individual ‘political entrepreneurs’. Election campaign costs are high, and candidates are largely responsible for raising their own election campaign finances. Thus, members of both Houses, but especially Representatives due to their short electoral terms, are constantly aware of the need to remain attentive to their constituencies. The result is that a member of either House is highly motivated to ensure the member’s constituency receives the maximum benefit from the federal treasury.

The separation of legislative and executive power allows for the possibility of differing party affiliations between the two branches, a pattern referred to as ‘divided government’. As well, it is possible for there to be differing party majorities in the two Houses of the federal legislature. While such patterns of partisanship can result in legislative impasses, in general the two branches and two Houses simply act as ‘checks and balances’ on each others’ actions.

The separation of powers principle is also adhered to at the state level. State legislatures are bicameral, except for unicameral Nebraska.¹⁴⁸ Governors of states are directly elected on state-wide constituencies, while state Senators and Representatives are elected directly by district.

The Courts

The courts are considered the third element of the system of checks and balances comprising the U.S. governmental structure. The Supreme Court of the United States is the only federal court established by the U.S. Constitution.¹⁴⁹ It has the power of constitutional review and invalidation of any federal or state law which it deems to be contrary to the federal Constitution.

¹⁴⁸ Daniel Elazar, *Federal Systems of the World: A Handbook of Federal, Confederal and Autonomy Arrangements* (Harlow, Essex, UK: Longman, 1991), 311.

¹⁴⁹ *Ibid.*, 311.

Constitutional Status of the Federal and State Governments

The preamble of the U.S. Constitution makes it clear that it is the people of the United States who are sovereign, and it is they who have established the federal Constitution. Similarly, each of the 50 constituent states of the federation has a constitution of its own design, the authority for which is derived from the people of the state, not from the federal Constitution.¹⁵⁰

The major feature of the distribution of powers is that the Constitution lists matters under federal authority, most of which are concurrent but some of which are exclusively federal, and leaves the unspecified residuum to the states. Administrative authority is allocated coincident with legislative authority.

The federal government's legislative ambit includes: the power to levy taxes, provided it does not discriminate among states; the exclusive power to negotiate treaties and conduct foreign relations; the power to regulate foreign and interstate commerce; the principal responsibility for defence and the armed forces; and the jurisdiction to deal with crimes against the United States. The states retain jurisdiction over the greater part of the criminal law and administration of justice; jurisdiction over the civil law; the responsibility for most domestic functions other than those associated with the regulation of the economy, including education, health, environmental protection and social services; and the power to levy taxes and other fees.¹⁵¹

Local Governments

The United States' Constitution makes no reference to local governments. The organization and activities of local governments are therefore a subject of the various state constitutions. Consequently, the nature of the relationship between state and local governments, and among local governments, varies from state to state.¹⁵²

¹⁵⁰ Ibid.

¹⁵¹ Ibid., 312.

¹⁵² Janet G. Stotsky and Emil M. Sunley, "United States," in Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington: International Monetary Fund, 1997), 359-60.

2. Constitutional Allocation of Revenue and Expenditure Responsibilities and Provisions Related to Intergovernmental Transfers

Constitutional Allocation of Revenue

The Constitution invests the federal government with a very broad discretionary revenue-raising power.¹⁵³ Article One, Section 8 states that “The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises...and provide for the...general Welfare of the United States.” However, as the federal government’s power to raise taxes is not exclusive, states retain the right to levy taxes and to regulate the taxing powers of local governments.¹⁵⁴ Thus, although there are no shared taxes, more than one order of government may exploit the major revenue sources. For example, both orders of government may levy personal and corporate income taxes, and selective sales taxes.¹⁵⁵ The U.S. has a decentralised tax administration system, with each order of government having its own administrative system to collect the taxes it imposes.¹⁵⁶

Personal Income Taxes. Both the federal and state governments levy personal income taxes. Individuals complete their federal tax return first; the state tax burden depends largely on the degree of conformity between the federal and state income tax laws. Overall, the federal government dominates the income tax field. State income taxes tend to be at relatively low levels.

Corporate Income Taxes. Corporate income taxes are levied by both federal and state governments. Businesses that operate in more than one state must apportion their income among the states.¹⁵⁷ Because apportionment formulas vary from state to state, it is possible to have either double taxation of income or to have income escape taxation. A strong case could be made for uniformity in regard to apportionment, but the federal government has no constitutional power to enforce such uniformity.

Sales Taxes. There is no broad-based consumption tax at the federal level.¹⁵⁸ The federal government does, however, impose selective sales taxes. States utilise both general and selective sales taxes.

¹⁵³ Ronald L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston: Institute of Intergovernmental Relations, 1999), 10.

¹⁵⁴ Stotsky and Sunley, 364.

¹⁵⁵ *Ibid.*, 368.

¹⁵⁶ *Ibid.*, 361.

¹⁵⁷ *Ibid.*

¹⁵⁸ *Ibid.*, 368.

Constitutional Allocation of Expenditure Responsibilities

In general, the Constitution does not distinguish between the law-making and spending powers of the federal and state governments.¹⁵⁹ Due to the large area of concurrent jurisdiction, there is extensive overlap in the jurisdictions of the two orders of government. In these areas there is extensive federal funding of matters that lie within the legislative competence, although not the exclusive competence, of the states.

Constitutional Provisions Related to Intergovernmental Transfers

There are no provisions in the U.S. Constitution which prescribe intergovernmental transfers. Consequently, there have been no generalized schemes in the U.S. for vertical transfers or for equalization programs.¹⁶⁰ Similarly, there have been no constitutionally specified portions of federal taxes dedicated to federal transfers to state governments. Only a few federal taxes, such as fuel and airport taxes, have been designated by federal statute for transfer to state or local governments to fund the transportation system.

However, because the Constitution does not prohibit intergovernmental transfers, and because of the broad discretionary revenue-raising and spending power of the federal government, an extensive, if uncoordinated, system of intergovernmental transfers has grown up. State and local governments have become heavily dependent on intergovernmental transfers from the federal government to meet their financial needs. Such transfers are almost solely in the form of conditional grants, often with the conditions closely specified.

Three sets of objectives have contributed to the growth of the system of intergovernmental transfers.¹⁶¹ First, they have been used by Congress to encourage the states to pursue nationally-defined policies. Second, they have been used to support the modernization of state administrative systems and thus to support the development of more effective policy. Third, they have been used to assist the states in their institution of, and continuing participation in, redistributive policies. The latter is necessary both due to the disparities among the states in regard to revenue-raising capacity, and to federal dominance in the collection of direct revenues, especially income taxes.

¹⁵⁹ Watts, *Spending*, 10.

¹⁶⁰ *Ibid.*, 11.

¹⁶¹ *Ibid.*

Two types of conditional transfers have been utilised: block transfers and categorical transfers. Block transfers apply to broad categories of related functions, and impose few restrictions on how states or local governments allocate funds to activities within the block. Block transfers have been used for areas such as health and social services.

Categorical transfers provide financial support for specific programs. Formula-based categorical transfers distribute resources to state and local governments according to legislative or administrative criteria defined at the federal level. Formula transfers include both open-ended grants with matching requirements, and closed-ended matching and non-matching grants. A second type of categorical transfer, project grants, are awarded selectively on the basis of applications.

Federal transfer programs have been used to cover a wide range of government services. The largest have been in the areas of education, health, social services, transportation, environmental protection, and regional development.¹⁶²

A large proportion of federal grants are passed on from state governments to local governments. In addition, state governments provide some own-source grants to local governments.

3. Institutional or Other Spending Power Provisions

As noted above, the federal government's expenditure powers, "to provide for...the general Welfare of the United States," are very broad. Thus, there are no legal limits or interdictions on the objects on which the federal government may spend its own-source revenues.

The courts have supported a broad interpretation of the federal government's revenue-raising and expenditure powers.¹⁶³ Courts have upheld the federal government's rights to these powers in regard to areas of both concurrent and exclusive state jurisdiction. Because the Constitution does not list powers specifically reserved to the states, the only provision protecting the position of the states is the Tenth Amendment, which prescribes that "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." Neither this constitutional provision, nor court rulings based upon it, have been taken to prohibit federal spending in areas of exclusive state jurisdiction.

¹⁶² Stotsky and Sunley, 370-71.

¹⁶³ Watts, *Spending*, 10.

Two features of the U.S. use of the federal spending power are particularly notable. First, the unsystematic use of conditional transfers produces an uncoordinated, complex web of intergovernmental transfers. Second, the Congress has in the past acted unilaterally to mandate that states or local governments establish programs for which the federal government has not allocated funds. These 'unfunded mandates' became highly controversial politically in the early 1990s, and have subsequently been in decline.

4. Political and Legal Dynamics – Including the Role of Law and Role of Politics in the Decision-Making Processes

The United States ranks as one of the most culturally homogeneous federations. While it has substantial black and hispanic minorities, in no state does either of these groups constitute a majority. There are some regional variations in political culture, but generally there is a substantial belief in the benefits of the dispersal of governmental power. It is the latter which supports the persistence of U.S. federalism.

The amendment of the federal Constitution requires the consent of both a majority in the federal Congress and a majority of the state legislatures. This process has proved to be relatively rigid in practice: after the first ten amendments were agreed during the ratification process and enacted in 1791, there have only been seventeen other successful amendments in the ensuing two hundred years.

As American society has evolved over the life of the federation, and as the text of the Constitution has remained relatively unchanged, other devices have been developed to allow the federation to adapt to new circumstances; intergovernmental relations is one of these devices.

Intergovernmental relations in the U.S. are best conceived of as a matrix of connections. Legislators, administrators, and executives in all three levels of government interact in an uncoordinated but ongoing basis. The federal Congress is a site for lobbying not only by societal interest groups but also by agents of state and local governments. The separation-of-powers model of governance allows a lack of party discipline to permeate the system. As a result, state and local views can be accommodated in the process of congressional deliberations.

However, to see the federal capital as the centre of decision-making would be to misunderstand the system. It is because the decision-making networks are not necessarily centred on Washington that U.S. federalism has been described as not only decentralised, but as 'noncentralized'. The locus of decision-making can shift over time due to the extensive area of effective concurrency of constitutional jurisdiction.

Extensive areas of shared jurisdiction thus allow for a degree of flexibility as to where legislative and administrative decisions are taken at a given time. The U.S. federation underwent a period of crisis-induced centralization in the 1930-45 period spanning the Depression and World War II.¹⁶⁴ The states proved unable to deal with the economic disruptions of the Great Depression. President Roosevelt's 'New Deal' brought explosive growth in unilateral federal actions, as well as in federal-state and federal-local co-operation. The basic outlines of the U.S. welfare state were defined during this period. The post-war period, from 1945 to the early 1960s was a period of consolidation, but little further federal expansion. The Johnson administration of the mid-1960s brought another period of new social policy initiatives from the federal government. The 'Great Society' initiative was embodied in a host of new federal programs; new federal agencies undertook to implement these programs on the basis of a conception of national needs and priorities.

The perception of the failure of many of the 'Great Society' initiatives, combined with the disillusionment caused by the Vietnam War and Watergate crises, led to a turn back to state powers beginning in the mid-1970s. The Ford and Carter administrations made some attempts to come to grips with this trend, but it was the Reagan administration that pushed the decentralist agenda. Transfer programs were restructured and cut back, and regulations associated with state receipt of federal funds were reduced. States responded by becoming stronger initiators of government services. These trends continued through the Bush and Clinton administrations.

In the latter 1990s one symptom of the decentralist trend has been the conversion of some categorical transfers to block transfers. In the mid-1990s, for example, one of the longest-running welfare state programs, the federal Aid for Families with Dependent Children (AFDC) program, established in 1935, was dismantled and replaced by a block grant program (see Section C, 1(b) below).

Role of Law in the Decision-Making Process

As noted, the non-constitutional processes of shifting of responsibilities according to the principle of concurrency and the noncentralized bargaining processes of intergovernmental relations have played the largest role in the resolution of issues affecting both the overall federal system and the fiscal arrangements within that system. However, the courts, as the third element of the

¹⁶⁴ Elazar, 313.

federal system of checks and balances, have also played a significant role in the evolution of U.S. federalism.

While the U.S. Supreme Court was established by the Constitution, its power of judicial review, that is, the power to review the constitutional validity of acts of Congress and the state legislatures, was not explicitly provided for by the Constitution.¹⁶⁵ The Court itself laid claim to the power of judicial review in a landmark decision in 1803.

Over the years the U.S. Supreme Court has been important in setting the legislative boundaries between the national and state governments. While there have been some important exceptions, in general the Court has been very sympathetic to the idea of a powerful national government. In the 1810s and 1820s, the Court established, via a series of decisions, Congress's authority to manage the national economy. In the late 19th century, the Congress established the Interstate Commerce Commission and passed legislation outlawing monopolies; both helped the federal government establish itself as a major actor in the national economy, and both were upheld by the Court.¹⁶⁶ In the early 20th century, the Court initially denied both orders of government the right to regulate conditions of work, citing the doctrine of economic *laissez-faire*; when the right was finally granted, however, it was held to be within federal jurisdiction.¹⁶⁷ After a constitutional *contretemps* with President Franklin Roosevelt, in the 1930s, over the rights of the federal government, the Court endorsed the federal government's right to regulate the market, redistribute income, create a modest welfare state, and manage the relationship between workers and employers.

The most dramatic Court-supported expansion of federal power came in the early 1960s. The federal government had been hesitant to challenge the system of state-sanctioned racial segregation that operated in the southern states, in part because it believed it lacked the jurisdiction to enforce civil rights. In 1964, however, the Congress used its power over the regulation of interstate commerce to ban discrimination, claiming that it substantially affected such commerce. The Supreme Court not only accepted that rationale, but interpreted so broadly what it

¹⁶⁵ Jennifer Smith, "Judicial Review and Modern Federalism," in Herman Bakvis and William M. Chandler, eds., *Federalism and the Role of the State* (Toronto: University of Toronto Press, 1987), 114.

¹⁶⁶ Robert C. Vipond, "Canadian and American Federalism: A Comparative Perspective," in Martin Westmacott and Hugh Mellon, eds., *Challenges to Canadian Federalism* (Scarborough: Prentice-Hall Canada, 1998), 19.

¹⁶⁷ André Bzdera, "Comparative Analysis of Federal High Courts: A Political Theory of Judicial Review," *Canadian Journal of Political Science* 26:1 (March 1993), 9.

meant to ‘affect interstate commerce’ that both Congress and state legislatures concluded that the Court would allow the federal government virtually unrestrained rights to regulate in this area.

In a 1985 decision, the *Garcia* case, the Court repudiated its role as the adjudicator of disputes between the states and the federal government, noting that the states should look to the political process for their protection. The Court has since moderated this extreme position; however, the long-term record of the Court remains one which indicates a general predisposition to support the expansion of federal power.

Reference Procedures

The U.S. Supreme Court does not accept reference cases; in a 1911 decision it rejected an attempt by Congress to require it to undertake such a task. It retains a strictly adjudicatory power, refusing to determine questions of constitutional validity not arising out of concrete disputes.¹⁶⁸

Appointments to the Appeal Courts

Appointments to all federal benches are made by the President, subject to ratification by the Senate. While appointments to the lower federal courts are generally uncontroversial, Supreme Court appointments have become increasingly contentious. Presidents regard the appointment of Supreme Court Justices as an opportunity to entrench their political philosophy in government in a way that will outlast their own term in office. As most Supreme Court nominees are sitting appellate court judges, they have a long history of judgements. The Senate ratification hearings are thus occasions of high political drama, in which the nominee’s judicial record, personal qualities, and political leanings are closely examined.

Role of Politics in the Decision-Making Process

Decisions concerning the use of the federal power to spend in areas of concurrent or exclusive state jurisdiction do not require any special procedures.¹⁶⁹ Thus, decisions about federal spending in these areas has rested with the Congress and the President. The Congress has not considered itself restricted by any

¹⁶⁸ Smith, 116.

¹⁶⁹ Watts, *Spending*, 12.

extra-legal principles, such as federalism, when deciding on the use of its spending power.

The noncentralized nature of intergovernmental relations in the U.S. means that there is little overall coordination between the two orders of government in regard to the design of programs involving the expenditure of federal funds. The diffusion of policy-making in both orders of government due to the institutional separation of powers, the large number of states, and the lack of any formal, high-level intergovernmental linkages all play a part in fostering uncoordinated program formulation. As there is no constitutional or statutory provision for a role for the states in decisions regarding the use of the federal spending power, state and local government representatives participate in lobbying the Congress on its decisions relating to the federal spending power along with a wide variety of other interest groups.

Ultimately, the acceptance or rejection of federal financial transfers is a decision left up to the states. However, there is no system in place which would allow a state which decided to opt-out of a program to receive financial compensation. In practice, therefore, opting-out of a significant federal grant program has not been a realistic option for states. Some states do, however, effectively opt out of some smaller project grants by simply declining to apply.

5. Transparency and Accountability

As noted above, the federal government has considerable discretionary power in both revenue-raising and expenditure decisions, and has chosen to spend in many areas of both concurrent jurisdiction and exclusive state jurisdiction. An uncoordinated, but extensive, system of intergovernmental transfers has developed. This combination conduces to a system with both low transparency and low accountability.

Consequently, there has been a high degree of concern in the U.S. literature on fiscal federalism around the principle of financial responsibility.¹⁷⁰ It is often argued that the achievement of political accountability depends upon adherence to the principle that the order of government that raises revenue should be the order of government that determines how that revenue is expended.

It is to be expected that this would be a particular concern in a separation of powers system. In a parliamentary system, accountability for funds transferred

¹⁷⁰ Ronald L. Watts, "Comment: The Value of Comparative Perspectives," in K.G. Banting and D.M. Brown, eds., *The Future of Fiscal Federalism* (Kingston: School of Policy Studies, Queen's University, 1994), 327.

intergovernmentally is enhanced as the executive in receipt of the funds is directly responsible to a legislature and thus to an electorate. In the U.S. system, however, the executive branch has no such direct responsibility.

The mechanism used to compensate for this lack of accountability at the state level is the conditional transfer. As the federal government has raised the funds that are transferred, it maintains its accountability for those funds by setting conditions on how the state or local government may expend them. Thus, currently virtually all federal grants to state and local governments are conditional in form. The trade-off for this level of accountability is decreased state autonomy. To the extent that the spending priorities established by the federal government do not coincide with state priorities, but states accept the conditions in order to access the funds, state autonomy is undermined.

One benefit of the extensive use of conditional grants is a higher degree of transparency than is found in some other federations. While we have noted that U.S. intergovernmental relations constitute a complex web, the adherence, to some degree, to the principle of financial responsibility means that citizens have been able to identify the federal government's responsibility.

B: Summary of Federal, State, and Local Budgetary Relations in the United States

In this section, we describe the trends in the evolving division of responsibilities for expenditures and revenue-raising of the federal, state, and local levels of government in the United States.

Our description of the trends in responsibilities of the various levels of government begins with the shares of federal, state, and local governments in public expenditures. We then examine the trends in the shares of federal, state, and local governments in government revenues. Following this, we examine the importance of transfers in total revenues of state and local governments. Lastly, we describe the importance of vertical and horizontal imbalances.

Federal, State, and Local Government Shares of Total Public Spending

Table B1 provides data from 1960 through 1995 on the shares of federal, state, and local government in total public spending. We have divided the data into two categories: one including intergovernmental transfers and one excluding them. We do this to avoid duplication so that, for example, transfers that are reported as expenditures of the federal government are not also included implicitly in the expenditures of state and local governments that they help finance. Thus,

data including transfers treat transfers as expenditures of the disbursing governments, whereas data excluding transfers treat them as receipts of the recipient governments.

TABLE B1: FEDERAL, STATE, AND LOCAL GOVERNMENT SHARES OF TOTAL PUBLIC SPENDING (PERCENTAGES)

| Year | Including Transfers | | | Excluding Transfers | | |
|------|---------------------|-------|-------|---------------------|-------|-------|
| | Federal | State | Local | Federal | State | Local |
| 1960 | 64.3 | 16.5 | 19.1 | 59.7 | 14.5 | 25.8 |
| 1961 | 63.6 | 17.1 | 19.3 | 59.3 | 14.9 | 25.8 |
| 1962 | 64.4 | 16.6 | 19.1 | 60 | 14.4 | 25.6 |
| 1963 | 64.2 | 17.2 | 18.6 | 59.6 | 15.0 | 25.4 |
| 1964 | 64.1 | 17.0 | 18.9 | 59 | 15.2 | 25.9 |
| 1965 | 63.2 | 17.4 | 19.4 | 57.9 | 15.3 | 26.9 |
| 1966 | 63.6 | 17.4 | 19.0 | 57.8 | 15.1 | 27.1 |
| 1967 | 64.7 | 17.5 | 17.8 | 58.9 | 15.4 | 25.7 |
| 1968 | 65.3 | 17.7 | 17.0 | 58.9 | 15.3 | 25.8 |
| 1969 | 63.6 | 18.4 | 18.0 | 57.3 | 15.8 | 26.9 |
| 1970 | 62.5 | 19.4 | 18.1 | 55.5 | 16.5 | 27.9 |
| 1971 | 61.2 | 20.5 | 18.2 | 53.8 | 17.9 | 28.4 |
| 1972 | 60.7 | 20.3 | 19.0 | 52.3 | 17.9 | 29.9 |
| 1973 | 62.4 | 20.1 | 17.5 | 53 | 17.9 | 29.1 |
| 1974 | 61.7 | 21 | 17.3 | 52.7 | 18.0 | 29.2 |
| 1975 | 60.8 | 21.8 | 17.4 | 51.9 | 19.0 | 29.1 |
| 1976 | 62.4 | 20.4 | 17.2 | 51.3 | 17.9 | 30.8 |
| 1977 | 63.3 | 20.2 | 16.5 | 52.4 | 18.0 | 29.6 |
| 1978 | 64.1 | 20.1 | 15.8 | 53.5 | 18.0 | 28.6 |
| 1979 | 64.4 | 20.3 | 15.4 | 54.1 | 17.9 | 28.0 |
| 1980 | 64.2 | 20.0 | 15.8 | 54.7 | 17.8 | 27.4 |
| 1981 | 64.6 | 19.9 | 15.5 | 56.1 | 17.8 | 26.1 |
| 1982 | 64.4 | 19.6 | 16.0 | 57.5 | 17.1 | 24.0 |
| 1983 | 64.6 | 19.5 | 15.9 | 57.7 | 17.2 | 25.0 |
| 1984 | 64.9 | 19.2 | 16.0 | 57.9 | 17.0 | 25.0 |
| 1985 | 65.2 | 19.3 | 15.5 | 58.4 | 17.1 | 24.5 |
| 1986 | 64.5 | 19.2 | 16.3 | 57.7 | 17.0 | 25.3 |
| 1987 | 63.4 | 19.9 | 16.7 | 57.2 | 17.5 | 25.3 |
| 1988 | 63.3 | 19.7 | 17.0 | 57.1 | 17.2 | 25.7 |
| 1989 | 62.5 | 20.3 | 17.2 | 56.3 | 17.6 | 26.1 |
| 1990 | 62.8 | 19.6 | 17.6 | 56.2 | 17.2 | 26.6 |
| 1991 | 62.2 | 20.1 | 17.7 | 55.5 | 18.1 | 26.4 |
| 1992 | 61.4 | 21.0 | 17.6 | 54.0 | 19.3 | 26.8 |
| 1993 | 61.0 | 21.2 | 17.8 | 53.1 | 19.9 | 27.0 |
| 1994 | 60.6 | 21.6 | 17.7 | 52.5 | 20.6 | 26.8 |
| 1995 | 60.1 | 22.2 | 17.6 | 51.9 | 21.1 | 26.9 |

Source: U.S. Census Bureau, *Statistical Abstract of the United States*, selected years and The Tax Foundation, *Facts and Figures on Government Finance*, 1999.

Examination of the data in Table B1 shows that there has been a small tendency for spending to become more decentralized over time from the federal to the state governments. This is true both including and excluding transfers. The federal share of total spending including (excluding) transfers was 64.3% (59.7%) in 1960 and had fallen to 60.1% (51.9%) in 1995. During the same period, the states' share of spending has increased from 16.5% (14.5%) to 22.2% (21.1%). Despite the tendency for state spending responsibilities to grow over time, the federal government still commands a dominant role in public spending in the United States. While many state and local expenditure responsibilities are in areas of high growth (e.g. education and health care), the federal government is actively involved in many high growth areas either concurrently with the states (e.g. health care) or predominantly independently (e.g. national defense and social security). Somewhat surprisingly, the same trend of increasing expenditure shares has not occurred with respect to local governments.

Federal, State, and Local Government Shares of Total Government Revenues

Data on federal, state, and local government shares of government revenues are provided in Table B2. Again, we provide the data under the two categories including and excluding transfers. Data including transfers treats them as revenues of the recipient governments. Data excluding transfers indicate own-source revenues. As was the case for spending shares, we see in the data that there has been a small tendency for revenue-raising responsibilities to become more decentralized to the states. Indeed, this trend is more pronounced for revenues than it is for expenditures. The data including transfers also indicates that there has been a slight increase in revenues of local governments to finance their expenditures.

Two trends are noteworthy in examining the data in Table B2. The first is that federal own-source revenues (i.e. excluding transfers) continue to dominate state and local government own-source revenues. However, the opposite is true if we include transfers as revenues at the state and local levels. Here, the federal share has fallen from 60.6% in 1960 to 47% in 1995. This indicates that transfers from the federal to the state and local governments have increased in importance. The second noteworthy trend is that the federal government continues to have a dominant role in revenue-raising despite the ability of the states to access many major tax fields.

The Importance of Intergovernmental Transfers

Data showing the importance of transfer payments from one level of government to another are provided in Table B3. We have divided the data into: (i) federal to state government transfers as a share of total state revenues, (ii) federal to local government trans-

fers as a share of local government revenues, (iii) state to local government transfers as a share of local government revenues, and (iv) combined federal and state transfers to local governments as a share of local government revenues.

TABLE B2: FEDERAL, STATE, AND LOCAL GOVERNMENT SHARES OF TOTAL GOVERNMENT REVENUES (PERCENTAGES)

| Year | Including Transfers | | | Excluding Transfers | | |
|------|---------------------|-------|-------|---------------------|-------|-------|
| | Federal | State | Local | Federal | State | Local |
| 1960 | 60.6 | 15.0 | 24.3 | 65.2 | 17.0 | 17.8 |
| 1961 | 59.4 | 15.2 | 25.4 | 63.8 | 17.5 | 18.6 |
| 1962 | 58.7 | 15.7 | 25.6 | 63.3 | 17.9 | 18.7 |
| 1963 | 58.8 | 15.9 | 25.3 | 63.5 | 18.2 | 18.3 |
| 1964 | 57.6 | 16.7 | 25.7 | 62.9 | 18.6 | 18.6 |
| 1965 | 56.7 | 16.9 | 26.5 | 62.1 | 19.0 | 18.9 |
| 1966 | 56.7 | 16.8 | 26.5 | 62.6 | 19.1 | 18.4 |
| 1967 | 57.9 | 16.4 | 25.7 | 63.9 | 18.5 | 17.6 |
| 1968 | 55.4 | 17.2 | 27.3 | 62.2 | 19.8 | 18.0 |
| 1969 | 57.8 | 16.3 | 25.8 | 64.1 | 18.9 | 17.1 |
| 1970 | 54.6 | 17.7 | 27.7 | 61.6 | 20.6 | 17.8 |
| 1971 | 51.4 | 19.0 | 29.6 | 59.5 | 21.9 | 18.7 |
| 1972 | 49.6 | 19.4 | 31.0 | 58.3 | 22.0 | 19.6 |
| 1973 | 49.2 | 20.3 | 30.5 | 58.7 | 22.5 | 18.8 |
| 1974 | 50.6 | 19.3 | 30.1 | 59.5 | 22.2 | 18.3 |
| 1975 | 48.7 | 19.9 | 31.4 | 58.2 | 23.0 | 18.8 |
| 1976 | 44.5 | 21.6 | 33.9 | 56.6 | 24.4 | 19.0 |
| 1977 | 46.9 | 21.4 | 31.8 | 58.1 | 23.7 | 18.2 |
| 1978 | 47.9 | 21.3 | 30.8 | 58.7 | 23.4 | 17.8 |
| 1979 | 50.0 | 20.5 | 29.6 | 60.2 | 22.9 | 16.9 |
| 1980 | 50.7 | 20.6 | 28.7 | 60.5 | 22.8 | 16.7 |
| 1981 | 52.5 | 20.1 | 27.4 | 61.3 | 22.3 | 16.4 |
| 1982 | 52.3 | 20.2 | 26.0 | 59.8 | 22.9 | 17.4 |
| 1983 | 49.5 | 21.5 | 28.9 | 57.4 | 24.1 | 18.5 |
| 1984 | 50 | 21.8 | 28.2 | 57.5 | 24.1 | 18.3 |
| 1985 | 49.2 | 22.1 | 28.7 | 56.8 | 24.6 | 18.6 |
| 1986 | 48.2 | 22.8 | 29.1 | 55.8 | 25.2 | 19.0 |
| 1987 | 50.0 | 22.1 | 27.9 | 56.7 | 24.7 | 18.6 |
| 1988 | 50.1 | 21.7 | 28.1 | 56.8 | 24.5 | 18.7 |
| 1989 | 50.2 | 21.7 | 28.1 | 56.8 | 24.6 | 18.6 |
| 1990 | 49.1 | 22.1 | 28.8 | 56.3 | 24.7 | 19.0 |
| 1991 | 48.9 | 22.0 | 29.1 | 56.4 | 24.3 | 19.3 |
| 1992 | 47.4 | 23.5 | 29.2 | 55.6 | 25.3 | 19.1 |
| 1993 | 46.4 | 24.6 | 29.0 | 55.0 | 26.0 | 19.0 |
| 1994 | 47.0 | 24.3 | 28.7 | 55.6 | 25.3 | 19.0 |
| 1995 | 47.0 | 24.6 | 28.4 | 55.7 | 25.7 | 18.6 |

Source: U.S. Census Bureau, *Statistical Abstract of the United States* and The Tax Foundation, *Facts and Figures on Government Finance*.

*TABLE B3: TRANSFER PAYMENTS FROM FEDERAL TO SUBNATIONAL GOVERNMENTS
AS A SHARE OF SUBNATIONAL GOVERNMENT REVENUES (PERCENTAGES)*

| Year | Federal to State | Federal to Local | State to Local | Total Local |
|-------------|-------------------------|-------------------------|-----------------------|--------------------|
| 1960 | 19.7 | 1.6 | 25.3 | 27.0 |
| 1961 | 18.7 | 1.5 | 25.1 | 26.6 |
| 1962 | 19.1 | 1.5 | 25.3 | 26.8 |
| 1963 | 19.3 | 1.5 | 26.1 | 27.6 |
| 1964 | 20.2 | 2.1 | 25.7 | 27.8 |
| 1965 | 20.4 | 2.2 | 26.4 | 28.7 |
| 1966 | 21.5 | 2.3 | 28.3 | 30.6 |
| 1967 | 22.5 | 2.2 | 29.4 | 31.5 |
| 1968 | 22.5 | 3.9 | 30.2 | 34.1 |
| 1969 | 22.3 | 3.1 | 30.8 | 33.9 |
| 1970 | 21.9 | 4.3 | 31.3 | 35.6 |
| 1971 | 23.4 | 4.7 | 32.3 | 37.0 |
| 1972 | 24.1 | 5.7 | 31.0 | 36.7 |
| 1973 | 24.4 | 7.5 | 30.9 | 38.4 |
| 1974 | 22.7 | 7.7 | 31.6 | 39.3 |
| 1975 | 23.3 | 8.3 | 31.8 | 40.1 |
| 1976 | 23.2 | 14.0 | 29.9 | 43.9 |
| 1977 | 22.8 | 13.5 | 29.2 | 42.7 |
| 1978 | 22.6 | 12.9 | 29.2 | 42.1 |
| 1979 | 22.3 | 12.6 | 30.4 | 42.9 |
| 1980 | 22.5 | 10.8 | 30.9 | 41.7 |
| 1981 | 22.0 | 9.1 | 31.0 | 40.1 |
| 1982 | 20.1 | 0.7 | 32.6 | 33.2 |
| 1983 | 19.5 | 6.9 | 29.1 | 36.0 |
| 1984 | 19.4 | 6.2 | 28.9 | 35.1 |
| 1985 | 19.5 | 5.6 | 29.4 | 35.0 |
| 1986 | 19.5 | 5.2 | 29.5 | 34.7 |
| 1987 | 18.7 | 3.4 | 29.7 | 33.1 |
| 1988 | 18.8 | 3.7 | 29.8 | 33.5 |
| 1989 | 18.7 | 3.5 | 30.2 | 33.7 |
| 1990 | 19.0 | 4.9 | 29.1 | 34.0 |
| 1991 | 20.7 | 4.1 | 29.6 | 33.7 |
| 1992 | 21.7 | 4.1 | 30.5 | 34.6 |
| 1993 | 22.3 | 3.9 | 30.5 | 34.4 |
| 1994 | 23.1 | 3.7 | 30.2 | 33.8 |
| 1995 | 22.7 | 4.1 | 30.6 | 34.6 |

Source: U.S. Census Bureau, Statistical Abstract of the United States and the Tax Foundation, Facts and Figures on Government Finance.

Beginning with the column showing transfers from federal to state governments, we see that there have not been any sizeable changes in the importance of federal transfers as a source of state revenues. Federal transfers constitute roughly 20% of state revenues, with only slight variations around that percentage in the pe-

riod from 1960 to 1995. There has, however, been greater variation in the importance of federal transfers in local government revenues. In particular, there was a large increase in intergovernmental grant programs in the 1960s and 1970s under the Johnson and Nixon administrations. Significantly, many of these programs specified direct transfers from the federal government to local governments, thereby by-passing state governments altogether. This trend came to an end in the 1980s under the Reagan administration and, today, direct federal transfers to local governments represent only a small share of local government revenues. This small share is misleading, however, because if we examine the importance of state transfers to local governments, we recognize that a significant proportion of federal transfers to state governments are passed on to local governments. By the mid-1990s, local governments relied on state and federal transfers for roughly 35% of their revenues. This percentage has increased gradually over time.

Vertical Fiscal Imbalances

Vertical fiscal balance occurs when subnational governments are able to raise sufficient revenues to finance their expenditures. This allows them full autonomy and accountability to their citizens. In most federations vertical fiscal imbalances are the norm and are dealt with through intergovernmental transfers from higher levels of government to lower levels. While this compromises lower-level governments' autonomy and accountability, there are arguments in favour of assigning greater revenue-raising abilities to higher levels of government. These arguments are described in Section C.

Table B4 reports figures for vertical fiscal imbalances in the United States without intergovernmental transfers. In Table B4, the vertical fiscal imbalances for the federal government are measured as the difference between expenditures net of transfers to lower-level governments and revenues as a percentage of expenditures net of transfers. The vertical fiscal imbalances for the states are measured as the difference between expenditures net of transfers to local governments and own-source revenues as a proportion of expenditures net of transfers. In the last column, the vertical fiscal imbalances for the local governments are the difference between expenditures and own-source revenues as a proportion of expenditures.

Vertical fiscal imbalances excluding transfers measure both the extent of deficit financing and the extent that own expenditure needs exceed own-source revenues. Since deficit financing is much more accessible to the federal government in the United States, the deficit financing component of the vertical fiscal imbalance is evident for the federal government in Table B4.¹⁷¹ In particular, we observe a sharp turn-around in the early

¹⁷¹ During the period under consideration, state governments were generally experiencing surpluses.

1980s when the federal government began to run very large budget deficits. During this period, the vertical fiscal imbalance went from negative to positive, reflecting the large deficits of the federal government.

*TABLE B4: VERTICAL IMBALANCES BETWEEN FEDERAL, STATE, AND LOCAL GOVERNMENTS [(EXPENDITURES-REVENUES)/EXPENDITURES]*100*

| Year | Including Intergovernmental Transfers | | | Excluding Intergovernmental Transfers | | |
|------|---------------------------------------|-------|-------|---------------------------------------|-------|-------|
| | Federal | State | Local | Federal | State | Local |
| 1960 | -10.5 | -18.8 | 30.3 | -2.6 | -3.4 | 4.5 |
| 1961 | -3.6 | -13.4 | 30.4 | 3.4 | 1.2 | 5.2 |
| 1962 | -0.7 | -18.5 | 30.2 | 6.2 | -2.5 | 4.6 |
| 1963 | -3.9 | -18.2 | 29.8 | 3.6 | -2.5 | 3.0 |
| 1964 | -4.4 | -19.9 | 29.6 | 4.0 | -5.3 | 2.6 |
| 1965 | -5.7 | -22.5 | 30.8 | 3.2 | -6.1 | 3.0 |
| 1966 | -8.6 | -26.7 | 31.9 | 1.3 | -7.6 | 1.9 |
| 1967 | -6.3 | -18.0 | 33.0 | 3.3 | -2.9 | 2.2 |
| 1968 | 0.7 | -21.2 | 34.3 | 10.4 | -3.8 | 0.4 |
| 1969 | -13.0 | -20.6 | 35.8 | -1.8 | -3.0 | 2.9 |
| 1970 | -11.2 | -24.8 | 36.0 | 1.3 | -4.8 | 0.6 |
| 1971 | -2.0 | -12.9 | 39.3 | 10.4 | 1.4 | 3.6 |
| 1972 | -7.1 | -18.4 | 37.0 | 7.8 | -2.9 | 0.5 |
| 1973 | -9.6 | -24.2 | 36.2 | 7.0 | -8.0 | -3.7 |
| 1974 | -14.1 | -24.9 | 36.8 | 2.4 | -5.4 | -4.1 |
| 1975 | -3.9 | -12.1 | 40.0 | 11.2 | 1.9 | -0.2 |
| 1976 | -0.8 | -24.4 | 43.6 | 17.0 | -6.7 | -0.6 |
| 1977 | -7.2 | -27.2 | 40.6 | 11.3 | -9.9 | -3.8 |
| 1978 | -7.8 | -28.2 | 38.7 | 10.1 | -11.1 | -5.8 |
| 1979 | -10.9 | -27.7 | 40.1 | 6.7 | -9.5 | -5.0 |
| 1980 | -7.5 | -24.4 | 40.8 | 8.4 | -8.2 | -1.7 |
| 1981 | -5.8 | -21.8 | 39.2 | 8.1 | -6.8 | -1.5 |
| 1982 | 3.4 | -24.0 | 36.9 | 13.9 | -6.4 | 5.5 |
| 1983 | 13.1 | -22.5 | 35.3 | 22.3 | -6.5 | -1.1 |
| 1984 | 9.1 | -29.9 | 33.0 | 18.8 | -12.0 | -3.2 |
| 1985 | 12.7 | -29.0 | 31.8 | 21.8 | -11.1 | -5.0 |
| 1986 | 13.6 | -32.4 | 32.9 | 22.7 | -13.5 | -2.8 |
| 1987 | 8.3 | -31.1 | 31.7 | 17.2 | -12.0 | -2.1 |
| 1988 | 7.9 | -31.6 | 32.7 | 16.9 | -11.7 | -1.2 |
| 1989 | 4.6 | -31.6 | 32.7 | 14.2 | -11.3 | -1.6 |
| 1990 | 7.6 | -32.5 | 34.1 | 17.3 | -12.8 | 0.2 |
| 1991 | 9.1 | -20.0 | 34.8 | 19.0 | -6.2 | 1.7 |
| 1992 | 6.4 | -19.5 | 35.3 | 17.8 | -7.5 | 1.1 |
| 1993 | 4.3 | -20.6 | 35.0 | 16.7 | -10.0 | 0.8 |
| 1994 | 1.0 | -14.9 | 33.8 | 14.2 | -7.3 | -0.1 |
| 1995 | -1.5 | -15.2 | 34.8 | 12.4 | -7.3 | 0.3 |

Source: U.S. Census Bureau, Statistical Abstract of the United States and The Tax Foundation, Facts and Figures on Government Finance.

The vertical fiscal imbalances for the states are consistently negative and large in absolute value, whereas those for the local governments are consistently positive and large. From this data we see the importance of intergovernmental transfers from state to local governments. The importance of transfers is also evident when we examine the data including intergovernmental transfers. When intergovernmental transfers are included, the vertical fiscal imbalances measure only deficits and surpluses.

Horizontal Fiscal Imbalances

Horizontal fiscal imbalances (HFIs) result from differences in the abilities of state and local governments to provide government services. HFIs can occur because of differences in the ability to raise revenues and because of differences in expenditure needs and costs. Programs that address HFIs are called equalization programs. A good equalization program addresses need, cost, and fiscal capacity differences. In contrast to several other federations (e.g. Canada and Australia), the United States has no explicit equalization program. However, many categorical grant programs have equalization components built within them.

In tables B5 through B7, we provide data on differences among states with regard to expenditures and revenues. To make the tables less cumbersome to read, we have grouped the states according to regions. This aggregation will necessarily smooth out differences among states. Consequently, in the appendix tables 1,2 and 3, we provide similar data on a state-by-state basis.

1. HFI of State Expenditures

In table B5, we show per capita state government expenditures as a percentage of the United States average. As the data shows, there is considerable variation across regions and over time. The East and West South Central regions tend to have low per capita expenditures compared to the national average, whereas the Pacific and, more recently, the New England and Mid-Atlantic regions tend to have per capita expenditures above the national average.¹⁷² Several regions, including the Mid-Atlantic, East North Central, West North Central, and South Atlantic regions, have all seen their expenditures per capita increase over time relative to the national average.

¹⁷² Table 1 in the Appendix shows that Alaska has very high per capita expenditures relative to the national average. Thus, the Pacific region data is heavily influenced by Alaska.

TABLE B5: STATE GOVERNMENT PER CAPITA EXPENDITURES AS A PERCENTAGE OF UNITED STATES AVERAGE

| Year | New England | Mid Atlantic | E. No. Central | W. No. Central | So. Atlantic | E. So. Central | W. So. Central | Mountain | Pacific |
|------|-------------|--------------|----------------|----------------|--------------|----------------|----------------|----------|---------|
| 1970 | 98.2 | 94.9 | 82.4 | 87.2 | 90.8 | 86.6 | 84.4 | 110.4 | 161.8 |
| 1971 | 101.0 | 95.7 | 81.8 | 86.2 | 91.4 | 85.3 | 83.4 | 105.4 | 168.9 |
| 1972 | 100.1 | 100.8 | 83.7 | 85.3 | 92.2 | 83.9 | 84.1 | 104.7 | 166.9 |
| 1973 | 101.1 | 101.3 | 86.3 | 84.9 | 96.1 | 82.5 | 81.7 | 99.7 | 168.1 |
| 1974 | 99.1 | 103.8 | 88.7 | 86.9 | 96.5 | 83.2 | 81.8 | 98.9 | 163.8 |
| 1975 | 94.1 | 103.3 | 90.4 | 87.9 | 96.5 | 83.7 | 82.1 | 100.1 | 164.4 |
| 1976 | 98.1 | 99.9 | 87.8 | 88.9 | 94.0 | 84.2 | 84.4 | 102.7 | 160.5 |
| 1977 | 95.4 | 102.5 | 89.3 | 91.8 | 92.8 | 84.2 | 83.7 | 101.5 | 161.0 |
| 1978 | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) |
| 1979 | 96.4 | 94.8 | 88.6 | 90.7 | 94.3 | 88.2 | 83.1 | 100.6 | 163.0 |
| 1980 | 95.5 | 92.1 | 88.3 | 91.5 | 89.2 | 85.8 | 81.8 | 98.6 | 179.2 |
| 1981 | 93.3 | 92.9 | 86.9 | 83.0 | 89.2 | 83.0 | 80.1 | 101.5 | 193.6 |
| 1982 | 91.5 | 92.4 | 81.6 | 89.2 | 85.4 | 76.6 | 82.6 | 101.2 | 202.3 |
| 1983 | 96.1 | 94.2 | 86.2 | 89.1 | 84.4 | 78.5 | 82.4 | 99.9 | 193.8 |
| 1984 | 96.0 | 95.9 | 86.5 | 91.5 | 83.2 | 77.8 | 80.3 | 102.1 | 189.6 |
| 1985 | 96.3 | 96.7 | 86.3 | 90.6 | 84.5 | 76.8 | 77.6 | 100.8 | 193.3 |
| 1986 | 97.0 | 111.8 | 95.1 | 96.0 | 77.6 | 77.7 | 85.2 | 108.8 | 158.5 |
| 1987 | 88.1 | 89.6 | 77.0 | 79.0 | 76.0 | 67.0 | 239.3 | 87.1 | 147.0 |
| 1988 | 106.9 | 107.0 | 89.7 | 88.8 | 90.6 | 80.2 | 76.8 | 98.8 | 164.8 |
| 1989 | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) |
| 1990 | 110.5 | 104.0 | 87.9 | 89.9 | 91.4 | 80.3 | 77.8 | 99.0 | 160.0 |
| 1991 | 110.2 | 104.0 | 87.8 | 90.2 | 91.8 | 81.4 | 80.1 | 97.9 | 158.5 |
| 1992 | 111.1 | 116.6 | 86.0 | 89.8 | 87.6 | 82.7 | 83.2 | 96.5 | 157.7 |
| 1993 | 111.9 | 110.1 | 89.0 | 85.6 | 89.6 | 83.5 | 85.7 | 96.9 | 157.0 |
| 1994 | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) |
| 1995 | 108.5 | 111.5 | 91.6 | 90.9 | 91.9 | 84.7 | 84.1 | 94.9 | 150.1 |
| 1996 | 107.9 | 108.4 | 91.5 | 90.4 | 93.8 | 86.8 | 83.5 | 96.2 | 147.1 |
| 1997 | 106.0 | 101.3 | 92.1 | 93.5 | 95.0 | 88.5 | 84.1 | 96.1 | 145.2 |

Source: U.S. Census Bureau, Statistical Abstract of the United States.

Examination of the data over time shows that there has been a small progression towards lower HFIs of state expenditures. This tendency can be caused by several factors. One possible factor, as we noted above, is that federal grant-in-aid programs to state and local governments have equalization-type components within them. The increase in the importance of intergovernmental transfers has thus served to partially reduce HFIs. Another possible factor leading to the reduction in HFIs is that there has been an increase in coordination among states

and between the states and the federal government with regard to the uniformity of program requirements. Other possible factors may be a convergence of preferences among states for government expenditure programs.

TABLE B6: STATE GOVERNMENTS PER CAPITA REVENUES, BEFORE INTERGOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF THE UNITED STATES AVERAGE

| Year | New Eng-land | Mid Atlantic | E. No. Central | W. No. Central | So. Atlantic | E. So. Central | W. So. Central | Mountain | Pacific |
|------|--------------|--------------|----------------|----------------|--------------|----------------|----------------|----------|---------|
| 1970 | 99.7 | 112.1 | 96.1 | 91.7 | 93.2 | 84.3 | 85.5 | 107.8 | 129.7 |
| 1971 | 101.5 | 112.4 | 97.4 | 92.5 | 95.5 | 85.0 | 88.3 | 110.3 | 117.2 |
| 1972 | 106.7 | 114.0 | 96.6 | 93.2 | 95.3 | 84.8 | 87.3 | 106.0 | 116.1 |
| 1973 | 108.6 | 118.2 | 97.2 | 95.5 | 96.6 | 85.6 | 84.1 | 101.5 | 112.6 |
| 1974 | 103.8 | 115.9 | 97.9 | 101.0 | 95.4 | 85.5 | 86.9 | 102.4 | 111.3 |
| 1975 | 97.6 | 111.7 | 96.4 | 97.8 | 93.9 | 86.2 | 87.9 | 108.1 | 120.4 |
| 1976 | 105.0 | 113.0 | 93.6 | 96.4 | 90.3 | 84.0 | 90.3 | 106.0 | 121.4 |
| 1977 | 103.9 | 115.4 | 95.4 | 95.2 | 89.9 | 84.7 | 87.2 | 103.4 | 124.8 |
| 1978 | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) |
| 1979 | 102.8 | 106.0 | 96.6 | 96.1 | 91.8 | 85.9 | 87.9 | 107.5 | 125.6 |
| 1980 | 102.9 | 105.9 | 93.7 | 96.6 | 88.6 | 81.3 | 90.9 | 105.5 | 134.6 |
| 1981 | 102.9 | 104.3 | 90.9 | 92.5 | 87.1 | 84.3 | 95.5 | 106.2 | 136.3 |
| 1982 | 109.0 | 109.6 | 91.1 | 94.8 | 89 | 81.8 | 101.3 | 115.9 | 107.6 |
| 1983 | 111.4 | 112.2 | 93.4 | 97.5 | 86.9 | 80.7 | 87.1 | 104.8 | 126.1 |
| 1984 | 113.3 | 105.1 | 99.3 | 99.0 | 86.8 | 81.5 | 83.6 | 106.3 | 125.1 |
| 1985 | 114.6 | 118.1 | 95.2 | 95.1 | 86.3 | 79.0 | 85.1 | 103.8 | 122.9 |
| 1986 | 122.4 | 119.8 | 95.4 | 92.3 | 86.4 | 78.7 | 80.4 | 101.6 | 122.9 |
| 1987 | 126.9 | 123.3 | 95.6 | 92.1 | 87.4 | 78.2 | 74.1 | 98.9 | 123.5 |
| 1988 | 123.0 | 120.3 | 95.6 | 95.8 | 90.7 | 79.1 | 79.5 | 98.8 | 117.2 |
| 1989 | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) |
| 1990 | 124.0 | 120.5 | 97.6 | 98.2 | 92.8 | 63.5 | 80.3 | 102.1 | 121.1 |
| 1991 | 121.2 | 116.5 | 94.7 | 97.2 | 89.3 | 83.4 | 80.4 | 98.9 | 118.4 |
| 1992 | 125.3 | 125.8 | 92.0 | 95.6 | 87.5 | 82.3 | 79.4 | 97.1 | 115.0 |
| 1993 | 125.2 | 119.8 | 93.9 | 96.4 | 89.0 | 82.4 | 80.2 | 99.8 | 113.3 |
| 1994 | 123.2 | 118.7 | 96.4 | 98.1 | 90.9 | 83.9 | 79.2 | 98.6 | 110.9 |
| 1995 | 124.4 | 119.0 | 99.3 | 96.1 | 91.4 | 84.6 | 78.5 | 93.2 | 113.5 |
| 1996 | 125.3 | 114.9 | 98.8 | 97.6 | 91.9 | 84.3 | 78.5 | 93.5 | 115.1 |
| 1997 | 124.0 | 114.4 | 99.3 | 101.4 | 90.3 | 83.2 | 80.2 | 93.9 | 113.4 |

Source: U.S. Census Bureau, Statistical Abstract of the United States.

2. HFI of State Revenues Before Intergovernmental Transfers

Table B6 provides data on per capita state revenues excluding transfers from the federal government as a percentage of the national average. Differences across regions arise due to differences in preferences and in the ability to raise

revenues. With regard to the latter, there is a wide variation among states in types of revenue sources. For example, several states levy no personal or corporate income taxes or sales taxes. Some states levy property taxes at the state level, the local level, or both.

The data shows that New England, the Mid-Atlantic, and the Pacific regions have been consistently above the national average in revenues per capita.¹⁷³ As was true for per capita expenditures, the East and West South Central regions are considerably below the national average. The New England and West North Central regions have witnessed a considerable increase in revenues per capita compared to the national average whereas the Pacific and Mountain regions have seen a considerable decrease.

3. HFI of State Revenues After Intergovernmental Transfers

In Table B7, we provide data on state per capita revenues including transfers from the federal government as a percentage of the national average. By comparing this data to that of Table B6, we are able to determine whether intergovernmental transfers have had any effect on reducing HFIs on the revenue side. A comparison with Table B6 shows that there has been a slight equalization of revenues per capita because of intergovernmental transfers. One striking anomaly is the Pacific region. In that region, transfers have increased revenues per capita even more above the national average. If we ignore the Pacific region, the equalization among the other regions would likely be more pronounced.

The extent of equalization of revenues can be measured by the coefficient of variation. Tables 2 and 3 in the Appendix provide measures of the coefficient of variation of revenues across states for selected years from 1970 to 1995. As is evident in the tables, the variation in revenues is reduced because of intergovernmental transfers for all years except 1975, where it is slightly higher after transfers.

The data in Tables B6 and B7 show that the New England, Mid-Atlantic, and East and West North Central regions are net contributors to redistribution among regions. Note that the latter two are net contributors despite being below the national average. Also noteworthy is the fact that the East and West South Central regions continue to be well below the national average despite intergovernmental transfers.

¹⁷³ As was true for expenditures, revenues per capita in Alaska are very high relative to the national average, and this is reflected in the data for the Pacific region.

TABLE B7: STATE GOVERNMENTS PER CAPITA REVENUES, AFTER INTERGOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF THE UNITED STATES AVERAGE

| Year | New England | Mid Atlantic | E. No. Central | W. No. Central | So. Atlantic | E. So. Central | W. So. Central | Mountain | Pacific |
|------|-------------|--------------|----------------|----------------|--------------|----------------|----------------|----------|---------|
| 1970 | 81.4 | 80.8 | 75.7 | 77.6 | 78.8 | 74.4 | 77.4 | 99.1 | 254.7 |
| 1971 | 95.7 | 92.6 | 85.6 | 89.1 | 93.3 | 88.0 | 87.8 | 112.2 | 155.6 |
| 1972 | 99.4 | 97.7 | 88.4 | 88.0 | 94.4 | 86.3 | 89.6 | 109.5 | 146.8 |
| 1973 | 101.1 | 103.4 | 89.7 | 89.5 | 95.8 | 87.2 | 86.3 | 105.3 | 141.5 |
| 1974 | 99.0 | 101.6 | 92.1 | 92.6 | 95.7 | 85.9 | 87.1 | 104.0 | 142.1 |
| 1975 | 95.4 | 96.8 | 89.0 | 93.5 | 95.4 | 86.0 | 87.1 | 107.0 | 149.9 |
| 1976 | 97.1 | 94.4 | 86.5 | 91.0 | 90.8 | 83.2 | 86.8 | 105.6 | 164.7 |
| 1977 | 95.4 | 98.5 | 87.3 | 90.5 | 90.4 | 83.3 | 84.0 | 103.7 | 166.9 |
| 1978 | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) |
| 1979 | 95.2 | 94.2 | 88.1 | 88.4 | 92.8 | 84.9 | 85.2 | 104.6 | 166.6 |
| 1980 | 89.4 | 88.2 | 80.2 | 86.6 | 84.7 | 77.5 | 81.9 | 98.0 | 213.5 |
| 1981 | 82.9 | 81.7 | 74.7 | 80.0 | 79.3 | 73.3 | 78.8 | 94.9 | 254.3 |
| 1982 | 83.5 | 84.5 | 72.1 | 78.4 | 77.3 | 68.5 | 78.6 | 101.0 | 256.1 |
| 1983 | 91.1 | 92.5 | 80.0 | 84.3 | 82.5 | 72.5 | 76.8 | 100.1 | 220.3 |
| 1984 | 92.7 | 98.4 | 85.4 | 86.7 | 83.1 | 73.8 | 74.8 | 100.4 | 204.7 |
| 1985 | 94.7 | 99.7 | 83.9 | 85.2 | 85.0 | 74.1 | 77.2 | 100.8 | 199.4 |
| 1986 | 98.9 | 102.9 | 85.8 | 83.9 | 85.4 | 74.9 | 76.0 | 100.5 | 191.7 |
| 1987 | 105.1 | 109.1 | 88.5 | 85.7 | 89.1 | 75.8 | 76.0 | 98.9 | 171.8 |
| 1988 | 103.5 | 106.1 | 87.5 | 88.0 | 89.7 | 77.3 | 77.2 | 97.1 | 173.6 |
| 1989 | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) | (NA) |
| 1990 | 104.3 | 105.5 | 88.4 | 90.0 | 91.7 | 69.6 | 80.7 | 101.0 | 168.8 |
| 1991 | 101.5 | 102.8 | 86.2 | 89.6 | 88.6 | 81.9 | 80.2 | 97.0 | 172.2 |
| 1992 | 107.0 | 113.0 | 84.5 | 88.5 | 88.4 | 82.1 | 81.8 | 95.8 | 158.9 |
| 1993 | 105.4 | 107.4 | 86.1 | 89.3 | 88.3 | 81.8 | 83.0 | 97.5 | 161.3 |
| 1994 | 105.7 | 106.9 | 89.7 | 91.9 | 91.5 | 83.4 | 82.9 | 98.3 | 149.7 |
| 1995 | 107.5 | 110.4 | 90.8 | 90.1 | 91.1 | 83.9 | 83.4 | 94.1 | 148.7 |
| 1996 | 107.2 | 107.8 | 90.9 | 89.9 | 93.2 | 86.3 | 83.0 | 95.6 | 146.1 |
| 1997 | 102.9 | 104.4 | 89.0 | 90.9 | 91.4 | 84.2 | 82.3 | 94.0 | 160.8 |

Source: U.S. Census Bureau, Statistical Abstract of the United States.

APPENDIX TO SECTION B

APPENDIX B, TABLE I: STATE GOVERNMENT PER CAPITA EXPENDITURES AS A PERCENTAGE OF THE UNITED STATES AVERAGE, SELECTED YEARS

| Year | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 |
|---------------------------|-------|-------|-------|-------|-------|-------|
| New England | | | | | | |
| Maine | 90.2 | 101.3 | 91.3 | 90.1 | 101.3 | 100.2 |
| New Hampshire | 68.6 | 77.3 | 71.7 | 62.4 | 68.6 | 80.2 |
| Vermont | 139.6 | 127.1 | 106.9 | 109.7 | 118.0 | 107.4 |
| Massachusetts | 94.5 | 108.9 | 105.1 | 107.4 | 128.4 | 122.0 |
| Rhode Island | 99.3 | 103.1 | 112.3 | 113.5 | 124.3 | 121.1 |
| Connecticut | 96.9 | 47.2 | 85.5 | 94.4 | 122.5 | 120.2 |
| Mid-Atlantic | | | | | | |
| New York | 121.3 | 126.2 | 109.3 | 115.4 | 125.3 | 127.2 |
| New Jersey | 72.9 | 86.0 | 88.9 | 96.4 | 105.9 | 112.7 |
| Pennsylvania | 90.4 | 97.7 | 78.1 | 78.3 | 81.0 | 94.5 |
| East North Central | | | | | | |
| Ohio | 62.4 | 73.8 | 73.3 | 80.6 | 85.7 | 85.6 |
| Indiana | 70.0 | 74.2 | 72.8 | 74.1 | 81.7 | 83.7 |
| Illinois | 82.3 | 93.0 | 86.9 | 78.8 | 79.5 | 82.9 |
| Michigan | 93.0 | 103.0 | 102.0 | 95.1 | 95.4 | 110.0 |
| Wisconsin | 104.3 | 107.6 | 106.5 | 103.0 | 97.3 | 96.2 |
| West North Central | | | | | | |
| Minnesota | 105.3 | 108.3 | 111.7 | 109.9 | 107.9 | 108.7 |
| Iowa | 91.6 | 89.8 | 95.9 | 90.2 | 96.9 | 94.3 |
| Missouri | 72.9 | 67.8 | 66.1 | 66.5 | 68.3 | 72.6 |
| North Dakota | 104.3 | 106.4 | 117.4 | 129.3 | 112.6 | 108.2 |
| South Dakota | 84.7 | 86.8 | 92.7 | 83.8 | 83.5 | 82.4 |
| Nebraska | 71.2 | 77.1 | 76.7 | 79.2 | 80.9 | 84.6 |
| Kansas | 80.3 | 78.9 | 80.0 | 75.3 | 79.2 | 85.4 |
| South Atlantic | | | | | | |
| Delaware | 139.1 | 129.4 | 123.8 | 123.7 | 135.8 | 128.0 |
| Maryland | 89.9 | 111.4 | 101.0 | 89.4 | 93.3 | 86.8 |
| Virginia | 77.9 | 89.1 | 82.7 | 78.0 | 87.1 | 80.2 |
| West Virginia | 105.8 | 99.4 | 104.3 | 88.3 | 89.3 | 100.5 |
| North Carolina | 83.0 | 86.2 | 81.7 | 77.0 | 85.9 | 88.1 |
| South Carolina | 78.9 | 95.8 | 80.7 | 80.9 | 88.1 | 91.4 |
| Georgia | 79.6 | 81.7 | 75.2 | 72.9 | 79.8 | 83.5 |
| Florida | 71.7 | 78.9 | 64.6 | 65.7 | 72.1 | 76.8 |
| East South Central | | | | | | |
| Kentucky | 91.8 | 87.2 | 103.4 | 82.2 | 93.6 | 89.5 |
| Tennessee | 74.1 | 76.0 | 69.4 | 64.9 | 73.1 | 81.2 |
| Alabama | 86.8 | 82.5 | 82.7 | 84.8 | 82.9 | 83.7 |
| Mississippi | 93.5 | 88.9 | 87.7 | 75.4 | 76.1 | 84.3 |

APPENDIX B, TABLE 1 (CONTINUED): STATE GOVERNMENT PER CAPITA EXPENDITURES AS A PERCENTAGE OF THE UNITED STATES AVERAGE, SELECTED YEARS

| Year | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 |
|---------------------------|-------|-------|-------|-------|-------|-------|
| West South Central | | | | | | |
| Arkansas | 54.7 | 78.2 | 63.3 | 63.1 | 62.9 | 82.8 |
| Louisiana | 98.6 | 99.3 | 95.4 | 90.0 | 91.6 | 102.6 |
| Oklahoma | 97.6 | 82.5 | 85.2 | 81.4 | 80.9 | 78.3 |
| Texas | 68.3 | 68.4 | 68.3 | 65.9 | 63.1 | 72.9 |
| Mountain | | | | | | |
| Montana | 104.0 | 92.7 | 98.6 | 98.1 | 93.7 | 99.8 |
| Idaho | 95.9 | 95.2 | 87.2 | 76.9 | 82.4 | 85.4 |
| Wyoming | 142.4 | 117.0 | 137.3 | 164.9 | 148.3 | 127.5 |
| Colorado | 91.4 | 92.9 | 80.2 | 80.9 | 77.5 | 76.2 |
| New Mexico | 123.0 | 109.0 | 115.0 | 121.0 | 117.0 | 118.0 |
| Arizona | 99.3 | 95.5 | 80.9 | 82.0 | 93.2 | 79.3 |
| Utah | 110.0 | 97.7 | 98.2 | 95.8 | 91.3 | 91.5 |
| Nevada | 117.0 | 101.0 | 91.9 | 86.6 | 89.3 | 82.1 |
| Pacific | | | | | | |
| Washington | 101.2 | 108.2 | 115.0 | 119.2 | 118.9 | 132.9 |
| Oregon | 100.7 | 95.3 | 102.0 | 91.2 | 88.8 | 102.3 |
| California | 114.4 | 104.9 | 111.7 | 106.8 | 107.0 | 100.9 |
| Alaska | 271.9 | 329.8 | 433.6 | 543.7 | 353.3 | 283.8 |
| Hawaii | 203.1 | 182.1 | 143.3 | 121.4 | 145.2 | 154.3 |

Source: U.S. Census Bureau, *Statistical Abstract of the United States*, Selected Years.

APPENDIX B, TABLE 2: STATE GOVERNMENT PER CAPITA REVENUES, BEFORE INTERGOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF THE UNITED STATES AVERAGE, SELECTED YEARS

| Year | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 |
|---------------------------|-------|-------|-------|-------|-------|-------|
| New England | | | | | | |
| Maine | 79.9 | 88.9 | 80.5 | 85.2 | 102.9 | 102.2 |
| New Hampshire | 70.7 | 92.8 | 76.5 | 83.2 | 102.1 | 97.5 |
| Vermont | 52.1 | 60.4 | 51.2 | 54.5 | 59.1 | 73.4 |
| Massachusetts | 115.4 | 129.2 | 100.7 | 106.9 | 116.4 | 112.0 |
| Rhode Island | 79.1 | 93.5 | 93.8 | 99.3 | 111.0 | 111.8 |
| Connecticut | 90.9 | 105.9 | 105.7 | 114.9 | 118.4 | 129.1 |
| Mid-Atlantic | | | | | | |
| New York | 109.7 | 125.0 | 100.3 | 116.9 | 127.2 | 121.3 |
| New Jersey | 65.6 | 77.2 | 83.2 | 102.8 | 109.5 | 120.2 |
| Pennsylvania | 76.4 | 95.7 | 81.5 | 78.3 | 81.2 | 94.3 |
| East North Central | | | | | | |
| Ohio | 57.1 | 72.8 | 64.0 | 78.7 | 81.1 | 85.0 |
| Indiana | 70.1 | 91.0 | 71.3 | 73.4 | 88.1 | 89.9 |
| Illinois | 81.3 | 95.1 | 82.5 | 74.0 | 82.8 | 83.9 |
| Michigan | 90.0 | 98.3 | 92.8 | 93.8 | 96.6 | 115.8 |
| Wisconsin | 102.2 | 115.0 | 99.3 | 96.4 | 101.9 | 102.2 |
| West North Central | | | | | | |
| Minnesota | 94.2 | 130.2 | 112.4 | 114.9 | 115.3 | 116.7 |
| Iowa | 79.5 | 96.2 | 86.5 | 77.8 | 94.5 | 96.6 |
| Missouri | 57.1 | 66.1 | 58.2 | 63.0 | 70.2 | 70.2 |
| North Dakota | 91.8 | 135.7 | 117.8 | 121.5 | 107.4 | 103.5 |
| South Dakota | 68.5 | 76.1 | 72.7 | 64.8 | 71.4 | 71.4 |
| Nebraska | 68.2 | 75.5 | 76.7 | 67.7 | 79.7 | 86.5 |
| Kansas | 69.4 | 86.7 | 76.3 | 72.5 | 80.0 | 89.5 |
| South Atlantic | | | | | | |
| Delaware | 126.4 | 154.5 | 131.5 | 154.4 | 156.1 | 145.4 |
| Maryland | 91.9 | 108.8 | 99.3 | 93.7 | 101.1 | 93.5 |
| Virginia | 73.4 | 90.8 | 78.8 | 79.3 | 89.1 | 88.4 |
| West Virginia | 74.2 | 98.2 | 85.6 | 84.3 | 92.7 | 89.9 |
| North Carolina | 77.7 | 86.3 | 75.3 | 74.7 | 84.6 | 89.7 |
| South Carolina | 71.1 | 92.2 | 76.2 | 76.6 | 86.3 | 87.5 |
| Georgia | 67.8 | 76.5 | 66.0 | 66.7 | 74.2 | 80.6 |
| Florida | 68.2 | 81.0 | 65.0 | 61.6 | 74.3 | 80.0 |
| East South Central | | | | | | |
| Kentucky | 73.7 | 95.5 | 82.6 | 77.9 | 87.2 | 89.8 |
| Tennessee | 59.6 | 69.4 | 58.6 | 57.8 | 65.4 | 73.3 |
| Alabama | 69.1 | 81.7 | 70.3 | 73.6 | 37.1 | 80.7 |
| Mississippi | 40.0 | 47.1 | 36.7 | 30.5 | 34.5 | 44.5 |

APPENDIX B, TABLE 2 (CONTINUED): STATE GOVERNMENT PER CAPITA REVENUES,
BEFORE INTERGOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF THE UNITED
STATES AVERAGE, SELECTED YEARS

| Year | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 |
|---------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| West South Central | | | | | | |
| Arkansas | 60 | 74.4 | 69.1 | 65.8 | 71.7 | 77.8 |
| Louisiana | 88.1 | 105.9 | 94.5 | 88.4 | 89.5 | 87.2 |
| Oklahoma | 77.5 | 88.5 | 88.7 | 89 | 85.2 | 80.4 |
| Texas | 62.5 | 77.2 | 72.2 | 67.2 | 66.3 | 70 |
| Mountain | | | | | | |
| Montana | 69.9 | 89.5 | 84.2 | 86 | 92.8 | 93 |
| Idaho | 74.3 | 93 | 76.6 | 69.2 | 86.2 | 88.8 |
| Wyoming | 101.9 | 117.5 | 135 | 185.1 | 146.9 | 104.3 |
| Colorado | 78.4 | 95.4 | 79.7 | 71.6 | 77.7 | 74.8 |
| New Mexico | 107.8 | 133.8 | 136.7 | 134.1 | 125.8 | 124.2 |
| Arizona | 92 | 104.1 | 84.8 | 83 | 89.8 | 81.6 |
| Utah | 86.3 | 90.6 | 82.6 | 82.6 | 86.1 | 91.8 |
| Nevada | 101.1 | 115.5 | 84.8 | 88.7 | 91.7 | 92.1 |
| Pacific | | | | | | |
| Washington | 101.7 | 111.1 | 101.4 | 94 | 110 | 115.6 |
| Oregon | 76.6 | 96 | 93.1 | 84.1 | 85.3 | 96.4 |
| California | 92.8 | 112.6 | 108.3 | 97.2 | 103.4 | 98.7 |
| Alaska | 1015.9 | 228.3 | 749.2 | 713.9 | 443.8 | 340.2 |
| Hawaii | 151.2 | 177.4 | 149.6 | 128.5 | 168.7 | 166.4 |
| Coefficient of Variation | 1.336 | 0.300 | 0.962 | 0.923 | 0.556 | 0.403 |

Source: U.S. Census Bureau, Statistical Abstract of the United States, Selected Years.

APPENDIX B, TABLE 3: STATE GOVERNMENT PER CAPITA REVENUES, AFTER INTER-GOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF THE UNITED STATES AVERAGE, SELECTED YEARS

| Year | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 |
|---------------------------|-------|-------|-------|-------|-------|-------|
| New England | | | | | | |
| Maine | 75.6 | 97.9 | 87.7 | 90.7 | 102.9 | 100.2 |
| New Hampshire | 56.5 | 66.6 | 61.1 | 61.1 | 62.6 | 80.2 |
| Vermont | 114.9 | 124.8 | 103.2 | 105.1 | 113.0 | 107.4 |
| Massachusetts | 81.9 | 94.4 | 98.4 | 102.0 | 116.0 | 122.0 |
| Rhode Island | 86.0 | 102.7 | 104.9 | 109.8 | 114.0 | 121.1 |
| Connecticut | 77.6 | 83.5 | 83.8 | 103.0 | 117.0 | 120.0 |
| Mid-Atlantic | | | | | | |
| New York | 106.7 | 121.1 | 105.1 | 120.3 | 129.4 | 127.2 |
| New Jersey | 63.6 | 77.8 | 81.3 | 100.0 | 105.0 | 113.0 |
| Pennsylvania | 74.1 | 90.4 | 79.5 | 80.3 | 82.0 | 94.5 |
| East North Central | | | | | | |
| Ohio | 56.7 | 70.2 | 63.8 | 78.6 | 81.7 | 85.6 |
| Indiana | 66.4 | 80.6 | 65.9 | 73.8 | 85.7 | 83.7 |
| Illinois | 78.4 | 90.0 | 80.9 | 76.2 | 80.9 | 82.9 |
| Michigan | 85.8 | 96.3 | 92.9 | 95.4 | 94.1 | 110.0 |
| Wisconsin | 94.4 | 106.0 | 99.5 | 97.9 | 99.6 | 96.2 |
| West North Central | | | | | | |
| Minnesota | 93.1 | 121.0 | 108.0 | 113.0 | 112.0 | 109.0 |
| Iowa | 78.2 | 90.8 | 84.9 | 79.3 | 93.2 | 94.3 |
| Missouri | 62.1 | 66.9 | 62.4 | 65.7 | 69.5 | 72.6 |
| North Dakota | 94.4 | 128.2 | 116.2 | 122.8 | 113.1 | 108.2 |
| South Dakota | 79.7 | 86.1 | 85.3 | 75.0 | 83.5 | 82.4 |
| Nebraska | 68.3 | 75.5 | 75.6 | 71.3 | 80.3 | 84.6 |
| Kansas | 71.6 | 83.3 | 76.6 | 73.3 | 78.6 | 85.4 |
| South Atlantic | | | | | | |
| Delaware | 112.5 | 133.2 | 125.5 | 141.7 | 140.2 | 128.0 |
| Maryland | 85.3 | 100.1 | 95.9 | 92.3 | 97.0 | 86.8 |
| Virginia | 70.9 | 86.7 | 78.8 | 77.0 | 83.4 | 80.2 |
| West Virginia | 87.7 | 107.0 | 93.5 | 87.5 | 94.4 | 101.0 |
| North Carolina | 74.8 | 88.0 | 76.5 | 75.7 | 82.6 | 88.1 |
| South Carolina | 70.0 | 89.4 | 78.0 | 77.6 | 88.2 | 91.4 |
| Georgia | 70.7 | 81.1 | 70.2 | 72.4 | 76.7 | 83.5 |
| Florida | 64.0 | 75.2 | 62.8 | 59.5 | 70.8 | 76.8 |
| East South Central | | | | | | |
| Kentucky | 78.4 | 95.0 | 85.6 | 82.7 | 88.5 | 89.5 |
| Tennessee | 64.9 | 71.8 | 65.1 | 64.2 | 72.7 | 81.2 |
| Alabama | 75.2 | 85.4 | 78.2 | 78.7 | 39.0 | 83.7 |
| Mississippi | 81.7 | 90.4 | 82.4 | 72.2 | 78.0 | 84.3 |

APPENDIX B, TABLE 3 (CONTINUED): STATE GOVERNMENT PER CAPITA REVENUES,
AFTER INTERGOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF THE UNITED STATES
AVERAGE, SELECTED YEARS

| Year | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 |
|---------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| West South Central | | | | | | |
| Arkansas | 68.8 | 79.5 | 77 | 70.9 | 76.6 | 82.8 |
| Louisiana | 91.2 | 101.6 | 95.4 | 88.7 | 93.9 | 102.6 |
| Oklahoma | 87.1 | 90.3 | 86.7 | 85.4 | 84.3 | 78.3 |
| Texas | 65.3 | 75.5 | 70.1 | 65.6 | 67.8 | 72.9 |
| Mountain | | | | | | |
| Montana | 89 | 99.9 | 100.6 | 96 | 101.6 | 99.8 |
| Idaho | 80 | 95 | 81.3 | 73.8 | 87.9 | 85.4 |
| Wyoming | 130.6 | 132.9 | 142.4 | 191.3 | 162 | 127.5 |
| Colorado | 83.4 | 96.2 | 80.8 | 73.1 | 77.9 | 76.2 |
| New Mexico | 119.6 | 129.4 | 127.7 | 124.9 | 119.3 | 117.6 |
| Arizona | 92.7 | 94.2 | 79 | 77 | 84.6 | 79.3 |
| Utah | 98.5 | 96.3 | 89.2 | 89.7 | 90.9 | 91.5 |
| Nevada | 105.8 | 108.4 | 86.9 | 85.3 | 83.8 | 82.1 |
| Pacific | | | | | | |
| Washington | 99.8 | 110 | 97.9 | 96 | 105 | 109 |
| Oregon | 83.2 | 99.1 | 97.9 | 86.7 | 91 | 102 |
| California | 103 | 108.6 | 104.7 | 99.8 | 103.3 | 100.9 |
| Alaska | 844.6 | 261.2 | 630 | 598.1 | 390.8 | 283.8 |
| Hawaii | 153.7 | 167.8 | 141.9 | 121.7 | 153.9 | 154.3 |
| Coefficient of Variation | 1.092 | 0.305 | 0.788 | 0.756 | 0.475 | 0.318 |

Source: U.S. Census Bureau, Statistical Abstract of the United States, Selected Years.

C. The System Of Intergovernmental Transfers In The United States

In this section, we describe the system of intergovernmental arrangements in the United States and how they have evolved over time. We begin with a discussion of the types of intergovernmental arrangements that exist between the federal and the state/local governments. Next, we discuss the need for intergovernmental transfers. Lastly, we describe the programs directed towards correcting vertical and horizontal fiscal imbalances.

Prior to the Great Depression, federal intergovernmental transfers represented only a small fraction of revenues of state and local governments. The 1930s and again in the 1960s and 1970s witnessed a substantial increase in federal intergovernmental transfers. For example, in 1929, federal transfers comprised only 1.3% of state and local government revenues, whereas in 1997, they comprised 20% of state revenues and 3% of local government revenues. As well, intergovernmental transfers from state to local governments represented approximately 35% of local government revenues in 1997.

As was discussed in Section B, revenue-raising in the United States is relatively centralized, although states have considerable taxing ability. At the same time, most services are provided by state and local governments. This asymmetry between revenues and expenditures at the state/local level means that the federal government today plays a significant role in financing and influencing the provision of services at the state and local levels of government. The areas affected by most federal grants-in-aid are those traditionally reserved for the states as part of their residual powers in the United States Constitution.¹⁷⁴ However, the delegated powers of the Congress have been interpreted over the years in a way that allows the federal government very few restrictions on the use of its spending power.

The states, in turn, play a significant role in the financing and influence of the provision of services at the local level. Given that local government powers are granted by the state governments, there is no common system of local government in the United States and the amount of state financial aid to local governments varies considerably among states. Some states allow local governments

¹⁷⁴ The powers reserved for the states are in three broad categories: (i) The police power, which includes powers such as the regulation of hospitals and doctors, zoning laws, child labour laws, and working hours; (ii) Public services, which include schools, police force, welfare services, public health, transportation services, and agricultural and research services; and (iii) The Local Government System. See Zimmerman (1991) for more information.

considerable discretion in the financing and provision of services while others tightly control the activities of local governments. Given the limited revenue-raising ability of local governments, however, intergovernmental transfers from the federal to local governments and from state to local governments comprise a significant proportion of local revenues.

We now describe the different forms in which intergovernmental arrangements take in the United States.

Types of Federal-State/Local Fiscal Arrangements

1. Categorical Grants

The categorical grant is the most popular form of federal financial assistance to subnational governments. Categorical grants provide funds for specific programs. Use of these types of grants allows the federal government to influence and increase the provision of services at the state and local levels. Categorical grants also provide incentives for subnational governments to implement projects and programs that adhere to national goals. Most categorical grants in the United States require subnational governments to match a portion of the federal funding.

There are two types of categorical grants: formula grants and project grants. The distribution of a formula grant is based on a formula containing factors such as population and per capita income. These grants thus contain an equalizing component. Project grants, on the other hand, are distributed at the discretion of federal administrators.

Categorical grants provide financing for numerous projects and programs. The more important funding areas are described below. Table C1 provides data on federal aid to state and local governments for selected years from 1970 to 1998.

(a) Health Care¹⁷⁵

The largest intergovernmental assistance program is Medicaid. Medicaid was created in 1965 and provides health care to the poor, aged in nursing homes, blind, and disabled. It is administered by the states and they have considerable discretion over eligibility standards. The federal government does, however, stipulate a minimum level of benefits. The federal government provides 20-50% of

¹⁷⁵ The federal government is involved in the financing of health care in several ways. Medicaid involves financial assistance to the states. However, the federal government administers and finances Medicare, which is a health care program directed to the aged. As well, the federal government finances the Public Health Service, veterans hospitals, and medical research and teaching.

the financing of benefits and 50% of the financing of administrative costs. Expenditures for Medicaid have increased significantly in recent years and are expected to continue increasing into the future.

TABLE C1: FEDERAL AID TO STATE AND LOCAL GOVERNMENTS, PERCENTAGE OF FEDERAL AID, SELECTED YEARS

| Program | 1970 | 1980 | 1990 | 1998 |
|--|-------------|-------------|-------------|-------------|
| National Defense | 0.1 | 0.0 | 0.1 | 0.0 |
| Energy | 0.0 | 0.2 | 0.1 | 0.1 |
| Natural resources and environment | 0.6 | 2.1 | 1.0 | 0.6 |
| Environmental Protection Agency | 0.3 | 1.8 | 0.7 | 0.4 |
| Agriculture | 0.9 | 0.2 | 0.3 | 0.1 |
| Commerce and Housing Credit | 0.0 | 0.0 | 0.0 | 0.0 |
| Transportation | 7.0 | 5.2 | 5.0 | 3.8 |
| Airports | 0.1 | 0.2 | 0.3 | 0.2 |
| Highways | 6.7 | 3.7 | 3.7 | 2.9 |
| Urban mass transit | 0.2 | 1.3 | 1.0 | 0.6 |
| Community and regional development | 2.7 | 2.6 | 1.3 | 1.1 |
| Appalachian regional development | 0.3 | 0.1 | 0.0 | 0.0 |
| Community development block grants | 0.0 | 1.6 | 0.7 | 0.7 |
| Education, employment, training, social services | 9.7 | 8.7 | 6.1 | 5.3 |
| compensatory education for the Disadvantaged | 0.0 | 0.0 | 0.0 | 0.0 |
| School improvement programs | 2.2 | 1.3 | 1.2 | 1.1 |
| Bilingual and immigrant education | 0.1 | 0.2 | 0.3 | 0.2 |
| Federally affected areas impact aid | 0.0 | 0.1 | 0.0 | 0.0 |
| Vocational and adult education | 0.9 | 0.2 | 0.2 | 0.1 |
| Payments to states for Family Support Activities | 0.4 | 0.3 | 0.3 | 0.2 |
| Social services-block grants | 0.1 | 0.2 | 0.1 | 0.0 |
| Children and Family services programs | 0.9 | 1.1 | 0.7 | 0.4 |
| Training and employment assistance | 0.6 | 0.6 | 0.7 | 0.7 |
| Office of libraries | 1.4 | 2.5 | 0.8 | 0.5 |
| Health | 0.2 | 0.1 | 0.0 | 0.0 |
| Alcohol, drug abuse, and mental health | 5.8 | 6.3 | 11.5 | 15.4 |
| Grants to states for medicaid | 0.2 | 0.3 | 0.3 | 0.3 |
| Income security | 4.1 | 5.6 | 10.7 | 14.8 |
| Family support payments | 8.8 | 7.4 | 9.2 | 8.6 |
| Food stamps-administration | 6.3 | 2.8 | 3.2 | 0.3 |
| Child nutrition/special milk programs | 0.8 | 0.2 | 0.6 | 0.5 |
| Housing assistance | 0.6 | 1.4 | 1.3 | 1.2 |
| Veterans benefits and services | 0.7 | 1.4 | 2.5 | 2.9 |
| Administration of justice | 0.0 | 0.0 | 0.0 | 0.0 |
| General government | 0.1 | 0.2 | 0.1 | 0.5 |
| Grant-in-aid Shared Revenues | 0.7 | 3.4 | 0.6 | 0.3 |
| | 36.4 | 36.6 | 35.3 | 35.9 |

(b) Income Redistribution¹⁷⁶

Another large categorical matching grant is directed towards assistance to low income families. Aid to Families with Dependent Children (AFDC) was introduced in 1935 and was replaced in 1997 with a block grant program entitled Temporary Assistance for Needy Families (TANF). AFDC was a joint federal and state program, as is TANF. States administer the program and set benefit levels. The federal government provides one-half to three-quarters of the financing, depending on a state's per capita income.

The Medicaid program described above is also aimed at redistributing income. It provides medical care to the poor (especially children), the aged in nursing homes, the blind, and the disabled. Prior to the reform of AFDC in 1996, all families receiving benefits under AFDC were entitled to Medicaid. Today, states are required to provide Medicaid to families who would have been eligible to receive benefits under AFDC. In addition, the Children's Health Insurance program (CHIP) was introduced in 1997 and provides funds to states to provide health care for children with family incomes below 200% of the federal poverty threshold.

(c) Education

The federal government provided nearly 10% of the funding for education in 1996 in grants-in-aid to state and local governments. Federal aid, however, is directed primarily toward special programs for the disadvantaged, children and family services, and training and employment assistance. The bulk of expenditures for elementary and secondary schools and higher education are financed by state and local governments.

(d) Transportation

The federal government provides grants-in-aid to state and local governments for transportation, which includes airports, highways, and urban mass transit. Close to 80 percent of federal funding for transportation in 1996 was directed towards highways. Federal funds comprise nearly 25% of state and local expenditures on highways. The federal government assists in highway funding by contributing to the states' highway trust funds.

(e) Housing and Community Development

¹⁷⁶ In addition to the intergovernmental financial assistance programs for income redistribution, the federal government also administers and finances the food stamps program, the Head Start program, which provides preschooling for children of low-income families, Pell grants, which provides funding for college education for children of low-income families, and the Low-Income Home Energy Assistance Program (LIHEAP).

Federal grants to state and local governments for housing and community development comprised nearly 70% of state and local funding in 1996. The funding is distributed by the Department of Housing and Urban Development (HUD). Close to half of the funding from HUD is directed towards lower income housing assistance and, thus, can also be grouped with the federal government's income redistribution programs.

2. Conditional Block Grants

Conditional block grants are funds provided for expenditures incurred within a general functional area such as welfare or housing. There is no matching component. They allow greater discretion for how funds are spent than do categorical grants. The states and local governments generally prefer the added flexibility of block grants. In addition, regulations for block grants tend to be shorter and simpler than for categorical grants. Critics of block grants argue that there is less adherence to standards, less oversight of grant monitoring, and that they provide less assistance to poorer segments of the population.

In the past thirty years, there has been a movement towards converting categorical grants into block grants. For example, in 1971, 129 categorical grant programs for education, law enforcement, community development, urban development, manpower training, and transportation were converted into 6 block grants. Again in 1981, 57 categorical grants were converted into 9 block grants. As noted above, in 1997 one of the largest categorical matching grant, Aid to Families with Dependent Children, was converted into a block grant entitled Temporary Assistance for Needy Families.

3. General-Purpose Grants: General Revenue Sharing

A program of general revenue sharing was enacted in 1972 under the State and Local Fiscal Assistance Act. The program provided funds for state and local governments to spend at their discretion. From 1972 to 1980, states received one-third of the funds and local governments received two-thirds. In 1980, states were removed from eligibility in the program and the program for local governments was terminated in 1986. There is now no general-purpose grant program in the United States.

4. Tax Deductions

Historically, Congress allowed deductibility of most state and local taxes from federal income tax. Today, only income and property taxes are deductible, and limitations on this have also been imposed. Tax deductibility allows state and local governments to raise their taxes without the full burden falling on their citizens. In essence, then, tax deductibility is a form of financial assistance from the federal government to the state and local governments.

5. Tax-Exempt Municipal Bond Interest

Interest income from state and local government bonds are exempt from federal taxation. This provision essentially lowers the rate of interest that state and local governments pay on borrowed funds. To the extent that the proceeds from issuing debt are used to finance government services such as education, policing, etc, this provision provides another means through which the federal government helps finance services provided by subnational governments.

6. Federal Mandates

Often, the federal government mandates that subnational governments undertake specific activities or provide specific services. Examples of federal mandates are the removal of asbestos from school buildings, the filtering of drinking water, and access by the disabled to public buildings and public transportation. While state and local governments often support these regulations, they are expensive and the federal government often does not provide the funds needed for their implementation. The imposition of “unfunded mandates” by Congress has been highly controversial.

7. Threats of Loss of Funds

The federal government sometimes threatens the loss of funds if state and local governments do not comply with congressional statutes. For example, in 1974 Congress wanted the official speed limit on highways to be reduced to 55 miles per hour. To ensure that states complied with this reduction, the federal government threatened to remove 10% of a state’s highway aid funds if it did not reduce the speed limit. Other examples where threats of loss of funds have been employed are allowing right turns on red lights, raising the minimum age to purchase alcohol, and implementing affirmative action programs.

The Need for Intergovernmental Transfers

There are varied opinions on the need for intergovernmental transfers. Those in favour of transfers point to the improved efficiency and equity that results from assigning superior taxing powers to higher levels of government while assigning greater spending responsibilities to lower levels of government. Those against transfers argue that accountability and efficiency suffer when lower levels of government are prevented from raising the revenues needed to finance programs designed to respect the preferences of their citizens. Complete decentralization of tax and expenditure powers, however, can result in inefficiencies and inequities, which may be corrected by utilizing intergovernmental transfers.

1. Correcting for externalities

Many government services impart benefits and costs that reach beyond municipal or state boundaries. For example, education creates positive externalities when educated citizens relocate to other regions of the country. Another example is when citizens who travel from other jurisdictions benefit from a state highway system. If these positive externalities are not taken into account by lower-level governments, then too little spending is undertaken. Intergovernmental transfers can correct for these inefficiencies. As well, it can be argued that government services that affect citizens across jurisdictions should conform to some type of uniform standards. Consequently, when conditions are attached to the transfers, they persuade subnational governments to implement programs that adhere to national standards.

Subnational governments can also enter into competition with each other in attracting certain types of individuals and businesses and discouraging others from moving into their jurisdictions. For example, because individuals and business activity are mobile across the federation, a state or local government may be reluctant to implement a progressive tax system or a generous welfare or health care program. Intergovernmental transfers can then be used to persuade subnational governments to implement national redistributive policies.

2. Correcting for Vertical Fiscal Imbalances

The mobility of people and business activity creates a rationale for assigning a greater responsibility to higher levels of government in raising tax revenues from mobile tax bases. In the United States, the federal government dominates the personal income tax, corporate income tax, and payroll tax fields. The state and local governments rely mostly on sales and property taxes. In addition, the federal government can resort to deficit financing much easier than can states and local governments. As a result, federal receipts have traditionally grown faster than state and local revenues. Furthermore, demand for state and local government services has grown considerably. These two facts have resulted in a vertical fiscal imbalance whereby federal revenues exceed federal expenditures (excluding intergovernmental transfers) and state and local government expenditures exceed their tax revenues. Similarly, the limited taxing ability of local governments has resulted in a large vertical fiscal imbalance between states and local governments. Intergovernmental transfers correct for vertical fiscal imbalances and offer subnational governments the ability to provide more and better government services.

3. Correcting for horizontal fiscal imbalances

In the United States, there is considerable variation in the abilities of state and local governments to raise revenues to finance their expenditures. The ability to raise revenues is defined as the government's fiscal capacity. Differences in fiscal capacity are especially prominent among local governments. Thus, poor jurisdictions must levy higher tax rates than rich jurisdictions in order to provide the same level of services. Furthermore, there is considerable variation in the need for and the costs of certain types of expenditures across jurisdictions. For example, some states or municipalities may have a larger proportion of elderly or poor individuals. Inefficiencies arise when individuals make their location decisions based on horizontal fiscal imbalances. Intergovernmental transfers can correct for these horizontal inequities.¹⁷⁷

Programs Mainly Focused on Vertical Fiscal Imbalances

Vertical fiscal imbalances arise when revenues of higher-level governments exceed their spending responsibilities (excluding intergovernmental transfers). As described earlier, the federal government has superior taxing powers than the state and local governments. At the same time, the states and local governments are responsible for providing numerous government services. The combination of these two facts result in a vertical fiscal imbalance among the three levels of government.

In order to correct for vertical fiscal imbalances, a General Revenue Sharing program was implemented in 1972, but was terminated in 1986. It is the only program in the United States that had, as a main purpose, the correction of vertical fiscal imbalances.¹⁷⁸ The program provided funds for state and local governments to spend at their discretion. Two formulas were employed to determine the amount of funds a state would receive. The House of Representatives' formula was based on population, urban population, per capita income (inversely), state income tax collections, and tax effort. The Senate's formula was based on population, per capita income (inversely), and tax effort.¹⁷⁹ The state would receive whichever formula provided the highest transfer. The formula used for determin-

¹⁷⁷ Note that some economists argue that transfers directed towards correcting for horizontal imbalances create inefficiencies in that they result in individuals staying in less productive regions.

¹⁷⁸ For a description of the General Revenue Sharing program, see Aronson and Hilley (1986), pp. 56-58.

¹⁷⁹ Tax effort is measured as the ratio of total tax revenue to personal income.

ing the amount of funds a local government would receive was based on population, per capita income (inversely), and tax effort. From 1972 to 1980, states received one-third of the funds and local governments received two-thirds. In 1980, states were removed from eligibility, leaving transfers only to local governments. The program for local governments was terminated in 1986.

Today, no program exists that explicitly corrects for vertical fiscal imbalances. However, the whole system of categorical grants and conditional block grants from federal to state and local governments and from state to local governments can perhaps be viewed in part as correcting for vertical fiscal imbalances. While there are other motives for these grants, such as persuading governments to adopt national policies and correcting for horizontal imbalances, their very existence derives from vertical fiscal imbalances.

Programs Mainly Focused on Horizontal Fiscal Imbalances

Horizontal fiscal imbalances arise when state or local governments differ in their ability to provide government services. These differences occur because of different fiscal capacities and needs. Horizontal fiscal imbalances are important at both the state and local levels of government, but are especially prominent at the local level. Local governments are responsible for a large proportion of service provision, but they have limited ability to raise revenue. The base of their primary revenue source, the property tax, is inequitably distributed within states and across states. Reliance on this revenue source results in large horizontal fiscal imbalances.¹⁸⁰ The states thus provide a large proportion of local revenue in the form of grants-in-aid in order to correct for these imbalances. As was described in Section B, real per capita intergovernmental aid from state to local governments has increased significantly over time.

Just as for vertical fiscal imbalances, there is now no program that explicitly addresses horizontal fiscal imbalances. The General Revenue Sharing program discussed in the previous section and is no longer in existence was also intended to address horizontal fiscal imbalances. As was described earlier, the formulas used to determine the level of transfers had equalizing components in them, such as tax effort, per capita income, urban population, and personal income tax reve-

¹⁸⁰ These inequities among local governments have led poorer regions to file lawsuits against the state. School districts in several states have won court battles arguing that, since the state is responsible for creating the system of local governments, it is responsible for addressing the inequitable distribution of tax bases. For a discussion of this, see J. Stonecash (1998), pp. 77-78.

nues. Today, equalization is addressed in part by the system of categorical and conditional block grants. Many of these grants have equalizing components in that their allocation is based on criteria such as per capita income and tax effort, but there is no systematic overall scheme of equalization.

D. Tax Harmonization and Tax Collection

In the United States, the federal government and the states have considerable independent taxing powers. While the federal government is the dominant player in raising revenues, the United States Constitution allows the states to levy any type of tax except import and export duties and duties on tonnage. Thus, states raise a considerable proportion of their revenues through the use of personal and corporate income taxes, sales taxes, property taxes, and payroll taxes. There is, nonetheless, an enormous variation among states in the types of taxes that they levy. For example, some states have no income tax or sales tax and rely primarily on property taxes and payroll taxes. Other states rely heavily on income and sales taxes for their revenues.

The primary sources of revenue for the federal government are the personal income and payroll taxes. Taken together, these two taxes provide roughly 80 percent of federal revenues. Payroll taxes are used mainly to finance social insurance and hospital costs in the Medicare program.¹⁸¹ The next largest revenue source is the corporate income tax, which contributes about 12% of total federal revenues. Note that the federal government does not levy a sales tax. By contrast, the primary tax revenue sources for state and local governments are retail sales and property taxes, contributing over 40 percent of their total revenues. Personal income taxes make up about 15% of state and local revenues. In addition, transfers from the federal government contribute roughly 20% of state and local revenues.

The legal and constitutional right of the federal and state governments to levy taxes independently means that the issue of tax harmonization is likely to be an important one for the United States. Without harmonization, administrative and compliance costs are higher when both the federal and state/local levels of

¹⁸¹ The Old-Age, Survivors, and Disability Insurance (OASDI) program is the largest social insurance program in the United States. The second largest is Medicare. Both programs are administered and financed by the federal government and both provide insurance and redistribute income. The OASDI is financed by a payroll tax that is shared between employers and employees. Hospital costs in the Medicare program are financed through a payroll tax.

government levy taxes on the same base. These costs are compounded when each level provides different deductions, credits, and exemptions, thus introducing differences in tax bases. As well, issues of tax competition can arise among states when they levy taxes on mobile bases such as personal and corporate income. These types of problems can be alleviated or avoided by either assigning tax bases exclusively to one level of government or by developing tax harmonization and tax collection systems.

Despite the potential problems that result when both the federal and state/local levels of government have access to a wide range of tax instruments, there is no system of tax harmonization in place in the United States for any taxes. With regard to tax collection systems, the only arrangements that exist are very minor and occur at the state/local level. In particular, in some states, the state government collects revenues from sales and/or income taxes and remits part of the proceeds to local governments.

Since the federal government does not have a broad-based sales tax and the property tax is entirely left to the state/local government, the issue of tax harmonization is particularly relevant in the United States only for the personal and corporate income taxes, although the corporate income tax is a relatively minor tax at the state level. As described above, the federal and state/local governments levy personal and corporate income taxes independently. Thus, there are likely to be large administrative and compliance costs that would be avoided if there were a system of tax harmonization in place such as exists in most provinces in Canada.

With respect to sales taxes, the issue of tax harmonization will become important if ever the federal government decides to adopt a broad-based sales tax such as a VAT. If this ever comes to be, it would be desirable on both administrative and compliance grounds for there to be some arrangement of coordinating sales taxes at both levels of government. However, negotiating the arrangement with 50 states with widely varying sales tax systems would be a very difficult task.

Although payroll taxes are levied at both levels of government, the issue of tax harmonization is not as important as it is for, say, income taxes. The reasons for this are that payroll taxes are levied at flat rates and on payroll as the tax base. Thus, administration and compliance costs are low, so that administration and collection at one level of government is not as important an issue with the payroll tax.

E. Analysis

1. Economic Aspects

There is a large body of theory dealing with the optimal relationship among levels of government within a federation. As a practical matter, however, there is no definitive consensus on what this optimal relationship should be. Much depends on how best the federal system in a particular nation fits the underlying assumptions of the theory. Thus, whether economic efficiency is best served through a highly decentralized or highly centralized system is a matter of debate. A factor that makes this debate a more difficult one to resolve in the United States is the wide variation that exists among states. The federal system in the United States is comprised of one federal government, fifty states, and over 87,000 local governments. There are very large states and very small states. Some states levy income and sales taxes, while others do not. Some states leave the provision of major expenditures to local governments, whereas others do not. Some states have generous programs for the sick, aged, and needy, whereas others do not. Some states depend a great deal on transfers from the federal government, whereas others do not. This variation among states is shaped by historical factors as well as the evolving preferences for the role of government within the economy. Consequently, rather than attempt to determine one way or the other whether the current system in the United States is an ideal one, we will discuss some of the theoretical arguments of the federalism literature in light of the experience in the United States.

1. Impacts on Economic Efficiency

It is generally agreed that national public goods and services should be provided and financed by the federal government. National public goods and services are those whose benefits or costs accrue to citizens across the country. The rule for assigning national public goods and services to the federal government is indeed followed in the United States. The federal government is responsible for “national” areas such as national defense, energy, the money supply, international commerce, and the postal service. What is more debatable is whether subnational governments should be responsible for providing and financing subnational public goods and services, i.e. those goods and services that mainly benefit citizens within a particular jurisdiction. A famous theory of fiscal federalism, known as

the Tiebout Hypothesis¹⁸², argues in favour of decentralized provision of goods and services because competition among subnational governments ensures that citizens of a particular jurisdiction receive the public goods and services that best represent their preferences. Decentralized expenditure provision and revenue raising also improves accountability by ensuring that the level of government responsible for providing goods and services is also responsible for financing them. Two key assumptions for the Tiebout hypothesis to hold are that citizens must be mobile, so that they may easily relocate in response to differences in the provision and financing of public goods and services, and that there are no spillovers across jurisdictions. The first assumption is likely to hold in the long-run in the United States due to the absence of language and cultural barriers and the absence of restrictions in hiring citizens from other jurisdictions. In the short-run, migrating across jurisdictions is costly in terms of having to find new employment, sell one's house, etc. Consequently, citizens are more likely to move in the long-run to jurisdictions that have the mix of expenditure and taxation that best satisfies their preferences. The second assumption of no spillovers across jurisdictions is likely not to hold, but its degree of severity is open to debate. Many public goods and services can have benefits or costs that cross state (or local) boundaries. Spillovers (or externalities) can take many forms. Highways, for example, can benefit citizens residing outside the state or local boundary. As well, education can benefit citizens of other jurisdictions either directly, if they attend a particular state university, for example, or indirectly, if they migrate to another jurisdiction, bringing the skills learned with them. Externalities are also created when citizens move across jurisdictions to take advantage of generous health or welfare programs. Similar arguments can be made on the taxation side. State and local governments may compete for mobile individuals or businesses by offering lower tax rates. They do so without taking into account the effects of their tax incentives on citizens in other jurisdictions. When externalities of this sort are present, there is a rationale for more central control of goods and service provision and taxation.

The provision of subnational public goods and services is relatively decentralized in the United States. State and local governments provide many goods and services and they have wide discretion on the details of the various programs provided. Although the federal government stipulates conditions in many of its grant-in-aid programs to the state and local governments, the United States fol-

¹⁸² C. Tiebout (1956), "A Pure Theory of Local Expenditure", *Journal of Political Economy*, 64, 416-24.

lows a general principle of state sovereignty in the provision of subnational goods and services. As a result, inefficiencies that may result from spillovers across jurisdictions may be left uncorrected in the United States. On the other hand, efficiency may be enhanced for those goods and services with benefits or costs accruing to citizens within a particular jurisdiction.

Turning to the raising of revenues, we saw in Section B that large vertical fiscal imbalances exist in the United States and, thus, revenue-raising is much more centralized in the United States than expenditure provision. This is true despite the fact that states have access to most major tax sources. Whether this situation is more efficient than one where states have greater revenue-raising responsibilities is open to debate. Certainly, the fact that state and local governments are responsible for providing various goods and services to their citizens but are not fully responsible for financing them detracts from accountability. It is also true, however, that administrative and compliance costs are lowered by assigning greater taxing powers to the central government. Also important are the facts that citizens and businesses are fairly mobile in the United States and that there are no tax harmonization agreements. These two facts imply that tax competition among state and local governments is likely to be important in the United States. This is especially relevant for redistributive or ability-to-pay taxes. A state wishing to increase the amount of redistribution in its tax system would likely find those that contribute to the system migrating out of the state and those that could benefit from the system migrating from other states. As a result, it can be argued that for administrative, compliance, and tax competition reasons, efficiency is enhanced in the United States because the federal government has greater revenue-raising powers than lower-level governments.

2. Impacts on Equity

As was mentioned above, the United States has a relatively decentralized system of expenditure provision. This is true even for redistributive programs such as the former Aid to Families with Dependent Children program, the current Temporary Assistance for Need Families program, and Medicaid. Two notable exceptions are the Food Stamps and Medicare programs, which are federal. The federal government does attach conditions when financing redistributive programs. Nevertheless, the states have a great deal of discretion in the design of the programs, which results in citizens residing in different states having access to different levels of service. Some may argue that this is not very equitable and should be corrected by the federal government assuming a greater role in the design and implementation of redistributive programs. Others, on the other hand,

have argued strongly that achieving more equity detracts from efficiency in the abilities of the states to provide services that respect the preferences of their citizens.

On the revenue side, we already mentioned above that the federal government has a dominant role in the United States in levying redistributive taxes such as the personal income tax. This allows for greater redistribution because a large federal role mitigates the states' abilities to compete for mobile tax bases. It does not eliminate tax competition completely, however, since the states do have access to the income tax base.

Redistribution not only applies to individuals; it also applies to state and local governments. The issue of whether the federal government should redistribute economic activity across states is a hotly debated one in the United States. Because states differ in their abilities to provide goods and services, individuals in similar circumstances will necessarily be treated differently across states. Those in favour of redistribution argue that all citizens of similar economic status within a federation should have access to similar public goods and services at similar tax levels. These people would thus argue for a strong federal role in redistribution across states. This argument has, however, had relatively little impact on the design of intergovernmental transfers in the United States. As we have noted in earlier sections, there is no explicit system of equalization in the United States. There are, however, equalization-type components imbedded in the system of grants-in-aid. Those opposed to redistribution across states argue that states should receive "fair" treatment from the federal government in the sense that what each state pays in taxes should equal what it receives in expenditures. Furthermore, they argue that redistribution exacerbates inequities and inefficiencies by encouraging poorer individuals to stay in poorer regions.

2. Political Aspects

1. Impact on Stability

The process of intergovernmental relations and fiscal arrangements has been both a stabilizing influence and a source of conflict in the United States.

Areas of Consensus. *Lack of Equalization:* One area in which a consensus exists is in attitudes to a generalized equalization program. No such program exists, and none is contemplated. The U.S. is, among federations, exceptional in this regard. While the scope of equalization transfers in federations varies, it is noteworthy that all other developed countries utilising a federal system of gov-

ernment have some type of equalization system. The lack of such a program in the United States cannot be attributed to a lack of need for such a system, based on a dearth of horizontal fiscal inequities. In fact, horizontal fiscal inequities among U.S. states are of the same order of magnitude as among Canadian provinces.¹⁸³ Explanation of the absence of an equalization program may be attributable to cultural factors, discussed below.

Areas of Dispute. *Goals of federal spending:* There is no consensus in the U.S. as to whether it is a goal of the federal fiscal transfer system to redistribute economic activity across states, or whether such redistribution is merely an unintended consequence of decisions taken with other motivations.¹⁸⁴ Three differing conceptions of the federal financial role can be detected in different parts of the ongoing debate.

One political conception of the federal financial role is that federal transfers should be *designed to be neutral* across states; i.e., that each state should get back a close approximation of what it pays in. Under this conception, the federal government's role is to operate a unified tax system, but not to redistribute the collected resources via the federal fisc.

A second conception of the federal financial role is that the federal fiscal transfer system should be *designed to redistribute* resources among the states. This conception prescribes that the federal government should use resources available from states with higher per capita incomes or stronger economies to finance programs that less wealthy states would be unable to support using their own resources alone.

A third conception of the federal financial role is that net redistribution of resources and economic activity among states is allowable as long as it is an *unintended consequence* of individual programs designed to achieve important federal purposes. This conception prescribes that programs should be financed through a unified tax system, but that program spending should be located wherever activities need to be, or best can be, carried out; program spending would thus be 'blind' to any redistributive effects.

Given this lack of consensus as to the goals of federal transfers, it is no surprise that concerns about whether states receive a 'fair' proportion of federal expenditures, or pay more than their 'fair' share in federal taxes, have become a

¹⁸³ Ronald L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston: Institute of Intergovernmental Relations, 1999), 11.

¹⁸⁴ Herman B. Leonard, Jay H. Walder, and José A. Acevedo, *The Federal Budget and the States: Fiscal Year 1998* (Cambridge, Mass., U.S.A.: Taubman Center for State and Local Government, 1999), 17.

prominent feature of political debates at the federal level. That is, as participants in policy debates have differing conceptions of the goals of the system, they differ as to their evaluations of what is 'fair'. Consider, for example, the political difficulties involved in designing a new welfare system to replace the AFDC (Aid to Families with Dependent Children) program.

The AFDC program, a categorical transfer program, was in 1996 converted to a block transfer program and renamed Temporary Assistance for Needy Families (TANF). Under TANF, the states were given almost total discretion to set program rules; thus, there is relatively little policy to be set at the federal level, other than the distribution of federal funding levels among states. Consequently, one of the most contentious issues in designing TANF became finding 'fair formulas' to allocate and distribute federal transfers.

Some wealthier states argued that fairness prescribed that future allocations should be based on past allocations. Under AFDC, state contributions were matched by federal transfers, so that states had an incentive to contribute more. If the new block transfers were distributed based on prior year allocations, states that were receiving a relatively large amount of federal support because of their own spending would continue to receive higher funding. This would persist even if they subsequently cut their own contributions.

Many poorer states took a different view of what would be a fair allocation. At one point, a group of 30 Senators from the "Sunbelt" states proposed a formula that would have taken child poverty rates and the size of the state into account. Under this formula, more money would have been directed to southern states and states with small populations. Wealthier states, that had been able to afford higher own-source funding under AFDC, would have experienced a commensurate drop in federal transfers.

In the end, a compromise involving transitional measures was agreed upon. What the TANF debate demonstrates is that without political agreement on the goals of federal transfers, determination as to what constitutes a 'fair' funding formula must be made on a case-by-case, *ad hoc* basis.

Beyond the difficulties involved in formulating 'fair' rules for transfers given a lack of consensus of the overarching goals of the transfer system, are the problems associated with the uncoordinated nature of the transfer system. As the system is not often considered in its totality, but rather only on an issue-by issue or program-specific basis, policy debates are plagued by misconceptions as to the actual redistributive effects of federal transfers. For example, it is commonplace for citizens and even policy-makers to consider the large cities of the north-east and Great-Lakes regions to be beneficiaries of federal transfers due to high wel-

fare costs; in fact, however, the states of the north-east and Great Lakes regions are net contributors to the federal revenues while many Sunbelt and western states are net recipients.¹⁸⁵

Unfunded Mandates: Mandates is a broad term used to refer to a number of different tools used by the federal government to regulate the activities of state and local governments.¹⁸⁶ Four types of tools are relevant to the discussion of fiscal federalism. First, there are the program-specific conditions attached to conditional transfers. These requirements, attached to major fiscal assistance programs, demand significant fiscal and policy actions by state and local governments. As we have noted, while it is technically possible for state and local governments to avoid the conditions by non-participation in a program, this is not practically feasible in the case of the major programs. Avoidance is also made more difficult by the next two types of mandates.

Second, there are 'crossover sanctions'. Such sanctions link compliance with conditions of smaller programs to the continued receipt of funds from larger programs. They may mandate a withdrawal of all or a portion of a federal transfer; for example, federal funding for highways is dependent upon a state maintaining a minimum legal drinking age of 21 years.

Third, there are 'cross-cutting requirements' attached to many transfers. Technically, these are conditions of transfers as well. However, these cut across policy areas, making it difficult for recipient governments to avoid them. The stipulation that capital funding on any federally-funded facility is dependent upon the facility being accessible to the disabled is an example of such a cross-cutting requirement.

Fourth, there are direct orders. These are seen as the most coercive of mandates, and involve federal direction of policies or programs to be carried out by state or local governments. Typically, these carry criminal or civil sanctions for non-compliance. Examples include federal labour and environmental standards.

State and local officials oppose mandates principally on three grounds.¹⁸⁷ First, they argue that mandates distort their priorities by tying up resources to comply with federal priorities. As the ability of state governments to respond to state priorities is diminished, they argue, the political viability of state-order government is undermined. Second, mandates carry non-fiscal implications for state

¹⁸⁵ Ibid., 2-3.

¹⁸⁶ Paul I. Posner, *The Politics of Unfunded Mandates: Whither Federalism?* (Washington: Georgetown University Press, 1998), 4, 13.

¹⁸⁷ Ibid., 6.

and local governments. It is argued that the initiative of these governments to experiment with innovative approaches to policy problems is diminished. Third, it is argued that mandates serve to undermine accountability. To the degree that mandates are ‘unfunded’, federal legislators are free to enact benefits without facing the concomitant political pressures associated with paying for them.

Supporters of mandates counter with four arguments. First, they argue that states, if left to their own devices, would provide inadequate levels of funding and services to what have been identified as national priorities. They believe a federal role is thus justified in such areas as assistance for those with disabilities or protection of the environment. Second, economists argue that federal action is necessary due to spill-over effects. Federal regulation prevents states from exporting costs in policy areas such as higher education and environmental protection. Third, it is argued that the U.S. needs a national system of regulation of corporate activity, as it has developed a nationally integrated economy. Federal regulation is seen as necessary to prevent ‘jurisdiction shopping’ by corporations. Fourth, it is argued that the U.S. has become a national community, with expectations of common levels of public services and benefits. It is thus argued that only the federal government can avoid a patchwork of services.

The significant use of mandates began in the 1960s, and continued through the 1970s. The Reagan administration ameliorated the effects of unfunded mandates in the 1980s by requiring all executive regulations to undergo cost-benefit analyses. However, the number of mandates imposed by Congress continued to grow, and the fiscal pressures related to the recession of the early 1990s led to high-profile protests by state and local governments against unfunded mandates. A coordinated National Unfunded Mandates Day, first held on October 23, 1993, received wide-spread press attention.

The federal legislative response to state and local protest was the Unfunded Mandates Review Act of 1995. In the aftermath of the Act, some unfunded mandates were reversed, and new mandates were modified.¹⁸⁸ However, as the Act covers only one of the four types of mandates identified above, i.e., direct orders, the political debate on mandate issues can be expected to endure.¹⁸⁹

Ability to Adapt to Changes. The U.S. fiscal transfer system has shown a remarkable ability to adapt to changing circumstances. As we have noted, the matrix of connections among legislators, administrators, and executives in all three levels of government produces an uncoordinated but flexible system. The

¹⁸⁸ *Ibid.*, 206.

¹⁸⁹ *Ibid.*, 204.

federal Congress, as a site for lobbying by agents of state and local governments, is able to incorporate regional views in its decision-making processes.

The noncentralized character of U.S. federalism has allowed the locus of legislative and administrative decision-making to evolve over time. Periods of more centralised decision-making, such as that induced by the crises of the Great Depression and the Second World War, have alternated with periods of greater legislative and fiscal decentralization, such as the period beginning in the 1980s. Such flexibility has been facilitated by the Constitution's provision of extensive areas of shared jurisdiction.

2. Transparency and Accountability Considerations

The complex uncoordinated system of intergovernmental transfers produces a system with both low transparency and low accountability. However, because of the degree of concern in the U.S. around the principle of financial responsibility, accountability has been enhanced via the extensive use of conditional transfers.

A benefit of the systematic use of conditional grants is a relatively high degree of transparency. While it is true that the U.S. system of intergovernmental relations constitutes a complex matrix, the importance attached to the principle of financial responsibility means that citizens are able to identify the site where decisions are taken. As compared to the relatively closed system of intergovernmental relations in those federations utilising executive federalism, the bargaining 'free for all' which takes place in the U.S. Congress is relatively open.

3. Political Culture

United States' society is characterized by relative homogeneity and the process of intergovernmental relations and fiscal arrangements reflects and reinforces this characteristic.

Overall, cultural homogeneity is reflected and reinforced by the conditional transfer system. The federal government has been able to use conditional transfers to develop a relatively uniform set of nation-wide programs and services. While states and localities are allowed some discretion in regard to implementation of these programs, the over-arching principle has been support for uniform federation-wide standards.

The political culture of the United States has been described as being civic, republican, and participatory.¹⁹⁰ While there are regional variations, this political culture places an emphasis on the individual, as opposed to the group, as the primary political unit. It is in this context that the systems of intergovernmental relations and fiscal transfers must be understood.

Rather than relating to each other as coherent entities, the governments of the U.S. relate as congeries of interests. That is, in the federations utilising executive federalism (such as Canada and Germany) each government defines a constituent-unit interest which is a compromise worked out within the political community of the constituent unit. That collective interest is then represented by the executive of the constituent-unit government in intergovernmental bargaining. In the U.S., by contrast, constituent-unit interests are not defined at the state-government level and then represented; rather, each interest represents itself in the uncoordinated bargaining that occurs in Congress. State legislators, and state and local executive agencies pursue what they perceive to be in their individual or institutional interests. Definition and representation of a collective, state-wide interest has not been in practice the overriding concern.

The fiscal transfer system is also in accord with a political culture rooted in individualism. The lack of an overarching equalization system is consonant with a focus on individuals, rather than on states as collectivities. The tolerance for horizontal fiscal imbalances among states may be related to the belief that individuals have the ability to avoid the effects of such imbalances by relocating to more prosperous areas. Such relocation is in practice facilitated by the relative cultural homogeneity of the United States since there are no linguistic barriers to overcome when moving from one region of the country to another.

¹⁹⁰ Daniel Elazar, *Federal Systems of the World: A Handbook of Federal, Confederal and Autonomy Arrangements* (Harlow, Essex, UK: Longman, 1991), 313.

Chapter 8. Fiscal Federalism in Canada

A. Federalism in Canada: The Constitutional and Political Context

Canada is a fundamentally federal country marked by a vast territory, second only to Russia in area, and by a diverse population of over 30 million descended from immigrants drawn from many cultures around the world as well as an aboriginal population. Canada has two official languages, English and French, and the country consists of distinct economic regions. Canada became a federation in 1867 when the former British colony of Canada was split into two new provinces, Quebec with a French-speaking majority and Ontario with an English-speaking majority. Two other British colonies along the Atlantic coast, Nova Scotia and New Brunswick, were added to establish a four-province federation. In the 133 years since that time, the federation has grown to encompass most of the northern half of the North American continent stretching from the Atlantic Ocean to the Pacific Ocean to the Arctic Ocean and consisting of ten provinces and three territories. Commencing as a relatively centralized federation, Canada in accommodating the internal diversity of its population and regional economies has become one of the more decentralized federations in the world, while developing at the same time a cohesive transportation network and system of federation-wide social programs.

1. Constitutional Status of Various Orders of Government

The government structure consists of a federal government, 10 provincial governments, 3 territorial governments and numerous municipal (or local) governments. All of the federal, provincial and territorial governments are organised on the basis of the Westminster parliamentary system. There is also a newly evolving system of self-government for many of the aboriginal communities.

The Federal, Provincial and Territorial Legislatures

The fusion of the legislative and executive branches of government within the federal and provincial legislatures with executives chosen from within and responsible to the legislatures, combined with strong political conventions of party discipline, have effectively transferred legislative power in practice to the executive branches.

The Senate of Canada is the Upper House and its members are appointed by the prime minister and hold office until retirement at 75. Although the Constitution gives the Senate extensive legislative powers these are rarely fully exercised because the chamber lacks democratic legitimacy. As a result there are few checks on the power of the executive when it is supported by a majority in the House of Commons.

The House of Commons (the Lower House) of Canada is elected by a first past the post electoral system and the number and distribution of seats is based on population (giving provinces with a larger population more seats). The Canadian prime minister must choose the executive from the members elected to the House of Commons or from members in the Senate¹⁹¹ and as a matter of convention the executive reflects regional, linguistic and other important interests. In order to stay in government the executive must win votes in the Lower House on issues that are considered central to their governing platform. This is usually assured by the electoral system which gives the governing party a majority of seats and the use of party discipline to ensure that members of parliament from the government's party vote in support of the executive's legislation. This ensures a very stable executive and very stable government (as long as one party holds the majority of seats) that faces few challenges from the legislature or the Upper house.

Provincial and territorial legislatures are unicameral. These legislatures are elected by the same method as the federal House of Commons and the relationship between the executive and the legislature is the same as it is in the federal House of Commons.

The Courts

One institution that does have considerable power to check the power of the federal, provincial, and territorial governments is the courts. They conduct judicial review on two bases; 1) the division of powers (as it is specified in the Constitution) and 2) since 1982 on the basis of an entrenched Charter of Rights. In both of these cases the courts have the power to rule legislation null and void if it is found to violate the terms of the Constitution.

¹⁹¹ Although members from the Senate can be appointed to the executive this is very rare.

Constitutional Status of the Federal and Provincial Governments

The federal government and the 10 provincial governments are recognised and their existence is guaranteed in the Constitution (Canada Act 1867, s.1-5). The federal and provincial governments are independent of each other; there is **not** a hierarchical relationship between the two orders of government. The provincial legislatures and the federal parliament are each considered sovereign within their own constitutionally defined areas of jurisdiction.

The federal government has legislative and regulatory powers in areas that include: regulation of trade and commerce, national defence, foreign affairs, criminal law, unemployment insurance, and direct and indirect taxation. The provinces have legislative and regulatory powers in important, and costly, areas that include: education, health, social assistance, civil law (and the administration of justice), municipal affairs, licensing, and management of public lands and non-renewable natural resources and forestry resources, property law, civil law, direct taxation, “property and civil rights within a province” and other matters of a “local nature.”

Local and Territorial Governments

Canada’s three territories remain under the constitutional authority of the federal government and their legal structures are specified in several federal statutes.¹⁹² The territorial legislatures derive their legislative powers from the federal government. In the statutes that created the territories, the federal government delegated extensive powers to the territorial legislatures that roughly corresponds to the list of provincial powers.

Local governments (city governments, town governments, village governments, township governments, etc) are the creation of the provincial and territorial governments and are subject to regulation by the provincial and territorial governments that create them.

¹⁹² The *Yukon Act*, *Northwest Territories Act*, *Nunavut Act*, *Government Organisation Act*, and the *Federal Interpretation Act*.

2. Constitutional Allocation of Revenue and Expenditure Responsibilities and Provisions related to Intergovernmental Transfers

Constitutional Allocation of Revenue

In Canada both the federal and provincial governments have broad taxing powers. The result is overlapping tax jurisdictions that make the taxation and revenue system rather complex.

The constitution gives the federal government an exclusive power to “raise money by any mode or system of taxation.”¹⁹³ However, the Constitution also gives the provinces the power to apply direct taxation in their provinces.¹⁹⁴ As a result the federal and provincial governments share several of the most significant taxation powers. For example, both orders of government levy personal income taxes and general sales taxes. Table A1 indicates the various types of taxes levied by the federal and provincial governments and indicates the areas of overlap.

Personal Income Taxes

The federal and provincial governments levy personal income taxes. The federal government determines the base for personal income tax and the provinces use this as the base for determining provincial personal income taxes.¹⁹⁵

Corporate Income Taxes

Corporate income taxes are levied by both the federal and provincial governments. The federal government sets the basic rate and allows for an abatement of income earned in a province. This allows the provinces some tax room to impose their own taxes on corporate income earned in their province although not all of the provinces do so.¹⁹⁶

Sales Taxes

General sales tax is levied by both federal and provincial governments.

¹⁹³ *Constitution Act, 1867*, s.91(3).

¹⁹⁴ *Constitution Act, 1867*, s. 92(2).

¹⁹⁵ Except in Quebec. The details of Quebec’s tax system are covered in later sections of the paper. See Section D. Systems of Tax Harmonization and Tax Collection.

¹⁹⁶ See Section D *Systems of Tax Harmonization and Tax Collection* for further details.

TABLE A.1: TAXES LEVIED BY FEDERAL, PROVINCIAL AND TERRITORIAL GOVERNMENTS

| Tax | Federal Government | Alberta | British Columbia | Manitoba | New Brunswick | Newfoundland and Labrador | Nova Scotia | Ontario | PEI | Quebec | Saskatchewan | Yukon & NWT |
|---------------------------|--------------------|---------|------------------|-----------------|----------------------|---------------------------|----------------------|-----------------|-----------------|------------------|-----------------|-------------|
| | Goods and Services | None† | Prov. Sales Tax | Prov. Sales Tax | Harmonised Sales Tax | Harmonised Sales Tax | Harmonised Sales Tax | Prov. Sales Tax | Prov. Sales Tax | Quebec Sales Tax | Prov. Sales Tax | None |
| Personal Income | √ | √ | √ | √ | √ | √ | √ | √ | √ | √* | √ | √ |
| Corporate Income | √ | √* | √ | √ | √ | √ | √ | √* | √ | √* | √ | √ |
| Corporate Capital | √ | √ | √ | √ | √ | √ | √ | √* | | √* | √ | |
| Customs and Excise | √ | | | | | | | | | | | |
| Real Property | √ | √ | √ | √ | √ | | | | √ | | | √ |
| Tobacco | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ |
| Fuel | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ | |
| Payroll | √ | | | | | | | | | | | |
| Insurance | | √ | √ | √ | | √ | √ | | √ | √ | √ | √ |
| Financial Institutions | | | | | | | | | | | | |
| Health and Education | | √ | √ | √ | | | √ | | | | | |
| Environment | | | | √ | | √ | | | | | | |
| Mineral/Natural Resources | | √ | | √ | √ | √ | √ | | | √ | | |

† = has the constitutional power to levy a sales tax but does not have a sales tax

* This tax is collected by the province, not the federal government.

Constitutional Allocation of Expenditure Responsibilities

The constitutional allocation of expenditure responsibilities can be found in the sections of the constitution that divides the legislative powers and responsibilities between the federal and provincial governments (Constitution Act, 1867, ss. 91 to 95). The division of powers divides legislative responsibilities into three categories: 1) powers that are exclusive to the federal government, 2) powers that

are exclusive to the provincial governments and 3) powers that are exercised concurrently by both orders of government.

In Canada almost all constitutionally specified legislative powers are exclusive powers. *De jure*, there are only four concurrent powers and they fall into the following areas: 1) exporting non-renewable natural resources, forestry resources, and electrical energy¹⁹⁷, 2) old age pensions and benefits¹⁹⁸, 3) agriculture and 4) immigration.¹⁹⁹ All other legislative powers are categorised as exclusive powers of either the federal or provincial governments.²⁰⁰ Although most powers are defined as exclusive powers the use of intergovernmental transfers has meant that in many policy areas the jurisdiction is a *de facto* concurrent jurisdiction (section C *System of Intergovernmental Transfers* provides further details on the system of intergovernmental transfers).

At the time of federation in 1867 the most important priority was to promote the economic development of the new country. The building of railways, roads, canals, harbours and bridges to link the provinces with each other and with the rest of the world was the prerequisite for economic development. These duties, along with national defence were assigned to the federal government. The provinces were given other important responsibilities, such as the administration of justice, local institutions, health, education, welfare and other matters of a “local nature.” However, in 1867 the principle of laissez-faire was the dominant governing philosophy and these responsibilities were much less costly to the state than today. The initial allocation of revenue sources reflected the allocation of expenditure responsibilities.

The building of a modern industrial welfare state meant that although the federal responsibilities remain significant, the responsibilities assigned to the provinces have increased enormously in relative importance and have become the focus of major government policy initiatives.

¹⁹⁷ *Constitution Act*, 1867, s.92A(3)

¹⁹⁸ *Constitution Act*, 1867, s. 94A

¹⁹⁹ *Constitution Act*, 1867, s. 95. Both agriculture and immigration are under this provision.

²⁰⁰ It should be noted that although the federal government has the jurisdiction to legislate in the area of criminal law the provinces are responsible for the administration of criminal law.

Constitutional Provisions Related to Intergovernmental Transfers

The provinces have constitutional jurisdiction in areas that have become the most costly expenditure responsibilities but they also have access to considerable financial resources. The provinces are able to finance a large percentage of their expenditures out of their own revenues (see section B *Economic Numbers* for particular details) but there has always been a discrepancy between the provinces' revenue capacity and their expenditure responsibilities.²⁰¹ The discrepancy between the provinces revenues and their expenditure responsibilities has resulted in a degree of vertical fiscal imbalance (VFI). There are also considerable differences in the size, population and economic wealth of the provinces that have resulted in horizontal fiscal imbalance between the provinces. These vertical and horizontal fiscal imbalances have led to the development of two types of transfers from the federal government to the provinces.

One set of transfers is intended to address the vertical imbalance between the federal government and the provinces. Under this system of transfers, the federal government transfers funds to the provinces that are to be spent in policy areas that are in the constitutional jurisdiction of the provinces (primarily in healthcare, post-secondary education, and welfare). The federal government attaches modest conditions to these funds and the provinces must satisfy these conditions in order to receive the transfers.²⁰² The ability of the federal government to attach conditions to these transfers allows the federal government to influence, or in some cases establish policies that are outside its constitutional jurisdiction. All of the provinces are eligible to receive these transfers. These transfers are known as conditional transfers and they are made through the federal government's spending power. The federal government has also used its spending power to transfer funds directly to individuals or to organisations and agencies to achieve certain policy objectives (section 3 *Constitutional or Other Spending Power Provisions* provides further details on the federal government's spending power).

A second kind of transfers, know as Equalisation, was established to address the horizontal fiscal imbalance between the 10 provinces. These are unconditional transfers and only the less wealthy provinces are eligible to receive them. Cur-

²⁰¹ This is a slight simplification for the purposes of clarity. For full details on the tax sharing arrangements between governments see Section D.

²⁰² Most conditions ensure accessibility and portability of benefits. For greater details on the conditions attached to these transfers see Section C *System of Intergovernmental Transfers*.

rently seven provinces receive equalization transfers (section C *System of Intergovernmental Transfers* provides further details on equalization transfers).

The Canadian federal system includes an extensive and complex system of intergovernmental transfers (see the section *System of Intergovernmental Transfers* for details) but with one exception there are no constitutional provisions concerning intergovernmental transfers. The one case where the constitution does mention intergovernmental transfers is in relation to the system of equalization.²⁰³ These provisions were added to the Constitution in 1982 and express the commitment of the federal and provincial governments to a set of principles that are the basis of the equalization system. One of the provisions 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.”²⁰⁴ These provisions on equalization only represent a commitment by the respective governments to the principles behind the equalization system and there are no provisions that commit governments to contributing or receiving particular levels of funds. Although these provisions are in the constitution, leading constitutional scholars have argued that the provisions are probably too vague, and too political to be justiciable in the courts.²⁰⁵

3. *Constitutional or Other Spending Power Provisions*

The use of the federal government’s “spending power” is one of the major sources of intergovernmental transfers. These transfers are aimed at addressing the vertical fiscal imbalance between the federal and provincial governments. In Canada the meaning of the “federal spending power” refers to the ability of the federal government to transfer funds to other governments, agencies or individuals for purposes which the federal government does not have the explicit constitutional authority, or in matters where the provinces have exclusive jurisdiction. Although the federal spending power has played a critical role in the establishment and evolution of major social policies in Canada, there is no explicit recognition of the federal spending power in the Canadian Constitution. However, the Constitution as interpreted by the courts allows the federal government to spend its revenues on any matter, as long as the legislation authorising the spending of revenues does not constitute a regulatory function that falls within the provinces

²⁰³ See the *Constitution Act, 1982* s. 36

²⁰⁴ *Constitution Act, 1982* s. 36(2).

²⁰⁵ Peter Hogg, *Constitutional Law of Canada*, 4th ed (Toronto, Carswell,1996), p. 142.

constitutional powers. The constitutional basis of the federal spending power is inferred from the federal government's powers to raise taxes²⁰⁶ and, to legislate in relation to "public property,"²⁰⁷ and from Parliament's authority to "appropriate" federal funds from the *Consolidated Revenue Fund*.²⁰⁸

In 1991 the Supreme Court of Canada's latest decision on the constitutionality of the federal spending power made it clear that as long as the federal government does not go beyond granting or withholding money, there is no unconstitutional trespass into provincial jurisdiction.²⁰⁹ The court's interpretation of the constitution has given the federal government a wide degree of discretion in how it chooses to use its spending power. In essence, there are no significant constitutional restrictions on the federal government's ability to use its spending power in order to transfer funds to individuals, agencies or other governments for policy purposes for which it does not have explicit constitutional authority to legislate or regulate. Despite occasional objections from the provinces most of them have accepted the court's interpretation of the spending power.²¹⁰

In recent years, the issue of the federal spending power has attracted renewed attention. After a period that saw the federal government make drastic reductions in transfers to the provinces, the federal government appears to be taking an interest in initiating new social programs or proposing substantial additions to existing programs (for example, adding a national home-care policy).

As a result, the use of the spending power has been a source of recent political debate that has resulted in the federal, provincial and territorial governments signing the *Social Union Framework Agreement* in February 1999.²¹¹ One of the sections in the agreement recognises the legitimacy of the federal spending power and in return the federal government accepts some restrictions on the exercise of its spending power.²¹² The *Social Union Framework Agreement* is only an inter-

²⁰⁶ *Constitution Act 1867*, s. 91(3)

²⁰⁷ *Constitution Act 1867*, s.91(1A)

²⁰⁸ *Constitution Act 1867*, s. 106.

²⁰⁹ *Re Canada Assistance Plan* [1991] 1 S.C.R. 525. For a detailed explanation of this case see Hogg, 1996, p. 149-150.

²¹⁰ Quebec has consistently rejected the legitimacy of the federal government's spending power. For further details on the use of the federal spending power see Section C *System of Intergovernmental Transfers*.

²¹¹ The government of Quebec did not sign the Agreement.

²¹² For the specific details on the use of the spending power see *The Social Union Framework Agreement*, section 5. It should be noted that one of Quebec's reasons for not

governmental political agreement however. Not only does it not have any constitutional status; it is not even legally binding.

4. Political and Legal Dynamics - including the Role of Law and Role of Politics in the Decision-Making Processes

Canada is a federation that consists of two principal linguistic communities (French and English). Major formal amendment of the constitution in response to changing social and economic circumstances that meets the needs of both communities has proven to be almost impossible. The lack of major formal amendments to the constitution does not mean that significant changes have not taken place to meet new challenges facing the federation. The federation has evolved largely through the non-constitutional processes of intergovernmental relations. Negotiations between the executives from each order of government (“executive federalism”) have allowed the federal government to pursue general policy objectives while at the same time leaving the provinces a major role in designing and financing the programs that meet the federal government’s Canada-wide objectives. This process has also been flexible enough to accommodate many of the particular needs of the provinces, but the historical demands of Quebec, for a greater degree of fiscal and policy autonomy from the federal government has put a considerable strain on the process of intergovernmental relations. These demands by Quebec have made it increasingly difficult for the federal government to pursue Canada-wide policy objectives while at the same time accommodating Quebec’s pressures for greater fiscal and policy autonomy. In recent years the larger and wealthier provinces have begun to articulate a position similar to Quebec’s. As early as the 1970s Alberta argued that they needed greater fiscal and policy autonomy in order to pursue provincial economic strategies. More recently the province of Ontario, and on occasion British Columbia, have made similar arguments.

Nevertheless, the informal (non-constitutional) process of intergovernmental relations has become one of the primary methods for responding to social and economic changes affecting the federation. These processes of intergovernmental relations have resulted in a complex series of fiscal arrangements between the federal and provincial governments. These fiscal arrangements, made in response to social and economic changes, have largely taken the place of formal constitu-

signing the Agreement concerned the provisions recognising the legitimacy of the federal spending power.

tional change which has proven to be politically divisive and almost impossible to achieve.

Role of Law in the Decision-Making Process

As already indicated, the non-constitutional process of intergovernmental relations has played a central role in issues that affect federalism and fiscal arrangements between the federal and provincial governments. Although this is the primary venue for resolving disputes over issues of federalism, the courts and the formal provisions of the constitution have played, and continue to play, a significant role in affecting these disputes and how they are resolved by providing the framework within which intergovernmental relations occurs.

One of the central features of the Canadian Constitution is the division of powers contained in the Constitution Act, 1867. Since 1867 the courts have had the responsibility of interpreting these provisions and determining whether an Act or some provision of an Act is within the legislative jurisdiction of Parliament or of a provincial legislature. The courts may only intervene in a dispute over the division of powers if a case is brought before the court or when a government requests the court's opinion through a procedure known as a "reference."²¹³

Section 91 of the *Constitution Act, 1867* specifies the list of exclusive federal powers and gives the federal government residual powers by assigning them legislative and regulatory powers that are not assigned to the provinces. It is through the provisions in s.91 of the Constitution Act, 1867 that the federal government is said to have been assigned all residual powers except in local matters.

Although the constitution assigns residual powers to the federal government this has not resulted in an expansion of its legislative powers because the courts have given a broad and expansive interpretation to the powers of the provinces under s.92 of the Constitution. By giving an expansive interpretation of the provincial authority there has been very little room for the federal government to assume new legislative powers.

To summarise, the courts have played a critical role in defining the relative powers of the federal parliament and the provincial legislatures. The court's narrow interpretation of the federal governments powers and a broad interpretation of the provinces' powers has meant that the federal government has a narrower range of powers than the constitution would seem to suggest and the provinces have a much wider range of powers. However, as noted earlier, the courts have given a broad interpretation of the federal government's spending power which

²¹³ This process will be explained later in this section.

has allowed the federal government to significantly expand its *de facto* policy jurisdiction.

The Constitutional Amending Formula and the Difficulty of Amending the Constitution

Amending the constitution in Canada has been a politically contentious and difficult task that has, at times, seriously threatened the unity of the federation. As a result, the federation has evolved mainly through a non-constitutional process of intergovernmental agreements.

Canada's original Constitution of 1867 did not specify a process whereby the Constitution could be amended in Canada. The issue of the amending formula for the Constitution was so politically contentious that it was the subject of over fifty years of constitutional debates between the federal government and the provinces until a formal amending process was adopted in 1982.²¹⁴ The 1982 amendments to the Constitution only exacerbated the Constitutional tensions, however, because Quebec refused to sign the new constitution.

A new federal government was elected in 1984 and initiated two rounds of major constitutional negotiations with Quebec and the other provinces in an attempt to get Quebec to sign the Constitution. Both of these major attempts at constitutional reform failed and further threatened the unity of the country.

The difficulty of formally amending the Constitution and the threat that constitutional negotiations pose for national unity means that the primary method of adapting to changing circumstances has been through the non-constitutional process of intergovernmental agreements and, in this regard, the instruments of fiscal federalism have played a key role.

Reference Procedures²¹⁵

An important role played by the courts in matters that affect the powers of the federal and provincial governments is their ability to provide advisory opinions to the federal and provincial governments concerning the constitutionality of legislation. The basis for this function is not found in the Constitution but is found in federal and provincial legislation.

The Supreme Court Act gives the Supreme Court the function of providing advisory opinions to the federal government on questions that it refers to the

²¹⁴ See the Constitution Acts, 1982 ss. 38-49

²¹⁵ For a thorough description of this topic see Hogg, 1996, 209-214.

Court.²¹⁶ Provincial governments cannot direct a reference to the Supreme Court but all of the provinces have legislation that allows them to request references from the highest provincial court. Once a provincial court of appeal has rendered its decision on a case there is a right of appeal to the Supreme Court which has the effect of allowing the provincial governments to secure a ruling from the Supreme Court. The reference procedure has been used mainly for constitutional questions and they usually concern the constitutionality of a federal or provincial law (or a proposed law).

Appointments to the Appeal Courts

The important role played by the courts in interpreting the constitution has meant that the method of appointing judges to the courts has attracted some political attention. The Constitution gives the federal government the power to appoint all superior court judges, which includes the judges on all of the highest provincial courts and the justices of the Supreme Court.²¹⁷ This gives the federal government the power to appoint federal and provincial judges that are responsible for interpreting the constitution and the relative powers of the federal and provincial governments. Because of the role the courts play, especially the provincial appeal courts and the Supreme Court, in interpreting the constitution on matters that relate to federalism the appointment process has been the subject of constitutional negotiations.

There are a number of constitutional conventions that are respected in the appointment of Supreme Court judges that ensure regional and linguistic representation on the Supreme Court but these conventions are not specified in the constitution. The provinces have argued that the constitution should be amended to give them a formal role in the appointment of judges to superior courts and that there should be guarantees written into the constitution of regional and linguistic representation on the Supreme Court.

Role of Politics in the Decision-Making Process

Executive Federalism

As indicated above, there is almost a total lack of attention to the issue of intergovernmental relations in the provisions of the constitution. This means that

²¹⁶ *Supreme Court Act*, s.53.

²¹⁷ *The Constitution Act, 1867* s.96.

the process of intergovernmental relations is governed almost entirely by a series of conventions and informal intergovernmental agreements. In the post-war period the process of intergovernmental relations in Canada has come to be a process called "executive federalism". Executive federalism is a process in which intergovernmental relations are carried out by the executive branches of the federal and provincial governments (this takes place at both the political and bureaucratic levels). The result is that most intergovernmental relations are conducted by the premiers and the prime minister or by ministers and officials that are under their direct control. The federal government and most of the provincial governments have separate ministries responsible for intergovernmental relations. The increasing significance of intergovernmental relations for both orders of government also means that the largest departments in the federal and provincial governments also have specific personnel, or in some cases entire bureaucratic divisions, that focus on intergovernmental issues.

The highest profile and most public meetings that take place between the federal and the provinces are the First Ministers' Conferences that are attended by the Prime Minister and the premiers of the provinces. These meetings are called by the Prime Minister and usually concern issues that are of the greatest political concern. There are also a variety of other meetings that take place among the premiers, without the prime minister. At these meetings the premiers may discuss issues that relate to provincial or federal social and economic policies, constitutional issues, and other issues that maybe of particular concern. Examples of these meetings includes: the Annual Premiers' Conference, the Council of Maritime Premiers, Conference of Atlantic Premiers, the Western Premiers' Conference, and the Council of New England Governors and Eastern Canadian Premiers. There are also extensive sectoral meetings (Ministerial Conferences) between cabinet ministers from the different orders of government that have responsibilities that require a great deal of intergovernmental consultation. Much more numerous are the meetings that take place at the bureaucratic level between the civil servants in the federal and provincial governments. These meetings are primarily concerned with implementing agreements that have been made at a higher level and ensuring that the necessary coordination is taking place on important policy issues.

It was the building of the modern welfare state in the immediate post-war period that initiated and accelerated the process of executive federalism. The provinces had constitutional jurisdiction in many of the policy areas that are a central part of the welfare state but, at that time, the provinces lacked sufficient financial resources to fulfil these responsibilities. Therefore the federal government, with

greater fiscal resources and fewer expenditure responsibilities, took a lead role in initiating and financing new major social programs through the use of its general spending power.²¹⁸ As the range of social programs expanded the federal and provincial governments became more interdependent. Although the constitution assigned the provinces exclusive powers over most areas of social policy the federal government used its spending power (and the conditions which it attached to it) to help finance and influence major social policies that were in the constitutional jurisdiction of the provinces. Therefore, despite assigning most social policy powers exclusively to the provinces the significant role played by the federal government means that these are in practice concurrent powers.²¹⁹

The Differences Between the Provinces

As indicated earlier, the provinces play a central role in the process of executive federalism. The provinces have constitutional jurisdiction in most social policy areas and they have access to a broad base of tax revenues. However, there is still a considerable degree of vertical fiscal imbalance between the federal government and the provincial governments (see section B). It is this imbalance that creates a role for the federal government to use its spending power to influence the design and delivery of social programs in areas such as healthcare, post-secondary education and welfare that are within the constitutional jurisdiction of the provinces. Although the data in section B (*the Economic Numbers*) indicates that the federal government's role in social policy spending has been declining over the last forty years, it was the federal government that initiated many of the programs that are now funded to a larger extent by the provinces. In addition, although the contribution of the federal government has been declining it continues to play a central role in influencing the financing and delivery of social programs at the provincial level.

One feature of Canadian federalism that has had a significant effect on the dynamics of intergovernmental relations is the asymmetry that exists between the various provinces. The data in section B provides some indication of the range in relative wealth of the 10 provinces. The relative wealth of provinces has played a

²¹⁸ The federal government had occupied extensive tax room during World War II through a political agreement with the provinces. Once the war was over, however, the federal government was reluctant to give up significant tax room to the provinces. See Section D for further details.

²¹⁹ It should be noted that the federal government does have exclusive jurisdiction for the provision of unemployment insurance.

role in the dynamics of executive federalism and negotiations over fiscal arrangements. The significant differences in the wealth of the provinces means that some provinces are much more dependent on transfers from the federal government than other provinces. Generally, the three wealthier provinces (British Columbia, Alberta, and Ontario) raise a higher proportion of their revenues from their own provincial sources and federal government transfers constitute a relatively small percentage of their provincial revenues (approx. 11 percent).²²⁰ To varying degrees and at different times, these provinces have expressed greater concerns that the use of the federal spending power trespasses on provincial jurisdiction. They have also expressed greater concerns to varying degrees over the conditions that apply to the use of the federal spending power.²²¹ For the other provinces, especially the poorer provinces, the federal government transfers account for a much larger percentage of provincial government revenues (almost 40 percent for Prince Edward Island and Newfoundland)²²² and these provinces are much more dependent on these transfers as a method of funding their social policy expenditures. Because of their dependence on these transfers these provinces have generally expressed fewer concerns about the use of the federal spending power.²²³

Although the spending power gives the federal government considerable power and influence in intergovernmental relations, it is the provinces that have the constitutional jurisdiction that is necessary for most social policy programs. This means that although the federal government has the ability to use its spending power to establish cost-shared programs (conditional transfers) it still relies on the cooperation of the provinces to provide similar levels of funding and implementation of these programs. Because the wealthier provinces rely on the federal government for a relatively small percentage of their total revenues they have a stronger position in negotiations with the federal government concerning the financing of jointly-financed programs. These provinces are more likely to challenge the federal government on the conditions that are attached to intergovernmental transfers and threaten the existence of country-wide programs with country-wide “standards.”

²²⁰ See Table 5 in Appendix to Section B.

²²¹ At present for example, Alberta and Ontario are strong critics of federal spending power, whereas British Columbia is favourably disposed to its use.

²²² See Table 5 in Appendix to Section B.

²²³ This statement is **not** true of Quebec.

The Role of Quebec

Quebec is not among the group of wealthy provinces but its unique status in the federation as the principal home of French speaking Canadians means that it has consistently sought much more political and fiscal autonomy from the federal government in order to preserve and promote its French language and culture. The result has been that Quebec has always been critical of the federal governments use of the federal spending power to implement policies that are within the exclusive constitutional jurisdiction of the provinces. Quebec has used its political power and significance, along with the argument of exclusive provincial jurisdiction, to negotiate a much reduced role for the federal government in influencing the development of social programs in Quebec. As early as the 1950s, the Quebec government began its opposition to federal government initiatives to establish federal programs in areas of provincial jurisdiction (such as funding for post-secondary institutions). Quebec's opposition to federal government interference in its provincial jurisdiction also meant that Quebec refused to sign tax "rental" agreements with the federal government in the 1950s and later refused to sign tax collection agreements with the federal government.²²⁴ Quebec has consistently argued that these agreements interfere with the province's exclusive power over direct taxation. As a result Quebec is the only province to have its own provincial tax system (see section D *Systems of Tax Harmonisation and Tax Collection* for further details).

Quebec is also unique among the provinces in that it receives a larger percentage of its transfers from the federal government in the form of tax points rather than cash transfers. This is the result of Quebec "opting-out" of national programs established through the federal government's spending power. Instead of participating in the national programs Quebec receives cash transfers from the federal government that allow Quebec to design and deliver its own provincial programs in the areas where the federal government has established a Canada-wide program. Because a larger portion of transfers to Quebec are in the form of additional tax points, these revenues are unconditional and provide greater discretion to the Quebec government in how they are spent. Therefore, a larger percentage of transfers to Quebec are unconditional in form than is the case for other provinces.

The constant pressure from Quebec for greater political and fiscal autonomy has presented a significant challenge to the federal government in creating new and additional social programs that achieve Canada-wide policy objectives.

²²⁴ This subject is covered in greater detail in Section D.

When the federal government initiated the creation of social programs that are the basis of Canada's modern welfare state there was little opposition from the English-speaking provinces to the use of the spending power.²²⁵ After forty years of experience with the federal spending power many of these provinces, however, especially the wealthier provinces, have become more critical of the federal government's use of the spending power. When the federal government has sought to extend the use of its spending power Quebec has registered its usual objections and sought to opt-out of any new initiative while receiving compensation from the federal government. Now that some other provinces are reluctant to agree to any extension of the spending power they are also demanding the opportunity to opt-out of new programs with compensation. The result is that the federal government is finding it increasingly difficult to accommodate Quebec's demands while at the same time coming to a common agreement on financing country-wide programs with the other provinces. Furthermore, the other provinces are increasingly reluctant to agree to any extension of the spending power unless they are given the same opportunity as Quebec to opt-out of country-wide programs with compensation. However, extending this option to all the other provinces, or even a few of them, would undermine the objectives of a country-wide program with uniform country-wide standards.

The *Social Union Framework Agreement* is the latest attempt by the federal and provincial governments to reach an agreement on the conditions under which the federal government could extend the use of its spending power. However, Quebec did not sign that Agreement because its provisions recognised the political legitimacy of the federal spending power and did not explicitly allow provinces to opt-out of new programs (created by the use of the spending power) with compensation.

Role of the Federal Government in Intergovernmental Relations

The federal government plays a leading role in the process of intergovernmental relations. A large part of the federal government's influence in intergovernmental relations comes from its use of the spending power. The federal government's spending power is used to provide funding for major social and other programs through intergovernmental transfers to the provinces and through transfers that are made directly to individuals, or organisations. As noted earlier, there

²²⁵ Richard Simeon, and Ian Robinson, *State, Society, and the Development of Canadian Federalism* (Toronto, University of Toronto Press, 1990), p. 150.

are very few restrictions on the federal government's use of the spending power, and with the exception of limitations it has accepted in intergovernmental agreements, the federal government retains unilateral decision-making power on the use of its spending-power. The use of its spending power therefore allows the federal government to influence programs delivered by the provinces by offering funding to the provinces with the requirement that programs fulfil certain conditions. Alternatively the federal government can use its spending power to transfer funds directly to individuals or organisations to create programs that will have a substantial effect on existing provincial programs.

Therefore the effects of the federal government's spending power, and its ability to make unilateral decisions on the use of the spending power,²²⁶ gives the federal government a powerful role in intergovernmental relations. However, the power and influence of the federal government is constrained by the fact that it lacks the necessary constitutional jurisdiction to implement its own programs in many areas and must rely on the cooperation of the provinces to implement many policies. Therefore, the federal government must be careful not to generate disagreements with the provinces on a particular issue in case the provinces use this as a reason for not negotiating or cooperating on other policy issues.

5. *Transparency and Accountability*

Revenue and Expenditure Responsibilities of Governments

The complexity of the fiscal arrangements between the two orders of government and the complexity of constitutional law surrounding the division of powers (and the exercise of the spending power) means that there is very little transparency in this area. In regards to the accountability of governments in this area, the primary method of ensuring accountability is through the traditional conventions of executive responsibility to the legislature within each of the participating governments.

As described earlier, the division of powers between the federal and provincial governments is easy to identify in the Constitution but the provisions themselves are not as clear as they might seem. The constitutional division of powers concentrates on dividing legislative powers that were significant in 1867 and does not reflect the functions that are carried out by modern governments that are

²²⁶ It is important to note the restriction the federal government has recently accepted on the use of spending power in the *Social Union Framework Agreement*.

responsible for maintaining modern welfare states. In addition, some of the powers granted to the federal and provincial governments are of a very general nature and it is not at all clear what power is being allocated to the respective governments. For example the federal government's power to legislate for the "peace, order and good government of Canada" and the provinces power to legislate in regards to "all matters of a merely local or private nature in the province" have been the subject of extensive litigation by governments and have resulted in many different judicial interpretations. The language used in the division of powers and the legal complexity surrounding the interpretation of government's legislative powers have made it very difficult for ordinary citizens to determine what order of government is responsible for a particular policy or program. In fact, governments are themselves often uncertain about the extent of their legislative powers and have made use of the reference procedure to the courts to seek clarification on their powers under the Constitution.

These problems of transparency are exacerbated by the complex system of intergovernmental transfers from the federal government to the provinces. The use of the spending power, and to a lesser extent Equalization, allow both orders of government to claim a role in many of Canada's most important social policies but the use of these transfers makes it difficult for citizens to determine which government is politically responsible for a particular program or policy. As discussed earlier, the use of intergovernmental transfers makes most social policy areas *de facto* concurrent powers rather than exclusive powers as indicated in the provisions of the Constitution. In this respect the formal provisions of the Constitution can be very misleading in indicating the *de facto* responsibilities of each order of government. It is not uncommon for governments to exploit the lack of transparency and argue that the other order of government is responsible for any problems being experienced or that a decline in levels of service is the result of decisions made by the other order of government. Therefore, a lack of transparency on government's legislative powers has undermined accountability to some extent.

The primary method of ensuring that governments are accountable in relation to the exercise of their expenditure and revenue responsibilities is through the standard parliamentary procedures of responsible government. This means that the members of the executive must be available each day in the legislature to answer questions from the opposition parties on any issue relating to the governments activities. The other aspect of accountability is that citizens are given the opportunity to judge the performance of their government in the election process. It might be added that an additional form of informal accountability is achieved

through the public relations efforts of each government. Governments will seek to maximise their visibility and seek recognition for their contribution to a policy or program or attempt to blame policy failures on the other order of government. The effectiveness of these accountability measures is undermined, however, by the lack of transparency and clarity concerning the role and responsibilities of each government in a particular policy or program.

Executive Federalism

There is a low level of transparency in intergovernmental relations and the process of executive federalism. The high profile First Ministers' Meetings between the Prime Minister and the Premiers are very public affairs with governments issuing press releases indicating their positions on certain issues. Despite the public attention given to these events, and the public statements of the governments, to ensure effective negotiation the most important negotiations are carried on in closed sessions. This prevents citizens from knowing what their governments' bargaining positions are on a particular issue or what compromises their governments are making in the process of negotiations. However, these First Ministers' Meetings constitute only a very small amount of the negotiations that go on between governments and their various departments. The vast majority of intergovernmental activity is carried out at a much lower level and receives much less, if any, public attention. Most intergovernmental meetings take place at the bureaucratic level between the public servants in the various departments of the federal and provincial governments. These are closed meetings and they receive little, if any, public attention.

There are no special accountability mechanisms to ensure the accountability of governments for the commitments they make in intergovernmental agreements. As already noted, the main methods of accountability are the standard parliamentary procedures whereby the executive must have the support of a majority in its legislature to remain in government.

Recent Developments: The Social Union Framework Agreement

The Social Union Framework Agreement is an intergovernmental agreement signed by the federal government and nine of the provincial governments early in 1999.²²⁷ Some of the provisions in the Agreement attempt to address issues that

²²⁷ Quebec did not sign the Agreement.

relate to the lack of accountability and transparency in the intergovernmental relations process.²²⁸

Although these provisions in the Social Union Framework Agreement are indicators that governments are attempting to address the issues of accountability and transparency it is important to remember that these commitments are themselves only part of an intergovernmental agreement. The Agreement is now 18 months old but as yet there are few visible signs that governments have made any progress in meeting these accountability and transparency commitments.

B. A Summary of Federal and Provincial Budgetary Relations in Canada

This section contains a description of the stylized facts of the relative magnitudes of federal and provincial fiscal responsibilities and how they have evolved over time. This includes the shares of federal and provincial governments in public spending and revenue raising, the importance of transfers between the two orders of government, and the extent of vertical and fiscal imbalance in the Canadian federation.

In Canada, there is a hierarchical fiscal relationship among the three main orders of government. The federal government deals mainly with the provinces, while the provinces deal with the municipalities within their borders. The division of fiscal responsibilities between a province and its municipalities differs considerably across provinces. As well, although the provinces are legislatively independent from the federal government, municipalities are not legislatively independent of the provinces. As already noted, the municipalities are the creation of the provinces and provincial governments exercise extensive oversight over their municipalities. This makes the provision of some important public services, such as education, welfare and health, very much subject to joint provincial-municipal decisions. For these reasons, we have aggregated provincial and municipal expenditures together, and refer to the result simply as ‘the provinces’.

For the most part, we treat the provinces as an aggregate, though presenting disaggregated data by province as well. In the following subsections, we present the shares of federal and provincial governments in total public spending; their shares in total revenues; the importance of transfers from one level to another,

²²⁸ See section three of the Social Union Framework Agreement, “Informing Canadians – Public Accountability and Transparency.”

and the manner in which these transfers affect the vertical and horizontal imbalances that exist across jurisdictions.

1. Federal And Provincial Shares Of Total Public Spending

Table B.1 provides almost 40 years of data indicating the shares of federal and provincial governments in total public sector spending.²²⁹ Since public sector spending includes transfers made to other orders of government, and those transfers go to finance programs of the latter, it would be misleading simply to record expenditure shares with those programs included. We have therefore presented two alternative calculations of shares — one with the transfers included, and one without. Recall that we have aggregated the provinces and their municipalities together, so this is really only an issue with respect to the federal government. Thus, shares of federal and provincial spending including intergovernmental transfers treat federal transfers to the provinces as a component of federal spending, while shares excluding intergovernmental transfers do not.

TABLE B.1: FEDERAL AND PROVINCIAL GOVERNMENT SHARES OF TOTAL PUBLIC SPENDING (PERCENTAGES)

| Year | Including Intergovernmental Transfers | | Excluding Intergovernmental Transfer | |
|------|---------------------------------------|------------|--------------------------------------|------------|
| | Federal | Provincial | Federal | Provincial |
| 1961 | 57.4 | 42.6 | 52.7 | 47.3 |
| 1962 | 56.8 | 43.2 | 51.8 | 48.2 |
| 1963 | 55.1 | 44.9 | 50.0 | 50.0 |
| 1964 | 53.6 | 46.4 | 48.7 | 51.3 |
| 1965 | 51.7 | 48.3 | 46.1 | 53.9 |
| 1966 | 51.5 | 48.5 | 45.6 | 54.4 |
| 1967 | 49.9 | 50.1 | 44.1 | 55.9 |
| 1968 | 48.8 | 51.2 | 42.6 | 57.4 |
| 1969 | 47.3 | 52.7 | 41.2 | 58.8 |
| 1970 | 46.4 | 53.6 | 39.7 | 60.3 |
| 1971 | 46.3 | 53.7 | 38.7 | 61.3 |
| 1972 | 47.1 | 52.9 | 40.5 | 59.5 |
| 1973 | 46.2 | 53.8 | 40.0 | 60.0 |
| 1974 | 48.2 | 51.8 | 42.0 | 58.0 |

²²⁹ The data used to obtain Tables B.1-B.7 come from the CANSIM database, which is a database of statistics about the Canadian economy produced and maintained by Statistics Canada. Tables B.8 and B.9 are based on data obtained from the Department of Finance of the federal government.

TABLE B.1 (CONTINUED): FEDERAL AND PROVINCIAL GOVERNMENT SHARES OF TOTAL PUBLIC SPENDING (PERCENTAGES)

| Year | Including Intergovernmental Transfers | | Excluding Intergovernmental Transfer | |
|------|---------------------------------------|------------|--------------------------------------|------------|
| | Federal | Provincial | Federal | Provincial |
| 1975 | 48.6 | 51.4 | 42.3 | 57.7 |
| 1976 | 46.5 | 53.5 | 40.2 | 59.8 |
| 1977 | 46.2 | 53.8 | 39.8 | 60.2 |
| 1978 | 46.3 | 53.7 | 39.9 | 60.1 |
| 1979 | 45.4 | 54.6 | 39.2 | 60.8 |
| 1980 | 45.4 | 54.6 | 39.5 | 60.5 |
| 1981 | 46.0 | 54.0 | 40.6 | 59.4 |
| 1982 | 46.3 | 53.7 | 41.0 | 59.0 |
| 1983 | 46.1 | 53.9 | 40.7 | 59.3 |
| 1984 | 47.5 | 52.5 | 42.0 | 58.0 |
| 1985 | 48.1 | 51.9 | 42.6 | 57.4 |
| 1986 | 46.9 | 53.1 | 41.7 | 58.3 |
| 1987 | 46.7 | 53.3 | 41.5 | 58.5 |
| 1988 | 46.4 | 53.6 | 41.0 | 59.0 |
| 1989 | 46.3 | 53.7 | 41.1 | 58.9 |
| 1990 | 46.3 | 53.7 | 41.3 | 58.7 |
| 1991 | 45.8 | 54.2 | 41.1 | 58.9 |
| 1992 | 44.7 | 55.3 | 39.7 | 60.3 |
| 1993 | 44.6 | 55.4 | 39.6 | 60.4 |
| 1994 | 44.3 | 55.7 | 39.4 | 60.6 |
| 1995 | 44.9 | 55.1 | 39.9 | 60.1 |
| 1996 | 44.2 | 55.8 | 39.8 | 60.2 |
| 1997 | 43.2 | 56.8 | 39.3 | 60.7 |
| 1998 | 43.1 | 56.9 | 39.1 | 60.9 |
| 1999 | 43.9 | 56.1 | 39.2 | 60.8 |

Shares Including Intergovernmental Transfers

As the Table indicates, there has been a gradual decentralization of spending responsibilities from the federal government to the provinces over the post-war period. In the early 1960s, almost sixty percent of government spending was by the federal government, while by the end of the century that had been reversed. Indeed, had only goods and services been included in government spending, the

decentralization would have been even more dramatic, given the relative importance of transfers as a component of federal spending.

There are a number of potential reasons for this turnaround in responsibilities. Provincial expenditure responsibilities happen to be in areas of growth in spending. Canadian provinces have exclusive legislative responsibility in the key areas of health, education and social services, and these have grown at relatively high rates in most countries. At the same time, some of the traditionally important federal spending responsibilities such as defence have not grown so rapidly, or even declined. Changes in federal transfers to the provinces might themselves be partly responsible for the decline in the relative share of the federal government. To see how important this might have been, we can contrast the results with and without intergovernmental transfers.

Shares Excluding Intergovernmental Transfers

As the table indicates, excluding intergovernmental transfers from the public sector spending enhances the share of the provinces relative to the federal government in all years. Federal shares tend to be 4-5 percentage points less and provincial shares the same amount more when intergovernmental transfers are removed. This is as expected, given that it is federal spending that is reduced by the change. The removal of intergovernmental transfers does not itself seem to have much effect on the downward trend of the federal share: it simply increases the provincial share in all years by roughly the same amount in percentage terms.

The extent of decentralization of spending responsibilities is not unusual among other federations. Comparable spending shares of regional governments would be found such federations as Australia, Belgium and Germany. In fact, even some unitary states have reasonably high levels of spending at the regional government level, such as Japan or the Scandinavian countries. Of course, levels of spending might not be a perfect indicator of the degree of decentralization. Different degrees of discretion could be associated with decentralized spending. Moreover, these degrees of decentralization may not be found on the revenue side, to which we turn below.

Before turning to the revenue side, it is worth mentioning that the shares of federal and provincial spending actually vary considerably across provinces. As Tables 1 and 2 in the Appendix indicate, federal government shares are substantially higher in lower-income provinces than in higher-income ones. The share of federal spending including (excluding) intergovernmental transfers range from about 60 (53) in the Atlantic Provinces to 45 (41) percent in the four western provinces. It is perhaps a bit surprising that these big differences persist, given

that the purpose of the transfers is to enable the provinces to provide comparable level of public services. Even when federal-provincial transfers are excluded, expenditure seems to be more decentralized in the better off provinces, perhaps reflecting greater concentrations of federal spending in the lower-income provinces.

2. Federal and Provincial Government Shares of Total Government Revenues

Table B.2 gives federal and provincial government shares of total government revenues for the same four decades. As with spending, a distinction must be made between revenues including and excluding intergovernmental transfers. In this case, it is the recipient government that is most affected, and in particular, the provincial governments. Revenues excluding intergovernmental transfers represent only own source revenues (mainly taxation) and not the substantial transfers the provinces receive from the federal government.

TABLE B.2: FEDERAL AND PROVINCIAL GOVERNMENT SHARES OF TOTAL GOVERNMENT REVENUES (PERCENTAGES)

| YEAR | Including Intergovernmental Transfers | | Excluding Intergovernmental Transfers | |
|------|---------------------------------------|------------|---------------------------------------|------------|
| | Federal | Provincial | Federal | Provincial |
| 1961 | 54.4 | 45.6 | 60.3 | 39.7 |
| 1962 | 50.8 | 49.2 | 56.5 | 43.5 |
| 1963 | 50.0 | 50.0 | 55.5 | 44.5 |
| 1964 | 50.7 | 49.3 | 55.7 | 44.3 |
| 1965 | 49.2 | 50.8 | 54.2 | 45.8 |
| 1966 | 48.1 | 51.9 | 53.4 | 46.6 |
| 1967 | 47.1 | 52.9 | 52.2 | 47.8 |
| 1968 | 46.2 | 53.8 | 51.4 | 48.6 |
| 1969 | 47.3 | 52.7 | 52.2 | 47.8 |
| 1970 | 45.8 | 54.2 | 51.3 | 48.7 |
| 1971 | 45.2 | 54.8 | 51.4 | 48.6 |
| 1972 | 46.0 | 54.0 | 51.6 | 48.4 |
| 1973 | 46.2 | 53.8 | 51.3 | 48.7 |
| 1974 | 47.8 | 52.2 | 53.1 | 46.9 |
| 1975 | 46.1 | 53.9 | 51.9 | 48.1 |
| 1976 | 45.1 | 54.9 | 50.7 | 49.3 |
| 1977 | 41.9 | 58.1 | 47.2 | 52.8 |
| 1978 | 40.0 | 60.0 | 45.1 | 54.9 |
| 1979 | 40.4 | 59.6 | 45.2 | 54.8 |
| 1980 | 41.1 | 58.9 | 45.8 | 54.2 |
| 1981 | 43.9 | 56.1 | 48.5 | 51.5 |
| 1982 | 42.4 | 57.6 | 47.1 | 52.9 |
| 1983 | 41.0 | 59.0 | 45.7 | 54.3 |
| 1984 | 40.8 | 59.2 | 45.7 | 54.3 |

TABLE B.2: FEDERAL AND PROVINCIAL GOVERNMENT SHARES OF TOTAL GOVERNMENT REVENUES (PERCENTAGES)

| YEAR | Including Intergovernmental Transfers | | Excluding Intergovernmental Transfers | |
|-------------|--|-------------------|--|-------------------|
| | Federal | Provincial | Federal | Provincial |
| 1985 | 41.5 | 58.5 | 46.5 | 53.5 |
| 1986 | 42.8 | 57.2 | 47.5 | 52.5 |
| 1987 | 42.8 | 57.2 | 47.4 | 52.6 |
| 1988 | 42.4 | 57.6 | 46.9 | 53.1 |
| 1989 | 42.2 | 57.8 | 46.5 | 53.5 |
| 1990 | 42.1 | 57.9 | 46.3 | 53.7 |
| 1991 | 43.0 | 57.0 | 47.3 | 52.7 |
| 1992 | 43.1 | 56.9 | 47.6 | 52.4 |
| 1993 | 42.0 | 58.0 | 46.4 | 53.6 |
| 1994 | 41.4 | 58.6 | 45.4 | 54.6 |
| 1995 | 42.0 | 58.0 | 46.0 | 54.0 |
| 1996 | 42.7 | 57.3 | 46.2 | 53.8 |
| 1997 | 44.1 | 55.9 | 47.0 | 53.0 |
| 1998 | 44.3 | 55.7 | 47.3 | 52.7 |
| 1999 | 44.0 | 56.0 | 47.3 | 52.7 |

When intergovernmental transfers are included, the shares are remarkably similar to those for spending, which is not surprising. However, when intergovernmental transfers are excluded both on the spending and on the revenue sides, the shares of federal government revenues are somewhat higher than for the provinces. Nonetheless, the federation is highly decentralized on the revenue side, and that is one of the things that make the Canadian federation rather unique.

At the end of the 20th century, the federal government raised less revenues than the provinces (47.3 percent of the total). This is a picture that is quite different than existed in the early post-war period when the federal government raised as much as 60 percent of total revenues. As in the case of spending, there has been a gradual decentralization of spending responsibilities to the provinces.

Once again, the extent of revenue decentralization varies among the provinces, but there seems to be no systematic difference between high- and low-income provinces as Tables 3 and 4 in the Appendix show. In the case of revenues excluding intergovernmental transfers (i.e., own-source revenues), the federal government's share is roughly the same in the highest-income province, Ontario, as in the low-income provinces of Prince Edward Island and New Brunswick.

3. Transfer Payments from Federal to Provincial Governments

Table B.3 shows transfers from the federal government to the provinces as a proportion of provincial government revenues for the years 1961-1999. Table 5

in the Appendix shows the same information disaggregated by recipient province. The message here is quite consistent with that of the previous tables. The Canadian federation has gradually become quite decentralized over the post-war period. The provinces now rely on the federal government for only 13 percent of their revenues compared with over 20 percent in the early 1960s. In fact, the pattern of decline really only began in the late 1970s, and was precipitous during the 1990s.

TABLE B.3: TRANSFER PAYMENTS FROM FEDERAL TO PROVINCIAL GOVERNMENTS AS A SHARE OF PROVINCIAL GOVERNMENT REVENUES (PERCENTAGES)

| Year | | Year | |
|-------------|------|-------------|------|
| 1961 | 21.5 | 1981 | 17.0 |
| 1962 | 20.3 | 1982 | 17.5 |
| 1963 | 19.7 | 1983 | 17.6 |
| 1964 | 18.1 | 1984 | 18.2 |
| 1965 | 18.3 | 1985 | 18.7 |
| 1966 | 19.0 | 1986 | 17.5 |
| 1967 | 18.6 | 1987 | 17.2 |
| 1968 | 18.9 | 1988 | 16.8 |
| 1969 | 18.0 | 1989 | 16.2 |
| 1970 | 19.5 | 1990 | 15.9 |
| 1971 | 22.0 | 1991 | 16.2 |
| 1972 | 20.1 | 1992 | 16.9 |
| 1973 | 18.3 | 1993 | 16.7 |
| 1974 | 19.0 | 1994 | 15.4 |
| 1975 | 20.9 | 1995 | 15.7 |
| 1976 | 20.2 | 1996 | 13.4 |
| 1977 | 19.7 | 1997 | 11.5 |
| 1978 | 19.1 | 1998 | 11.6 |
| 1979 | 18.3 | 1999 | 13.0 |
| 1980 | 17.8 | | |

A number of major episodes account for this pattern. The relatively high rate of provincial dependency on federal transfers at the beginning of the period was a reflection of the situation in the Second World War when the federal government occupied all of the income tax room with the agreement of the provinces (the federal-provincial tax rental agreements). The federal government began soon after the war to turn over revenue raising responsibility to the provinces, although not at a rate that satisfied all provinces. However, in the late 1950s and the 1960s, some major shared-cost programs were introduced in the areas of health and welfare, which precipitated modest increases in the proportions of provincial revenues obtained from federal transfers (or at least postponed their decline). In 1977, these shared-cost programs were replaced with bloc transfers whose rate of increase was tied to GNP rather than program expenditures because

program expenditures were rising faster than GNP. This was a major factor leading to the gradual decline of provincial reliance on federal transfers over the following two decades. The rate of decline accelerated in the mid-1990s when the federal government embarked on a major expenditure reduction program to reduce its budget deficit. A substantial amount of its expenditure reductions took the form of reduced transfers to the provinces causing an abrupt change in the proportion of provincial revenues coming from federal transfers from about 16 percent to less than 12 percent.

The aggregate data reported in Table B.3 do not tell the entire picture. As Table 5 in the Appendix shows, different provinces rely to very different degrees on federal transfers. In 1995, the latest date for which disaggregated data are available, the higher-income provinces — Alberta, British Columbia and Ontario — received 10-12 percent of their revenues from federal transfers, while the remaining provinces showed much higher reliance. Newfoundland obtained almost 42 percent and Prince Edward Island almost 40 percent of their revenues from the federal government. This reflects a common feature of federations, the fact that different provinces have quite different abilities to provide the sorts of basic public services with which they are entrusted. The federal system of transfers is designed explicitly to compensate for these differences, as we shall see further below.

The data for the various provinces have one feature in common with the aggregate data reported in Table B.3: the share of provincial revenues obtained from federal transfers has declined in tandem over the four-decade period. All provinces are now required to raise more revenues using their own tax sources. This decentralization in revenue-raising responsibility is quite unusual among federations. The relative ease with which it has occurred in Canada reflects the fact that the provinces have access to all of the main broad-based tax sources — personal and corporate income taxes, general sales taxes and payroll taxes. Moreover, they can set their rates independently. As the federal government reduced its transfers to the provinces, the provinces in turn were able to make up their revenues needs by increasing their tax rates as required. This implies that for the main tax sources, the provinces have occupied more and more of the available 'tax room'. While this has increased the fiscal responsibility of the provinces, it has also led to some concerns about the harmonization of the major taxes across provinces. We return to this issue in Section D.

The picture that emerges from looking at expenditure and revenue shares is one of a federation that is not only highly decentralized with respect to the delivery of public services, but also one in which the financing of those services has become highly decentralized. From this perspective, fiscal responsibility has become much more decentralized in Canada relative to some other established federations, such as Aus-

tralia and Germany, where lower level jurisdictions rely much more heavily on federal transfers than in Canada. This is documented in more detail under the next heading.

4. Vertical Fiscal Imbalances

A common way to characterize the extent of decentralization of fiscal responsibility is by using the concept of *Vertical Fiscal Imbalance* (VFI). The VFI indicates the imbalance between federal revenues and their expenditure responsibilities. A large vertical imbalance implies that the provinces rely heavily on the federal government for transfers to finance their expenditures. This is liable to detract from fiscal decentralization since transfers are often accompanied with some conditions on how they should be spent, and these may affect provincial spending priorities. In addition, provincial governments may be less accountable for the way in which they spend or the amount that they spend if they are not responsible for raising their own revenues.

As in the case of calculating spending shares, it is useful to distinguish the VFI before intergovernmental transfers with that after them. Table B.4 shows VFI calculations both excluding and including intergovernmental transfers. The VFI is defined as difference between expenditures and revenues, taken as a percentage of expenditures. This can be done for both the federal and the provincial levels of government.

VFI Excluding Intergovernmental Transfers

When intergovernmental transfers are excluded, the VFI for the federal government is the difference between its expenditures not including transfers to the provinces and its revenues as a proportion of expenditures less transfers. It represents the conventional definition of VFI: the extent to which federal expenditure needs are less than revenues. In fact, there are two elements of this difference that are difficult to distinguish. One is the amount of deficit financing, which in this definition would contribute to an excess of spending over revenues. The other is the conventional VFI, which is the imbalance between federal expenditure responsibilities and their revenue-raising ability. Similarly, for the provinces the VFI is provincial expenditures (including those of their municipalities) less revenues net of transfers from the federal government, as a proportion of expenditures. It measures the extent to which provincial expenditures exceed own source revenues, part of which will be reflected in a budget deficit and the rest covered by transfers from the federal government.

TABLE B.4: VERTICAL IMBALANCES BETWEEN FEDERAL AND PROVINCIAL GOVERNMENTS $[(EXPENDITURES - REVENUES) / EXPENDITURES] \times 100$

| Year | Intergovernmental Transfers Excluded | | Intergovernmental Transfers Included | |
|-------|--------------------------------------|------------|--------------------------------------|------------|
| | Federal | Provincial | Federal | Provincial |
| <hr/> | | | | |

| | | | | |
|------|-------|------|------|-------|
| 1961 | -17.1 | 14.3 | 3.3 | -9.2 |
| 1962 | -12.7 | 6.4 | 7.7 | -17.3 |
| 1963 | -16.2 | 6.7 | 5.4 | -16.2 |
| 1964 | -25.8 | 5.1 | -3.0 | -15.8 |
| 1965 | -32.9 | 3.7 | -6.2 | -17.8 |
| 1966 | -29.1 | 5.5 | -2.1 | -16.7 |
| 1967 | -25.8 | 9.1 | 0.4 | -11.7 |
| 1968 | -29.0 | 9.5 | -0.5 | -11.6 |
| 1969 | -40.3 | 10.1 | -9.5 | -9.7 |
| 1970 | -35.4 | 15.2 | -3.2 | -5.3 |
| 1971 | -37.3 | 18.0 | -0.5 | -5.1 |
| 1972 | -30.4 | 16.8 | 0.4 | -4.3 |
| 1973 | -34.9 | 14.4 | -4.7 | -4.8 |
| 1974 | -36.5 | 12.4 | -6.4 | -8.1 |
| 1975 | -17.6 | 19.9 | 8.5 | -1.1 |
| 1976 | -20.5 | 21.0 | 6.7 | 1.3 |
| 1977 | -11.0 | 18.0 | 14.6 | -1.9 |
| 1978 | -3.9 | 16.0 | 19.7 | -3.6 |
| 1979 | -7.8 | 15.6 | 16.3 | -3.0 |
| 1980 | -6.7 | 17.4 | 15.9 | -0.2 |
| 1981 | -14.6 | 16.7 | 8.0 | -0.1 |
| 1982 | -1.0 | 21.0 | 18.3 | 4.5 |
| 1983 | 3.1 | 20.7 | 22.0 | 4.0 |
| 1984 | 5.4 | 18.4 | 24.2 | 0.4 |
| 1985 | 6.3 | 19.8 | 24.7 | 1.6 |
| 1986 | -0.2 | 20.7 | 18.6 | 4.0 |
| 1987 | -4.8 | 17.6 | 15.3 | 0.7 |
| 1988 | -7.8 | 15.0 | 13.3 | -1.9 |
| 1989 | -6.3 | 14.5 | 13.7 | -1.8 |
| 1990 | -2.9 | 16.0 | 15.9 | 0.2 |
| 1991 | -0.3 | 22.1 | 17.2 | 7.2 |
| 1992 | -2.8 | 25.5 | 16.1 | 10.5 |
| 1993 | -0.6 | 23.7 | 18.1 | 8.7 |
| 1994 | -3.6 | 19.1 | 15.3 | 4.6 |
| 1995 | -6.5 | 17.3 | 13.2 | 2.3 |
| 1996 | -13.1 | 12.9 | 5.6 | -0.2 |
| 1997 | -23.8 | 9.9 | -5.2 | -1.5 |
| 1998 | -24.7 | 10.8 | -5.9 | -0.6 |
| 1999 | -28.9 | 7.5 | -6.4 | -6.1 |

As Table B.4 indicates, the federal vertical imbalance is negative in most years, and varies considerably over time. It is relatively low in the 1980s and early 1990s, largely reflecting the high budget deficits of those years. When the federal government responded to those deficits in the mid-1990s, the VFI took on more conventional magnitudes.

A similar picture is seen in the VFI for the provinces, though in this case, the mirror image. Provincial expenditures are significantly in excess of own source revenues during the 1980s. The differential falls rapidly in the mid-1990s, and is less than 10 percent by 1999. Table 6 in the Appendix disaggregates provincial VFIs by province.

VFI Including Intergovernmental Transfers

In this case, federal transfers are included as part of federal government expenditures and also as part of provincial revenues. Now the VFI calculated at each level of government simply reflects the extent of deficit financing. The large positive values of the federal VFI in the 1980s shows the proportion of federal spending that had to be financed by borrowing. The negative values in more recent years represent the government surplus. The same applies for the provinces.

5. *Horizontal Fiscal Imbalances*

Different provinces have different fiscal capacities for delivering public services to their residents — that is, there are *Horizontal Fiscal Imbalances* (HFIs). These can arise from both the revenue and the expenditure sides of the budget. With respect to revenues, different provinces have different tax capacities, that is, differences in the ability to raise revenues using a given tax effort. On the expenditure side, the need for public services of different types can differ across provinces because of different demographic make-ups of the provincial population. As well, costs of provision can differ. We begin by presenting some raw data to indicate per capita differences in public spending and revenues by province. However, these can be misleading since differences can arise not just because of differences in fiscal capacity, but also because different provinces choose to provide different levels of public services. To address this problem partly, we present some data on tax capacity differences used to determine equalization payments from the federal government to the provinces. These represent truer measure of tax capacity than simple per capita revenue differences because they abstract from difference in tax rates chosen by provinces. Unfortunately, similar data are not available on the expenditure side.

HFI of Provincial Expenditures

Table B.5 shows per capita provincial government expenditures as a proportion of the national average over all provinces for the years 1961-1995.

TABLE B.5: PROVINCIAL GOVERNMENTS PER CAPITA EXPENDITURES AS A PERCENTAGE OF CANADIAN AVERAGE

| Year | NFLD | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|-------------|-------------|---------------|-------------|-------------|-------------|-------------|-------------|--------------|-------------|-------------|
| 1961 | 78.2 | 86.3 | 82.9 | 85.8 | 89.2 | 103.7 | 99.8 | 114.6 | 119.8 | 117.9 |
| 1962 | 86.2 | 68.8 | 82.8 | 84.7 | 93.0 | 103.0 | 98.6 | 112.4 | 115.8 | 112.3 |
| 1963 | 76.1 | 84.6 | 80.5 | 74.5 | 92.0 | 104.7 | 99.0 | 120.1 | 113.5 | 112.9 |
| 1964 | 84.3 | 87.9 | 82.2 | 91.7 | 94.1 | 102.3 | 98.4 | 120.6 | 111.1 | 107.1 |
| 1965 | 83.8 | 55.9 | 81.1 | 82.8 | 99.7 | 102.0 | 94.3 | 110.8 | 111.6 | 103.0 |
| 1966 | 88.6 | 92.1 | 82.4 | 81.0 | 100.4 | 99.7 | 93.2 | 110.2 | 119.9 | 99.5 |
| 1967 | 105.6 | 89.9 | 79.0 | 72.7 | 97.5 | 103.2 | 90.0 | 102.6 | 128.4 | 93.9 |
| 1968 | 91.5 | 83.1 | 81.4 | 78.7 | 97.1 | 106.8 | 87.8 | 100.1 | 114.1 | 95.2 |
| 1969 | 86.0 | 78.8 | 82.1 | 90.4 | 93.4 | 108.3 | 89.8 | 94.8 | 115.8 | 97.6 |
| 1970 | 81.4 | 79.5 | 88.9 | 71.9 | 96.5 | 109.2 | 90.2 | 89.8 | 110.6 | 94.2 |
| 1971 | 89.8 | 84.7 | 87.6 | 86.1 | 98.4 | 107.7 | 91.4 | 87.1 | 109.8 | 89.2 |
| 1972 | 90.6 | 94.1 | 86.9 | 89.6 | 99.0 | 105.3 | 94.6 | 92.6 | 108.4 | 90.7 |
| 1973 | 86.7 | 92.4 | 88.4 | 78.3 | 104.2 | 102.0 | 95.0 | 90.8 | 107.7 | 93.6 |
| 1974 | 91.9 | 97.2 | 87.0 | 80.0 | 101.9 | 100.4 | 103.7 | 96.7 | 107.1 | 97.7 |
| 1975 | 91.0 | 95.4 | 91.9 | 82.9 | 99.4 | 100.2 | 102.3 | 103.6 | 107.9 | 100.1 |
| 1976 | 92.9 | 96.6 | 87.8 | 82.2 | 106.4 | 97.3 | 101.1 | 98.6 | 104.5 | 97.6 |
| 1977 | 90.0 | 97.5 | 84.9 | 83.5 | 112.5 | 94.4 | 98.2 | 100.8 | 102.7 | 94.5 |
| 1978 | 95.5 | 88.6 | 92.1 | 81.4 | 110.2 | 93.8 | 94.5 | 101.8 | 106.9 | 97.3 |
| 1979 | 94.9 | 85.0 | 89.0 | 79.1 | 114.4 | 90.5 | 95.3 | 102.5 | 110.6 | 96.4 |
| 1980 | 95.3 | 91.0 | 87.2 | 82.5 | 114.1 | 88.4 | 96.1 | 103.6 | 114.3 | 100.1 |
| 1981 | 95.1 | 91.6 | 87.3 | 79.8 | 113.6 | 88.2 | 93.8 | 104.3 | 115.1 | 101.3 |
| 1982 | 93.6 | 85.1 | 87.1 | 88.7 | 112.1 | 86.1 | 100.2 | 108.0 | 123.3 | 99.5 |
| 1983 | 96.5 | 86.3 | 83.7 | 84.0 | 107.8 | 86.0 | 99.6 | 107.9 | 141.6 | 96.5 |
| 1984 | 94.3 | 86.7 | 86.4 | 85.8 | 110.1 | 86.9 | 100.7 | 111.3 | 133.0 | 93.7 |
| 1985 | 93.3 | 83.1 | 86.3 | 86.3 | 111.3 | 88.5 | 101.2 | 110.8 | 129.5 | 89.1 |
| 1986 | 93.8 | 81.2 | 86.3 | 85.6 | 110.5 | 88.6 | 103.4 | 109.7 | 129.7 | 90.5 |
| 1987 | 95.9 | 85.3 | 87.2 | 87.5 | 108.0 | 91.4 | 108.5 | 106.9 | 123.2 | 90.3 |
| 1988 | 97.2 | 88.7 | 89.0 | 89.4 | 106.9 | 92.6 | 106.7 | 112.2 | 119.3 | 89.0 |
| 1989 | 98.6 | 90.5 | 89.4 | 89.0 | 107.1 | 93.4 | 108.2 | 109.9 | 118.2 | 87.6 |
| 1990 | 100.0 | 91.6 | 89.1 | 89.8 | 106.4 | 94.5 | 105.5 | 115.7 | 115.2 | 87.0 |
| 1991 | 96.7 | 89.4 | 86.5 | 88.4 | 106.2 | 96.6 | 104.3 | 108.9 | 109.4 | 89.5 |
| 1992 | 90.9 | 86.7 | 84.7 | 88.6 | 105.4 | 98.0 | 102.0 | 109.4 | 106.9 | 90.6 |
| 1993 | 91.7 | 91.1 | 89.6 | 90.7 | 105.7 | 97.4 | 101.5 | 105.0 | 103.3 | 94.0 |
| 1994 | 94.2 | 90.4 | 84.4 | 92.8 | 108.8 | 96.6 | 104.4 | 104.6 | 94.4 | 96.6 |
| 1995 | 97.7 | 87.8 | 84.7 | 94.6 | 110.9 | 96.7 | 99.6 | 104.0 | 89.8 | 96.4 |

These data reveal some interesting differences across provinces. Over the four decades, Quebec, Manitoba, Saskatchewan and Alberta have tended to spend above average amounts on a per capita basis, while the remaining provinces have been below. Prince Edward Island and Nova Scotia have been particularly low. In the very recent past, Alberta has gone from being an above average to a below average province, a finding that is consistent with a change in its policy stance.

These systematic differences over provinces have tended to persist over the four decades. In principle, they could arise from differences in needs for public expenditures, from differences in capacity to finance public services, and from differences in preferences towards public services. It seems likely, however, that at least part is due to differences in need and cost. The equalization system serves to equalize the ability to finance a common level of public services, so that should not be a major determinant of expenditure differences. Preference differences are possible in principle, but the fact that per capita expenditure differences persist over long periods of time makes one suspicious of that being the major determinant. Therefore, it seems likely to be the case that there are systematic differences across provinces in the need for public services or in their cost.

Unlike with the revenue-raising side, there is no explicit program that equalizes the ability of the provinces to provide a common level of public services to compensate for need differences. This is in contrast to Australia where the equalization system focuses primarily on equalizing for differences in need and cost. This is not surprising given that revenue-raising capacity of the Australian states is very limited compared to their Canadian counterparts.

HFI of Provincial Taxes Before Intergovernmental Transfers

Table B.6 shows per capita own source tax revenues by provinces for the same 1961-1995 time period.

Again, one must be cautious in interpreting these numbers since they reflect not only differences in tax capacity, but also differences in tax policy decisions taken by the provinces. Some provinces will choose lower tax rates than others and this will affect revenues per capita. Nonetheless, the data are suggestive. They reflect the wide disparities that exist across provinces in revenue-raising capacity. Alberta, British Columbia and Saskatchewan raise 6 to 8 percent more revenue per capita than the national average. (Quebec does too, but that is a bit of an anomaly arising from the fact that for historical reasons, it occupies more of the income tax room than the other provinces and receives correspondingly lower cash transfers from the federal government.) At the other end, the four Atlantic Provinces raise only between 70 and 80 percent of national average tax revenues. Ontario is near the average, reflecting the fact that its size dominates the calculation of the average.

TABLE B.6: PROVINCIAL GOVERNMENTS PER CAPITA REVENUES, BEFORE INTERGOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF CANADIAN AVERAGE

| Year | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|------|-------|--------|------|------|------|------|------|-------|------|------|
|------|-------|--------|------|------|------|------|------|-------|------|------|

| | | | | | | | | | | |
|-------------|------|------|------|------|-------|-------|------|-------|-------|-------|
| 1961 | 37.6 | 46.4 | 63.0 | 65.1 | 95.4 | 110.7 | 85.8 | 110.8 | 112.8 | 117.6 |
| 1962 | 41.2 | 48.5 | 65.7 | 62.5 | 90.1 | 113.1 | 85.2 | 114.5 | 114.8 | 120.3 |
| 1963 | 40.2 | 51.5 | 64.9 | 64.0 | 90.3 | 111.9 | 86.1 | 119.4 | 113.5 | 121.3 |
| 1964 | 42.9 | 46.7 | 63.4 | 62.6 | 91.2 | 112.1 | 85.7 | 118.1 | 108.6 | 122.8 |
| 1965 | 42.2 | 51.7 | 60.8 | 61.0 | 93.4 | 110.1 | 88.9 | 113.9 | 110.9 | 122.5 |
| 1966 | 44.1 | 46.0 | 59.8 | 61.2 | 95.1 | 111.7 | 83.9 | 111.1 | 105.5 | 118.2 |
| 1967 | 42.2 | 46.2 | 60.3 | 55.5 | 95.9 | 113.2 | 84.3 | 106.3 | 106.0 | 113.5 |
| 1968 | 45.2 | 47.1 | 58.9 | 55.9 | 95.2 | 114.4 | 88.5 | 101.7 | 102.5 | 112.6 |
| 1969 | 45.4 | 51.7 | 64.1 | 56.3 | 93.1 | 114.5 | 91.2 | 97.0 | 103.3 | 115.4 |
| 1970 | 48.1 | 48.4 | 65.4 | 58.2 | 93.1 | 116.0 | 92.4 | 91.8 | 107.7 | 105.9 |
| 1971 | 50.2 | 55.6 | 65.5 | 58.3 | 95.3 | 113.9 | 89.7 | 88.9 | 109.9 | 106.0 |
| 1972 | 50.4 | 52.2 | 71.4 | 63.3 | 98.9 | 110.0 | 92.5 | 87.1 | 108.4 | 106.3 |
| 1973 | 50.9 | 55.7 | 69.7 | 57.0 | 100.4 | 106.2 | 84.5 | 88.2 | 117.2 | 113.8 |
| 1974 | 54.3 | 52.0 | 65.1 | 60.4 | 98.7 | 101.7 | 87.2 | 103.3 | 139.4 | 110.0 |
| 1975 | 59.0 | 55.8 | 66.0 | 57.9 | 98.9 | 96.3 | 85.8 | 112.0 | 156.1 | 111.3 |
| 1976 | 61.0 | 51.9 | 63.4 | 55.7 | 99.1 | 95.7 | 87.8 | 112.5 | 158.6 | 110.5 |
| 1977 | 61.8 | 51.9 | 61.9 | 59.0 | 101.4 | 93.0 | 83.8 | 111.6 | 163.3 | 109.9 |
| 1978 | 61.3 | 49.4 | 61.2 | 58.1 | 99.9 | 90.0 | 76.3 | 112.0 | 181.8 | 110.5 |
| 1979 | 59.8 | 49.4 | 59.5 | 56.5 | 98.9 | 90.9 | 77.9 | 111.6 | 179.1 | 110.8 |
| 1980 | 59.9 | 52.6 | 61.2 | 58.3 | 97.6 | 89.0 | 77.1 | 117.9 | 188.3 | 106.8 |
| 1981 | 57.7 | 52.3 | 57.4 | 55.8 | 100.0 | 88.1 | 78.4 | 111.0 | 186.0 | 107.0 |
| 1982 | 56.0 | 52.4 | 59.5 | 55.6 | 102.5 | 87.9 | 80.8 | 104.1 | 184.8 | 102.6 |
| 1983 | 58.4 | 53.3 | 62.2 | 58.6 | 99.5 | 88.9 | 83.6 | 111.1 | 186.9 | 99.0 |
| 1984 | 60.3 | 58.6 | 63.1 | 62.4 | 99.2 | 92.0 | 81.9 | 109.0 | 179.5 | 96.2 |
| 1985 | 61.8 | 55.0 | 66.5 | 62.9 | 100.9 | 94.4 | 85.1 | 104.0 | 168.6 | 93.4 |
| 1986 | 64.4 | 57.4 | 68.4 | 68.0 | 105.8 | 100.3 | 88.2 | 91.5 | 132.4 | 93.7 |
| 1987 | 64.3 | 59.7 | 68.6 | 68.4 | 105.8 | 101.1 | 91.9 | 97.1 | 126.7 | 92.3 |
| 1988 | 62.6 | 60.0 | 66.6 | 67.7 | 106.2 | 102.1 | 92.2 | 95.8 | 119.9 | 94.9 |
| 1989 | 62.1 | 60.8 | 64.8 | 66.4 | 102.9 | 104.2 | 90.4 | 107.9 | 114.4 | 96.9 |
| 1990 | 65.0 | 61.6 | 68.4 | 67.9 | 103.5 | 101.6 | 88.3 | 107.7 | 119.9 | 98.1 |
| 1991 | 68.3 | 66.5 | 70.3 | 72.0 | 108.1 | 99.3 | 90.6 | 98.0 | 117.3 | 97.4 |
| 1992 | 68.4 | 69.3 | 71.0 | 74.7 | 108.8 | 97.3 | 91.8 | 102.9 | 113.5 | 102.1 |
| 1993 | 69.1 | 69.6 | 68.7 | 75.4 | 106.1 | 97.3 | 93.4 | 108.2 | 112.4 | 106.5 |
| 1994 | 69.2 | 69.7 | 69.1 | 77.1 | 103.7 | 97.3 | 94.4 | 108.5 | 113.3 | 109.6 |
| 1995 | 70.9 | 69.5 | 67.8 | 78.7 | 106.2 | 97.4 | 94.4 | 106.6 | 108.4 | 107.8 |

It is precisely these kinds of differences across provinces that motivate the use of equalization transfers. As we discuss in more detail in the next section, these transfers are designed to compensate those provinces that have below-average tax capacities.

HFI of Provincial Taxes After Intergovernmental Transfers

Table B.7 indicates provincial per capita revenues when federal-provincial transfers are included as provincial revenues.

TABLE B.7: PROVINCIAL GOVERNMENTS PER CAPITA REVENUES, AFTER INTERGOVERNMENTAL TRANSFERS, AS A PERCENTAGE OF CANADIAN AVERAGE

| Year | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|-------------|--------------|---------------|-------------|-------------|-------------|-------------|-------------|--------------|-------------|-------------|
| 1961 | 73.5 | 76.1 | 82.4 | 86.0 | 88.7 | 104.7 | 95.2 | 114.5 | 115.2 | 124.0 |
| 1962 | 81.5 | 79.1 | 83.6 | 82.0 | 90.5 | 106.5 | 89.2 | 117.1 | 112.4 | 113.6 |
| 1963 | 74.0 | 82.1 | 79.0 | 80.5 | 90.9 | 106.8 | 89.6 | 118.6 | 111.4 | 115.0 |
| 1964 | 76.0 | 75.1 | 77.3 | 82.5 | 95.0 | 104.8 | 90.9 | 116.7 | 104.6 | 115.1 |
| 1965 | 84.0 | 83.6 | 79.9 | 86.0 | 93.5 | 103.6 | 94.8 | 114.2 | 107.0 | 115.7 |
| 1966 | 80.1 | 78.1 | 82.6 | 83.5 | 94.3 | 105.6 | 93.7 | 113.7 | 102.8 | 111.0 |
| 1967 | 82.5 | 81.1 | 89.1 | 82.1 | 95.8 | 105.8 | 92.5 | 106.9 | 103.0 | 105.4 |
| 1968 | 82.5 | 78.6 | 88.1 | 82.1 | 94.9 | 107.7 | 93.8 | 102.4 | 100.0 | 105.5 |
| 1969 | 83.6 | 89.9 | 89.7 | 82.8 | 92.9 | 107.7 | 96.4 | 98.4 | 101.7 | 107.8 |
| 1970 | 85.2 | 84.6 | 84.2 | 81.5 | 94.1 | 108.9 | 98.3 | 94.1 | 104.9 | 99.4 |
| 1971 | 90.8 | 95.7 | 83.4 | 85.5 | 97.9 | 105.0 | 97.3 | 97.9 | 104.5 | 98.2 |
| 1972 | 85.4 | 94.2 | 91.7 | 88.7 | 99.0 | 102.8 | 99.5 | 101.5 | 104.0 | 97.3 |
| 1973 | 84.8 | 95.4 | 91.9 | 83.8 | 99.9 | 99.7 | 94.1 | 101.8 | 111.1 | 104.3 |
| 1974 | 89.7 | 91.5 | 86.1 | 85.5 | 99.1 | 95.4 | 94.8 | 108.6 | 135.2 | 101.5 |
| 1975 | 94.0 | 104.5 | 91.6 | 87.0 | 98.9 | 91.5 | 96.9 | 111.5 | 141.8 | 102.4 |
| 1976 | 90.4 | 103.5 | 86.2 | 82.1 | 98.3 | 92.5 | 97.0 | 107.0 | 143.6 | 104.0 |
| 1977 | 92.0 | 95.6 | 89.1 | 84.0 | 103.2 | 88.4 | 93.8 | 105.6 | 145.7 | 103.3 |
| 1978 | 94.2 | 92.5 | 86.0 | 85.3 | 103.4 | 85.2 | 87.5 | 109.3 | 160.1 | 102.7 |
| 1979 | 91.8 | 89.6 | 82.4 | 83.2 | 101.6 | 86.6 | 90.9 | 109.3 | 157.7 | 103.8 |
| 1980 | 91.0 | 94.0 | 85.7 | 83.1 | 101.0 | 84.7 | 91.2 | 114.1 | 164.9 | 100.4 |
| 1981 | 88.2 | 87.9 | 81.4 | 80.4 | 103.4 | 84.0 | 89.7 | 109.1 | 164.6 | 100.3 |
| 1982 | 88.3 | 91.0 | 82.8 | 82.5 | 107.7 | 81.8 | 91.3 | 102.8 | 165.8 | 96.5 |
| 1983 | 86.1 | 86.3 | 83.4 | 82.3 | 105.4 | 83.6 | 92.6 | 105.9 | 166.1 | 94.3 |
| 1984 | 87.3 | 93.8 | 84.3 | 84.7 | 104.1 | 86.5 | 91.9 | 105.4 | 160.6 | 92.3 |
| 1985 | 95.1 | 86.5 | 84.6 | 87.1 | 104.2 | 88.6 | 93.7 | 101.8 | 152.8 | 90.5 |
| 1986 | 96.1 | 87.2 | 86.1 | 90.6 | 107.1 | 93.6 | 95.1 | 92.6 | 123.6 | 91.6 |
| 1987 | 96.1 | 87.5 | 86.5 | 91.5 | 106.5 | 94.6 | 100.1 | 99.8 | 119.6 | 90.4 |
| 1988 | 94.8 | 89.5 | 86.6 | 90.7 | 106.6 | 95.1 | 103.3 | 99.1 | 114.5 | 92.0 |
| 1989 | 94.1 | 91.6 | 85.0 | 90.4 | 103.9 | 97.0 | 101.8 | 110.6 | 109.3 | 93.3 |
| 1990 | 98.3 | 93.3 | 88.7 | 92.5 | 104.0 | 94.9 | 100.2 | 114.6 | 113.5 | 93.4 |
| 1991 | 98.6 | 94.9 | 88.9 | 92.7 | 107.0 | 93.7 | 104.6 | 108.4 | 111.0 | 91.8 |
| 1992 | 99.2 | 96.1 | 88.7 | 98.9 | 107.9 | 91.9 | 102.6 | 110.4 | 109.9 | 96.2 |
| 1993 | 99.1 | 92.8 | 85.8 | 96.6 | 105.9 | 92.8 | 103.6 | 113.6 | 106.9 | 100.1 |
| 1994 | 98.4 | 95.5 | 88.8 | 96.7 | 103.9 | 92.9 | 105.9 | 113.5 | 106.3 | 102.8 |
| 1995 | 101.5 | 94.8 | 90.1 | 100.3 | 107.5 | 92.7 | 106.9 | 106.4 | 100.9 | 101.1 |

What is remarkable about these data is the similarity in per capita revenues across provinces once transfers are taken into account. It still remains true that there is some variability, but the range of differences is much narrower than in Table B.6.

As mentioned, these raw data are only imperfect indicators of the true differences in revenue-raising capacity across provinces. Per capita revenue differences can result not only from tax capacity differences, but also from differences

in tax policies adopted by the provinces. Those provinces that have higher tax rates (perhaps to finance higher needs for public services) will on that account have higher revenues per capita. We are able to obtain a more precise measure of tax capacity differences by using data calculated for equalization purposes, to which we turn next.

Tax Capacity Differences for Equalization Purposes

The Canadian Equalization scheme bases cash transfers to the low-income provinces on a measure of their tax capacity relative to a national standard. For this purpose, tax capacity is measured for each tax base by a series of steps. First, a common tax base is defined and then its size is measured for each province. Next, a national average provincial tax rate is calculated by taking the ratio of provincial taxes collected from that source to the sum of the tax bases over all provinces. Finally, a province's per capita equalization entitlement for that base is calculated by taking the difference between the revenue raised per capita when the national average tax rate is applied to the tax base of a representative set of provinces and the revenue raised when the same national average tax rate is applied to the province's tax base. For some provinces, this will be positive and for others it will be negative. Aggregating these entitlements over all tax bases yields net equalization entitlements.²³⁰

The first column in Table B.8 reports one component of this equalization calculation, referred to as the *Index of Revenue Equality*. It shows the per capita tax revenues that would be raised in each province from all tax sources by applying the national average tax rate to the standardized tax base for each revenue source. Data are presented for selected years in the 1980s and 1990s.

As these data show, there are systematic and persistent differences in revenue-raising capacity across provinces. All provinces except Alberta, British Columbia and Ontario are below the 10-province average, and the Atlantic Provinces are well below average. The first column in Table B.9 depicts the same information as percentages of the national average. As can be seen, the Atlantic Provinces have tax capacities that at roughly 70 percent of the national average, while Alberta is well above average (owing to its large oil and gas revenue base).

TABLE B.8: INDEXES OF REVENUE EQUALITY (\$ PER CAPITA)

FISCAL YEAR 1982/83

²³⁰ Note that this explanation is discussed more fully under Section C Nature of Programs Focussed on Horizontal Imbalances.

| | Own Revenues (Standardized) | Own Revenues plus Equalization | Own Revenues plus Equalization, CAP, and EPF ²³¹ |
|---------------------|--------------------------------|-----------------------------------|---|
| NFLD | 1 560 | 2 376 | 2 794 |
| P.E.I. | 1 513 | 2 474 | 2 927 |
| N.S. | 1 801 | 2 475 | 2 880 |
| N.B. | 1 732 | 2 430 | 2 888 |
| QUE. | 1 998 | 2 427 | 2 915 |
| ONT. | 2 491 | 2 491 | 2 861 |
| MAN. | 2 108 | 2 533 | 2 934 |
| SASK. | 2 763 | 2 763 | 3 209 |
| ALTA | 5 490 | 5 490 | 5 838 |
| B.C. | 2 802 | 2 802 | 3 247 |
| 10 PROV | 2 602 | 2 800 | 3 217 |
| FISCAL YEAR 1988/89 | | | |
| NFLD | 2 608 | 4 083 | 4 647 |
| P.E.I. | 2 705 | 4 083 | 4 670 |
| N.S. | 3 136 | 4 083 | 4 656 |
| N.B. | 3 003 | 4 083 | 4 711 |
| QUE. | 3 572 | 4 083 | 4 736 |
| ONT. | 4 574 | 4 574 | 5 084 |
| MAN. | 3 349 | 4 083 | 4 661 |
| SASK. | 3 631 | 4 083 | 4 643 |
| ALTA | 5 687 | 5 687 | 6 302 |
| B.C. | 4 389 | 4 389 | 5 028 |
| 10 PROV | 4 164 | 4 446 | 5 029 |
| FISCAL YEAR 1994/95 | | | |
| NFLD | 3 217 | 4 865 | 5 596 |
| P.E.I. | 3 451 | 4 879 | 5 541 |
| N.S. | 3 718 | 4 859 | 5 538 |
| N.B. | 3 652 | 4 877 | 5 537 |
| QUE. | 4 321 | 4 865 | 5 626 |
| ONT. | 5 083 | 5 083 | 5 662 |
| MAN. | 3 911 | 4 872 | 5 531 |
| SASK. | 4 545 | 4 953 | 5 576 |
| ALTA | 7 060 | 7 060 | 7 612 |
| B.C. | 5 576 | 5 576 | 6 187 |
| 10 PROV | 4 949 | 5 244 | 5 884 |
| FISCAL YEAR 1985/86 | | | |
| | Own Revenues (Standardized) | Own Revenues plus Equalization | Own Revenues plus Equalization, CAP, and EPF |

TABLE B.8 (CONTINUED): INDEXES OF REVENUE EQUALITY (\$ PER CAPITA)

²³¹ Explanation of CAP and EPF is provided in Section C under Nature of Programs Focussed on Vertical Imbalances. For fiscal year 97/98 these two transfers were replaced by the CHST.

| | | | |
|---------------------|-------|-------|-------|
| NFLD | 1 886 | 3 029 | 3 542 |
| P.E.I. | 1 965 | 3 029 | 3 561 |
| N.S. | 2 344 | 3 029 | 3 537 |
| N.B. | 2 178 | 3 029 | 3 603 |
| QUE. | 2 610 | 3 029 | 3 652 |
| ONT. | 3 271 | 3 271 | 3 728 |
| MAN. | 2 627 | 3 029 | 3 544 |
| SASK. | 3 368 | 3 368 | 3 955 |
| ALTA | 6 306 | 6 306 | 6 800 |
| B.C. | 3 248 | 3 248 | 3 845 |
| 10 PROV | 3 256 | 3 461 | 3 995 |
| FISCAL YEAR 1991/92 | | | |
| NFLD | 2 978 | 4 486 | 5 123 |
| P.E.I. | 3 063 | 4 485 | 5 136 |
| N.S. | 3 559 | 4 486 | 5 126 |
| N.B. | 3 193 | 4 486 | 5 161 |
| QUE. | 3 996 | 4 486 | 5 199 |
| ONT. | 4 807 | 4 807 | 5 366 |
| MAN. | 3 719 | 4 486 | 5 122 |
| SASK. | 4 011 | 4 486 | 5 053 |
| ALTA | 6 008 | 6 008 | 6 615 |
| B.C. | 4 912 | 4 912 | 5 520 |
| 10 PROV | 4 524 | 4 799 | 5 418 |
| FISCAL YEAR 1997/98 | | | |
| NFLD | 3 555 | 5 377 | 5 882 |
| P.E.I. | 3 833 | 5 385 | 5 828 |
| N.S. | 3 963 | 5 281 | 5 738 |
| N.B. | 4 032 | 5 391 | 5 834 |
| QUE. | 4 689 | 5 260 | 5 787 |
| ONT. | 5 450 | 5 450 | 5 805 |
| MAN. | 4 263 | 5 267 | 5 708 |
| SASK. | 4 919 | 5 105 | 5 521 |
| ALTA | 6 955 | 6 955 | 7 290 |
| B.C. | 5 702 | 5 702 | 6 111 |
| 10 PROV | 5 251 | 5 552 | 5 969 |

*TABLE B.9: INDEXES OF REVENUE EQUALITY
(PERCENTAGES OF NATIONAL AVERAGE)*

| | FISCAL YEAR 1982/83 | | |
|------|--------------------------------|-----------------------------------|--|
| | Own Revenues (Standardized) | Own Revenues plus Equalization | Own Revenues plus Equalization, CAP, and EPF |
| NFLD | 60 | 85 | 87 |

| | | | |
|---------------------|------|------|------|
| P.E.I. | 58 | 88 | 91 |
| N.S. | 69 | 88 | 90 |
| N.B. | 67 | 87 | 90 |
| QUE. | 77 | 87 | 91 |
| ONT. | 96 | 89 | 89 |
| MAN. | 81 | 90 | 91 |
| SASK. | 106 | 99 | 100 |
| ALTA | 211 | 196 | 181 |
| B.C. | 108 | 100 | 101 |
| 10 PROV | 100 | 100 | 100 |
| HIGH/LOW | 3.63 | 2.31 | 2.09 |
| FISCAL YEAR 1988/89 | | | |
| NFLD | 63 | 92 | 92 |
| P.E.I. | 65 | 92 | 93 |
| N.S. | 75 | 92 | 93 |
| N.B. | 72 | 92 | 94 |
| QUE. | 86 | 92 | 94 |
| ONT. | 110 | 103 | 101 |
| MAN. | 80 | 92 | 93 |
| SASK. | 87 | 92 | 92 |
| ALTA | 137 | 128 | 125 |
| B.C. | 105 | 99 | 100 |
| 10 PROV | 100 | 100 | 100 |
| HIGH/LOW | 2.18 | 1.39 | 1.36 |
| FISCAL YEAR 1994/95 | | | |
| NFLD | 65 | 93 | 95 |
| P.E.I. | 70 | 93 | 94 |
| N.S. | 75 | 93 | 94 |
| N.B. | 74 | 93 | 94 |
| QUE. | 87 | 93 | 96 |
| ONT. | 103 | 97 | 96 |
| MAN. | 79 | 93 | 94 |
| SASK. | 92 | 94 | 95 |
| ALTA | 143 | 135 | 129 |
| B.C. | 113 | 106 | 105 |
| 10 PROV | 100 | 100 | 100 |
| HIGH/LOW | 2.19 | 1.45 | 1.38 |

*TABLE B.9 (CONTINUED): INDEXES OF REVENUE EQUALITY
(PERCENTAGES OF NATIONAL AVERAGE)*

| FISCAL YEAR 1985/86 | | | |
|---------------------|----------------------------------|-------------------------------------|--|
| | Own Revenues (Standard- ized) | Own Revenues plus Equal- ization | Own Revenues plus Equal- ization, CAP, and EPF |
| NFLD | 58 | 88 | 89 |
| P.E.I. | 60 | 87 | 89 |

| | | | |
|---------------------|------|------|------|
| N.S. | 72 | 88 | 89 |
| N.B. | 67 | 88 | 90 |
| QUE. | 80 | 88 | 91 |
| ONT. | 100 | 95 | 93 |
| MAN. | 81 | 88 | 89 |
| SASK. | 103 | 97 | 99 |
| ALTA | 194 | 182 | 170 |
| B.C. | 100 | 94 | 96 |
| 10 PROV | 100 | 100 | 100 |
| HIGH/LOW | 3.34 | 2.08 | 1.92 |
| FISCAL YEAR 1991/92 | | | |
| NFLD | 66 | 93 | 95 |
| P.E.I. | 68 | 93 | 95 |
| N.S. | 79 | 93 | 95 |
| N.B. | 71 | 93 | 95 |
| QUE. | 88 | 93 | 96 |
| ONT. | 106 | 100 | 99 |
| MAN. | 82 | 93 | 95 |
| SASK. | 89 | 93 | 93 |
| ALTA | 133 | 125 | 122 |
| B.C. | 109 | 102 | 102 |
| 10 PROV | 100 | 100 | 100 |
| HIGH/LOW | 2.02 | 1.34 | 1.31 |
| FISCAL YEAR 1997/98 | | | |
| NFLD | 68 | 97 | 99 |
| P.E.I. | 73 | 97 | 98 |
| N.S. | 75 | 95 | 96 |
| N.B. | 77 | 97 | 98 |
| QUE. | 89 | 95 | 97 |
| ONT. | 104 | 98 | 97 |
| MAN. | 81 | 95 | 96 |
| SASK. | 94 | 92 | 92 |
| ALTA | 132 | 125 | 122 |
| B.C. | 109 | 103 | 102 |
| 10 PROV | 100 | 100 | 100 |
| HIGH/LOW | 1.96 | 1.36 | 1.32 |

The second column for each province shows what happens to the index when equalization payments are included. These payments go only to the ten below-average provinces. Not surprisingly, tax capacities are virtually fully equalized for the equalization-receiving provinces, while the three high-income provinces remain above the national average.

The final column includes the other major transfers that the provinces receive, those in support of health, welfare and post-secondary education.

C. System of Intergovernmental Transfers

The system of federal-provincial transfers is part of the broader system of fiscal arrangements between the two levels of government. The fiscal arrangements includes:

Bloc Transfers. There are two major bloc transfers, Equalization and the Canada Health and Social Transfer (CHST). Equalization transfers are made unconditionally to the low-income provinces based on their tax capacities. They are intended to provide all provinces with the ability to finance some minimum national standard of public services. CHST transfers are basically equal per capita transfers that are meant to assist the provinces in financing health, post-secondary and welfare programs. They have some general conditions attached involving the design of health and welfare programs. The CHST transfers evolved from a set of shared-cost programs in each of the three general areas.

Transfers for Specific Purposes. These are much less important than the bloc transfers in terms of size, although historically they were used in shared-cost form to establish major provincial social programs in the areas of medical care, hospitals and social assistance and services. Current examples include highways and immigration services.

Tax Harmonization Measures. These are bilateral agreements that involve harmonizing the tax base and sometimes the tax rate structure, and provide for a common tax collection process. They exist for selected provinces in the areas of personal income taxation, corporate income taxation and general sales taxation.

Other Negotiated Agreements. Various other negotiated agreements exist between the federal government and the provinces that attempt to ensure that provincial and federal fiscal policies are used in a way that is in the interest of the internal economic union. There is an Agreement on Internal Trade that sets out guidelines on government behaviour to ensure that efficiency in the internal common market for goods, services, labour and capital is not violated. The Social Union Framework Agreement (discussed above) involves the implementation of social policies whose objectives are shared by both orders of government. It is especially concerned with agreeing on the use of conditional federal-provincial transfers in areas of provincial legislative jurisdiction—the so-called federal spending power. There are also agreements in areas of immigration and the environment, as well as a recent agreement on the provision of transfers to families with children through the National Child benefit.

These fiscal arrangements taken together serve to facilitate fiscal decentralization and provincial accountability, while at the same time ensuring that national objectives are not compromised. Much of the literature on fiscal federalism is

devoted to studying how decentralized fiscal decision-making might lead to violations of national economic objectives, such as efficiency in the internal economic union and national equity objectives. The fiscal arrangements can be seen as means by which the possibility for such violations is contained. In part, this is by preserving the ability of the federal government to oversee responsibility for national objectives, for example through its use of the spending power. But also it involves cooperative agreements between the two levels of government. These agreements may involve both negative and positive measures. Negative measures are those that require governments to refrain from policies causing damage to national goals, such as those interfering with the free flow of products or factors of production across provincial borders. Positive measures are agreements to undertake some measures in order to attain some national objective, such as harmonizing tax or transfer policies or labour standards.

In the remainder of this section, the first two categories of the fiscal arrangements are discussed in more detail, while tax harmonization is discussed in the next section. The first two categories involve transfers between the federal government and the provinces.²³² These transfers fulfill a number of roles, all of which contribute to the objectives of the fiscal arrangements as outlined above. Four particular roles are typically emphasized in the fiscal federalism literature.

Correct Inter-Provincial Spillovers. Provincial expenditures programs may provide spillover benefits to residents of other provinces. Education and training programs may train workers who subsequently migrate to other provinces. Highways and other public infrastructure programs may benefit non-resident households and firms. Welfare programs may attract low-income persons from other provinces. Health programs and benefits for the elderly may be available to persons whose working and taxpaying years were spent in other provinces. Federal-provincial conditional transfers are one means by which provinces can be provided with the incentive to provide public services and infrastructure that may be of general benefit to residents of the nation regardless of where they live.

Close the Fiscal Gap. Provincial spending responsibilities may exceed their revenue-raising capacities. That is, the case for decentralizing expenditure responsibilities may be greater than the case for decentralizing tax responsibilities. Decentralizing spending may enhance the efficiency of provision by allowing provinces to cater better to the needs and preferences of their residents, while

²³² Recall that we are subsuming the municipalities within provincial governments. In fact, many of the principles that apply between the federal government and the provinces also apply with respect to the provinces and their municipalities.

decentralizing taxation may lead to a fragmented taxation system that does not reap the advantages of a single collection system. For these reasons, it is common in federations for the federal government to retain more revenue raising than it needs for its own purposes, and to transfer the excess to the provinces. The exact balance between provincial revenue-raising ability and federal transfers is very much one of judgment, and different federations resolve it in very different ways.

The Achievement of Fiscal Efficiency/Equity. The decentralization of fiscal responsibilities typically leaves different provinces with different capacities for providing public services to their residents. If these are not corrected, incentives will exist for businesses and households to move to provinces with greater ability to provide public services at given tax rates. To the extent that migration occurs in response to fiscal incentives, efficiency in the allocation of resources in the internal economic union is compromised. To the extent that migration does not occur, households in otherwise identical circumstances will be treated differently in different provinces, leading to a violation of horizontal, or fiscal, equity. The system of equalization transfers is intended to account for this.

Use of the Spending Power to Achieve National Objectives. Some important public services, such as those in the areas of health, education and welfare, are responsibilities of provincial governments. To the extent that the design of these programs has implications for national economic and social objectives, the federal government has an interest in how they are delivered. The main instrument available to the federal government is the spending power, which in this case involves transferring funds to the provincial government conditional on the design of the programs.

Federal transfers influence the ability of the provinces to deliver services for which they are responsible or provide incentives for the provinces to choose certain design features. This gives rise to inevitable tensions in the federal system between the exercise of federal prerogative regarding the spending power and the fiscal independence and legislative autonomy of the provinces. Increasingly, the Canadian federation has evolved in the direction of the latter. Provincial autonomy has gradually increased, and there has been more reliance on federal-provincial consultation and agreement to resolve potential conflicts and achieve shared goals. Of course, some tensions remain. Many provinces remain very skeptical about the federal spending power, at least partly because of a perception (well-founded) that the federal government has taken some unilateral decisions in the recent past that have been unannounced and have had adverse effects on provincial finances and programs. In addition, tensions remain over the federal role

in tax harmonization, a subject we return to in Section D – Systems of Tax harmonization and Tax Collection.

1. Nature Of Programs Focused On Vertical Imbalances

As mentioned, two transfer programs comprise the bulk of federal-provincial transfers — Equalization and the CHST. Both serve to some extent to close the fiscal gap, but the CHST is really the main vehicle for so doing. In the case of Equalization, addressing vertical imbalances is only incidental. Its primary focus is on horizontal imbalances: only the low-income provinces receive Equalization transfers.

The CHST was instituted in fiscal year 1996-97, replacing the EPF (Established Programs Financing) and CAP (Canada Assistance Plan) transfers that existed at that time. The CHST is in its early stages, so the precise formula for its evolution is not yet in place. It is an equal per capita bloc grant whose magnitude is determined not by formula but as part of the budget plan of the federal government.²³³ The annual allotments of these transfers from 1993-94 as projected until 2003-04 and those for Equalization are as shown in Table C.1.²³⁴

²³³ It has become an equal per capita grant.

²³⁴ Table C.1 is based on data presented in the budget documents that accompanied the 2000 federal budget produced by the Department of Finance.

TABLE C.1 EQUALIZATION AND BLOCK GRANT ALLOTMENTS 1993-2003 (\$BILLIONS)

| | <i>EPF/CAP</i> | <i>Equalization</i> |
|---------|----------------|---------------------|
| 1993-94 | 18.8 | 8.1 |
| 1994-95 | 18.7 | 8.6 |
| 1995-96 | 18.5 | 8.8 |
| | <i>CHST</i> | |
| 1996-97 | 14.7 | 9.0 |
| 1997-98 | 12.5 | 9.7 |
| 1998-99 | 12.5 | 9.6 |
| 1999-00 | 14.5 | 9.8 |
| 2000-01 | 15.5 | 9.5 |
| 2001-02 | 15.6 | 10.0 |
| 2002-03 | 15.5 | 10.3 |
| 2003-04 | 15.5 | 10.7 |

The CHST is nominally intended to support the financing of provincial expenditures in the areas of health, post-secondary education, social services and social assistance, all areas of provincial legislative responsibility. The funds are in no way tied to provincial expenditures in these areas: they are completely fungible. There are, however, some conditions that provincial programs must satisfy in order to be eligible for the full amount of the transfer. Health programs must satisfy five very general criteria. Provincial health insurance systems must be i) publicly administered, ii) comprehensive, iii) universal, iv) accessible, and v) portable. In addition, there can be no user fees, and doctors may not extra-bill patients over and above the fees paid by the public program. Violation of any of these conditions can lead to financial penalties being imposed by the federal government. Such penalties are a last resort, but from time to time they have been imposed. Given that the conditions are quite general, there are bound to be disagreements about how to interpret them.²³⁵ The only other conditions imposed apply to welfare (social assistance and social services). Welfare programs should not interfere with the mobility of welfare recipients across provinces. Otherwise, provinces are free to design their welfare systems as they see fit. No conditions apply to provincial post-secondary education programs.

The CHST thus provides provinces with considerable independence in determining the size and design of their social programs. The influence of the fed-

²³⁵ The federal government interprets the principles of the Canada Health Act that imposes the conditions on these transfers.

eral government exists by virtue of the fact that it provides some (conditional) financing in support of provincial programs. But this influence is limited. Not only are the conditions attached to the fund very general, but also the federal government contribution is relatively small, of the order of one-fifth of total program expenditures. This makes it difficult for the federal government to have the authority to insist on detailed design features. This is a relatively recent phenomenon. The CHST evolved from a system of shared-cost transfers in which the federal contribution was much higher.

Prior to 1977, the federal government funded approximately 50 percent of provincial health costs.²³⁶ In the case of welfare, the federal government matched each province's spending on approved social assistance and social services operating costs under the CAP.²³⁷ Transfers to the provinces for post-secondary education spending were based on the number of eligible students in the province. In 1977, the health and post-secondary education transfers were converted into a bloc transfer, the EPF, partly in recognition of the fact that the programs were now well 'established'. The EPF transfer had three features that differed from the previous shared-cost programs. First, the transfer was converted fully to an equal per capita transfer.²³⁸ Second, the rate of growth of the transfers was changed to the rate of growth of GNP rather than the rate of growth of provincial program expenditures. The implication was that the federal share of health and

²³⁶ Under the *Hospital Insurance and Diagnostic Services Payments* program the federal government contributed 25% of the national per-capita cost of in-patient service and 25% of the provinces per-capita cost of approved patient services multiplied by the average number of insured persons in the province in the year. As a result of this formula the high-cost provinces receive a lower percentage of their total expenditure from the federal government than do the low-cost provinces. Under the Medicare program the federal government provided the provinces with payments that were equivalent to half the national average per-capita cost of providing insured services multiplied by the average number of insured persons in each province in the year. Therefore, provinces with per-capita costs below the national average received more than 50% of their costs, and those with costs above the national average receive less.

²³⁷ In 1990 the federal government limited the increase in CAP transfers to the three wealthy provinces (British Columbia, Alberta and Ontario). Increases in CAP transfers were limited to a 5 per cent increase. In 1995, this limit on CAP transfers was made permanent when the CAP transfers were combined into the *Canadian Health and Social Transfer*. The evolution of these transfers is explained in Section C *The Nature of Programs Focused on Vertical Imbalances*.

²³⁸ This was not a major change, given that much of the health transfer was equal per capita since it was based on national average provincial health expenditures.

post-secondary expenditures was bound to fall gradually over time since program expenditure was growing in aggregate much more rapidly than GNP. Indeed, this was a major purpose of the change. Third, the equal per capita transfer was nominally divided between a cash component and a tax-transfer component. The federal government instituted the latter by reducing its personal and corporate income tax rates, thereby allowing the provinces to increase theirs. The effect of this was further to restrict federal cash contributions both initially and over time. In 1977, half of the EPF transfer took the form of cash and the rest of tax-transfers.²³⁹ As time passed by, the tax-transfer component rose more rapidly than the total EPF allotment implying that the cash transfer as a proportion of the whole fell.

When the CHST was instituted, the legacy of the EPF system was strongly felt. The CHST replaced both the EPF and the CAP, and in its initial years it replicated two features of those programs. First, the allocation among provinces reflected the total shares of provinces in the previous EPF and CAP systems, and this was quite different from equal per capita. Indeed, the three highest-income provinces received less per capita than the other provinces leading the former to argue that this represented an unnecessary addition to equalization. Second, the federal government continued to calculate its contribution to the CHST as including the tax-transfer that had been affected twenty years earlier. As the total CHST transfer was considerably less than the EPF and CAP programs it replaced (as part of the federal deficit reduction program) and as it was not intended to grow, the cash component of the CHST would gradually fall.

Subsequently, the CHST was reformed to avoid these problems. It was converted into an equal per capita grant in 1999, and its amount was defined fully in terms of a cash transfer. (The above table includes only federal cash contributions.) The federal government does, however, continue to count the tax-transfer as part of its contribution to federal social programs, even though these funds are now fully in the hands of the provinces as part of their own-source revenues.

2. Nature of Programs Focused on Horizontal Imbalances

The CHST has an equalizing effect. As an equal per capita transfer financed by federal general revenues, it effectively transfers from the high-income to the

²³⁹ In the case of Quebec, the tax-transfer was more than one-half since Quebec had been allowed to opt out of some of the shared-cost programs in return for tax points.

low-income provinces.²⁴⁰ But, the main program designed for correcting horizontal fiscal imbalance (HFI) is the Equalization program. The basic design of the Equalization system goes back to the early post-war period, although it has undergone many changes in detail since then. As mentioned earlier, it focuses entirely on equalizing tax capacity differences across provinces. There is no equalization of provincial expenditure needs. Unlike with the CHST, equalization transfers are completely unconditional.

The Canadian equalization system is based on the *Representative Tax System* (RTS) approach. The RTS system calculates equalization transfers on the basis of a province's ability to raise revenues from a set of tax bases that represent those actually used by the provinces. It involves defining a common tax base for all tax sources used, a task that is feasible when provinces' tax bases do not differ fundamentally. Alternative approaches to equalization involve so-called *Macro Formulas*, such as one based on some aggregate measure of provincial economic activity (Provincial GDP, sales, etc.). The RTS system suits Canada well, given that provinces use a large number of different tax sources, but ones whose bases do not differ too much between provinces. Moreover, the pattern of revenue sources across provinces differs considerably. The RTS approach is a way of aggregating these differences into a single measure. An important feature of the RTS approach is that it attempts to calculate provincial allocations in a way that affects as little as possible the incentive for provinces to vary their tax policies in order to increase their entitlements. We return to this issue below.

The calculation of a province's Equalization entitlement is as follows. For each of over forty tax bases, a common tax base is defined. The common base reflects the features of bases actually used by the provinces. In many cases, this is a relatively simple task. For example, in the case of income taxes, most provinces use the same base; excise taxes on cigarettes and alcohol tend to be the quantities of those products sold; payroll taxes use very similar bases. In other cases, provincial tax bases differ considerably, so the representative tax base is a compromise. This is the case for provincial sales taxes, property taxes, and many resource taxes. Once the representative tax bases are defined, a national average provincial tax is calculated by taking the ratio of total provincial tax revenues to the size of the representative tax base aggregated over all provinces. Next, a per capita Equalization entitlement is calculated for each tax base and for each prov-

²⁴⁰ This is because taxpayers from high-income provinces pay proportionally more taxes to the federal government, per capita, than do the taxpayers from the lower-income provinces.

ince. This is done by first calculating the amount of per capita revenues a province would raise by applying the national average tax rate to its own tax base. This is compared with the amount that would be raised per capita by applying the national average tax rate to the tax based aggregated over a representative set of provinces. The difference is the per capita equalization entitlement for that tax source: it may be positive or negative. The representative set of provinces includes British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec. Thus, it is referred to as a Five-Province Standard. The remaining five provinces (Alberta and the four Atlantic Provinces) are excluded from the representative set because of the special circumstances.²⁴¹

This procedure is used for each of the over forty tax bases. Entitlements are summed over all tax sources for each province. Those provinces that have a positive entitlement receive a per capita transfer equal to the full amount of the entitlement. Provinces with a negative entitlement — the so-called ‘have’ provinces — receive nothing (nor do they contribute anything directly). There are currently three have provinces — Alberta, British Columbia and Ontario. There has been remarkably little variation in the set of have provinces in the post-war period. This system is referred to as a gross system, as opposed to a net system in which transfers to the have-not provinces are fully financed by payments from the have provinces.²⁴² Nonetheless, the have provinces implicitly contribute to equalization since their residents pay a relatively high share of the federal revenues used to finance the program.

There are some other detailed features of the program that might briefly be mentioned. The growth of Equalization payments is subject to a ceiling (currently \$10 billion) that escalates at the growth rate of national GNP. The ceiling has been binding from time to time. There is also a floor that shelters provinces from sudden reductions in entitlements. As well, for some revenue sources, individual provinces constitute a substantial proportion of the national base. In these circumstances, the province will have a significant effect on the national average tax rate, and this would provide the province with an incentive to vary its tax rate to affect its entitlement. In these circumstances, only a portion of the province’s tax base is subject to Equalization.

²⁴¹ The Atlantic provinces are excluded because they are the poorest provinces and Alberta is excluded because of its enormous revenues from resources.

²⁴² The funds are not directly transferred from the ‘have’ provinces to the ‘have-not’ provinces. The funds go to the federal government and then to the ‘have-not’ provinces.

The Equalization program is under continual scrutiny, and has been subject to a variety of changes in the past. The number of tax bases used has gradually expanded over the post-war period. (Initially, only income taxes were included.) The treatment of resource revenues, particularly oil and gas, has varied from time to time. For example, in the 1970s and early 1980s, only half of provincial oil and gas revenues were included. Part of the reason for this was that equalizing provincial oil and gas revenues was expensive for the federal government, which had no direct access to those tax bases for its own use. As well, oil and gas was considered to be 'property' of the provinces. Finally, the standard used for Equalization has changed over time. The five-province standard replaced a full national average standard in which all ten provinces were included. This was also partly driven by the problems arising out of the very unequal distribution of oil and gas revenues. By excluding Alberta from the base, full equalization of these revenues was effectively ruled out.

There remain a number of issues over the design of the current system. Some of the more important ones are as follows.

Needs Equalization. As we have mentioned, only differences in tax capacity are equalized, and not equalization of needs. The purpose of equalization is to enable provinces to provide comparable levels of public services at comparable tax rates. In principle, this requires that differences in the need for public services, such as those that arise from demographic differences, to be equalized. Although this poses certain measurement problems, many countries with multi-level government systems do equalize for needs. Examples include Australia, Japan, South Africa and Sweden.

Incentive Effects. Ideally, Equalization transfers should be based on a province's tax capacity independent of its actual tax policies. In practice, this is very difficult to guarantee. Equalization is based on the size of a province's tax bases relative to the national average. To the extent that provincial policies affect its tax bases, they might have an incentive to design policies that will attract more Equalization transfers. This could be important in the case of resources, where provinces may have an influence on the rate at which resources are developed.

Treatment of Resources. In addition to the potential incentive problems arising from a province's ability to influence its resource tax base, resources give rise to other problems. Some resources are distributed very unevenly across provinces, and give rise to large Equalization payments. Since the federal government does not have direct access to resource taxation, it finds the costs of

equalizing resource revenues to be onerous.²⁴³ As well, the measurement of potential resource tax bases can be difficult. Ideally, the capacity to tax resources depends on the rents that the resources generate. But, the bases actually used tend often to be some measure of production. This is a very imperfect measure of the capacity to tax resources, since it neglects the fact that some resources are produced at a much higher cost than others.

Problems with Particular Taxes. Some taxes give rise to special problems. Property taxes are particularly problematic since the bases are defined and measured very differently in different provinces. A relatively recent major source of revenues for the provinces is lottery revenues. It is difficult to determine what the potential tax base is for this revenue source. User fees also give rise to conceptual problems. These can be viewed as benefit taxes to a large extent. Given that, they are not a source of financing general public services, and the case for equalizing them is not strong.

Macro Approaches. Some observers have suggested that some of the problems of the existing Equalization system can be avoided by adopting a macro approach to Equalization. This would avoid most of the incentive problems. It would reduce the complexity of the current system. And, it would avoid the difficulties that arise in defining standard tax bases when provinces are adopting increasingly diverse tax systems. On the other hand, macro approaches would simply not provide Equalization in accordance with actual provincial tax capacities, only with a rather broad and inaccurate proxy.

The Five-Province Standard. Finally, the five-province standard can lead to levels of Equalization that do not suffice to ensure that provinces are able to provide comparable levels of public services at comparable tax rates. The main reason for this is that, since the main oil and gas-producing province (Alberta) is excluded from the base, that source of revenues is far from fully equalized. Indeed, the adoption of the five-province standard was motivated largely by the desire to avoid the cost to the federal government of equalizing oil and gas revenues.

3. Nature Of Other Intergovernmental Transfers

Equalization and the EPF now comprise the bulk of the transfers from the federal government to the provinces. Historically, considerable reliance had been placed on shared-cost conditional transfers, often using 50 percent sharing

²⁴³ The federal government can, and does, levy corporate taxes but they can not levy royalty fees on production.

formulas. These were used to support major shared cost programs in health, welfare and post-secondary education. As mentioned above, shared-cost programs were abandoned for health and post-secondary education in 1977 and for welfare in 1996. What remains are much more specific and smaller shared-cost programs in areas like highway transportation, immigration and infrastructure.

The traditional economic argument for shared-cost or matching transfers is that some types of provincial expenditures yield spillover benefits to residents of other provinces. This rationale has been largely abandoned. It has been realized that the appropriate rate of matching from this perspective is difficult to know, and is likely to be much less than the full matching rates that have been used. In the case of the major matching transfers for health, welfare and education, the transfers served mainly as an inducement to the provinces to establish such programs. This was based less on spillover grounds than on arguments for harmonized social policy for all Canadians. Once the programs were established, the need for matching incentives became less compelling. On the contrary, the matching aspect was viewed as providing an adverse incentive to the provinces to increase their expenditures.

The use of shared-cost conditional grants has been controversial with the provinces. The major grants have been in support of expenditures in the legislative jurisdiction of the provinces. Although this use of the spending power has in the main been deemed to be constitutional, the strenuous objections of the provinces has led to the federal government agreeing not to institute them without consulting with the provinces. The recent Social Union Framework Agreement formalized this consultation. Under the agreement, the federal government has undertaken not to introduce new joint federal-provincial programs, whether shared-cost or bloc-funded, unless at least half the provinces agree. It is worth repeating that this is only a political agreement and therefore it is not legally binding.

As well as federal transfers to the provinces, there are also transfers between the federal government and the three northern territories, between the federal government and aboriginal communities, and between the provinces and their municipalities. The structure of federal-territorial transfers is similar to those of the provinces. The bulk of their transfers are one for Equalization and a bloc grant for social programs. They obtain a larger grant per capita than the provinces, reflecting the fact that costs are much higher: populations are sparse, and transportation costs are high.

Federal transfers to aboriginal communities reflect the special fiduciary responsibility that the federal government has for First Nations with whom treaties have been signed. These transfers have traditionally been tied to the provision of particular services. They differ in a significant way from most other intergovern-

mental transfers. Receiving communities are accountable to the federal government for how they are spent. This reflects the fact that these communities have had little legislative responsibility. Fiscal relations with aboriginal communities are gradually changing as self-government initiatives occur. These aim to give these communities more responsibility for delivering their own services, in which case the transfers would be much less conditional.

The relations between provinces and local governments in Canadian tend to be hierarchical in nature. Under the constitution, municipal governments are the creature of and responsible to the provinces, so most of their fiscal dealings are with the relevant provincial government. The result is that while the federal government transfers funds to the provinces, the latter transfer funds to municipalities, and in some cases, to special purpose bodies like school boards. The magnitude of provincial-municipal transfers is roughly the same as federal-provincial transfers. Provincial-municipal transfers differ considerably across provinces, but they bear some similarities to federal-provincial transfers. They often tend to have an equalizing component, though not one that is as highly developed as the federal Equalization program. They tend to have significant per capita components, which is implicitly equalizing. The transfers are typically more conditional than federal-provincial transfers and the municipalities are more directly accountable to the provinces, reflecting the fact that municipalities do not enjoy the same independence of legislative responsibility as the provinces.²⁴⁴ It also reflects the nature of services delivered by municipalities. They assume some delivery responsibility for important provincial public services in the areas of education, health and welfare, with the provinces overseeing the design and standards. They also provide public sector infrastructure, such as roads, water supplies and sewage. Provinces exercise control over the capital funding required to build and maintain such infrastructure.

Municipal own revenue systems are also quite different. Property taxes on both residences and businesses are the most important tax source, with reliance also placed on fees and licenses of various sorts. There are varying degrees of harmonization of property taxes. In some provinces, there is a single system of property assessment and tax collection, with the province setting a tax rate and municipal governments having limited ability (and need) to choose their own rate. Explicit sharing of tax revenues may exist with respect to certain functions. At the other extreme, property taxes may be administered and collected at the lower lever.

²⁴⁴ As indicated in Section A, municipal governments are the creation of the provinces and there is not constitutional recognition of local government in the constitution.

D. Systems of Tax Harmonization and Tax Collection

The tax system in the Canadian federation is relatively unique in the sense that not only is revenue raising highly decentralized to the provinces (as we have seen above), but also the provinces have independent access to all the main broad-based taxes. As already seen, they, along with the federal government, have full access to personal and corporate income taxation, sales taxation and payroll taxation.²⁴⁵ This makes the issue of tax harmonization extremely relevant. Moreover, this independent taxing authority implies that harmonization must come about via voluntary agreement with the provinces rather than being imposed by the federal government. As a result, the extent of harmonization varies considerably by tax type. Consider income, sales and payroll taxes in turn below.

1. Income Tax Harmonization

Income taxes — both personal and corporate — have been highly harmonized in Canada since the Second World War. This evolved quite naturally from a situation in which the federal government, following an agreement with the provinces, fully occupied the personal and corporate income taxes during the war as a result of the need to centralize revenue to fight the war. The system of income tax harmonization that has persisted until now has been based on bilateral *Tax Collection Agreements* (TCAs) between individual provinces and the federal government. Their structure differs slightly for the personal and the corporate tax.

Corporate Tax Collection Agreements

In the case of the corporate tax, provinces that choose to participate must abide by the corporate base as chosen by the federal government. They must also abide by an allocation formula for determining how the taxable income of a corporation operating in more than one jurisdiction is allocated among provinces. In

²⁴⁵ In fact, the Canadian constitution restricts the provinces to using ‘direct’ taxes for raising revenue for their own purposes. Although an economics interpretation of direct taxation would seem to preclude sales and excise taxation, provincial sales and excise taxes have been deemed by the courts to constitute direct taxation. This interpretation is based on the notion that retailers are the collection agents of the government and that they are merely collecting taxes that are intended to be imposed directly on consumers of taxed goods. This interpretation has been extended to include value-added taxation as well, despite the fact that tax liability can occur well before the retail stage. The argument is that ultimately the tax is intended to apply to consumers.

most cases, it is an average of the share of sales revenues and payrolls in each province. The provinces are allowed to set their own tax rate on the base, and are able to follow the federal government in giving preferential rates to small businesses and manufacturing and processing profits. The federal government acts as the tax collector for the agreeing provinces, and is willing to administer tax credits and surtaxes introduced by individual provinces provided they do not discriminate against non-residents, do not cause inefficiency in the internal common market, and are easy to administer.

All provinces except Alberta, Ontario and Quebec currently participate in the TCAs.²⁴⁶ The absence of those three provinces is a significant exception since they represent over 75 percent of the corporate tax base. In the case of Quebec, the decision not to participate is related to a more general desire to manage its own fiscal affairs separately from the federal government. Alberta and Ontario see the use of the corporate tax as a useful policy instrument that can be used to influence the pattern of private sector economic activity. Their provincial economies are large enough and concentrated in some large sectors (resource sectors in Alberta, manufacturing in Ontario) so that an independent industrial policy is considered to be feasible even in an otherwise highly open economy. But, even these non-participating provinces abide by the allocation formula to avoid double taxation. As well, their tax bases are not very different from that set by the federal government. The result is a highly successful and harmonized corporate income tax system in which provinces have leeway to set their own tax rates.²⁴⁷

Personal Tax Collection Agreements

The method of TCAs also exists for personal taxation. In the current system, which is under revision, the federal government sets the common base, administers the tax on behalf of participating provinces, and applies a common allocation formula (essentially allocating personal taxes according to the province of each taxpayer's residence on December 31 of the tax year). The federal government also sets a progressive rate structure, which includes not only a set of brackets and rates, but also a system of non-refundable and refundable tax credits. Participating provinces select a single tax rate to apply to federal taxes payable, thereby

²⁴⁶ It should be noted that these provinces constitute 70 percent of Canada's population.

²⁴⁷ Economists might argue that, given the mobility of capital, it might be preferable if the corporate tax were exclusively federal. However, given that the provinces have the right to levy income taxes, such a system could not be imposed on them.

abiding not only by the federal base but also to its rate structure — the so-called *tax-on-tax system*. The provinces effectively also abide by the non-refundable tax credits set by the federal government. As with the corporate tax, the provinces are allowed to establish their own set of credits and surtaxes to be administered by the federal government.

All provinces except Quebec participates in the personal TCAs, again leading to a highly harmonized system of personal income taxes, both with respect to the base and the rate structure. However, the system is about to change. Partly as a consequence of the growing share of personal income tax room occupied by the provinces, they have expressed a desire to have more discretion over their income tax policy. Recognizing this, the federal government in 1998 agreed with the provinces to revise the tax-on-tax system to a *tax-on-income system*. Provinces, should they choose, will be able within limits to set their own rate structures and their own non-refundable tax credits. This preserves the common base, while at the same time giving the provinces more discretion to implement their own preferred degrees of progressivity and to use non-refundable tax credits to achieve their own social policy objectives through the tax system. Several provinces have indicated that they intend to move to such a system in the very near future.

2. Sales Tax Harmonization

Unlike with the income taxes, sales tax harmonization is much less well-developed in Canada. Historically, the two orders of government have levied very different sales taxes. The provinces, in accordance with constitutional dictates, levied a sales tax at the retail level, while the federal government for many years levied theirs at the manufacturing level. In 1991, the federal manufacturers sales tax was replaced by a value-added tax called the *Goods and Services Tax* (GST). This was a very broad-based tax, including virtually all goods and services with relatively few exceptions. The GST was perceived as having a number of advantages in terms of economic efficiency over its predecessor, as well as over provincial retail sales taxes (RSTs). It removes taxes on business inputs, it treats domestic and foreign produced products equally, and it has a much broader base. The federal government has expressed the hope that the provinces would in time harmonize their RSTs with the GST, thereby reaping the same advantages.

Harmonization has been slow in coming. Part of the problem is that it is administratively rather difficult to harmonize a multi-stage tax system in a situation where no border controls exist, given the system of crediting that accompanies a value-added tax. This is especially difficult where different provinces

adopt different tax rates. The Quebec government was the first province to harmonize. It converted its RST into a multi-stage tax called the *Quebec Sales Tax* (QST), whose base was quite similar to that of the GST. Three features of the system are worth note. The first is that firms making purchases in Quebec would be liable for both the GST and the QST. Then, when subsequent sales are made, whether in or out of Quebec, they would be able to claim an input tax credit for both the GST they had paid and the QST. Thus, the firm would have to keep separate accounts for its transactions in Quebec from those elsewhere in Canada. Second, The GST and QST were subject to a common administration, but in this case it was the revenue department in Quebec rather than the federal government. Thus, the Quebec government would collect taxes on behalf of the federal government, the opposite of the case with income taxes. Third, Quebec retained the right to set its own QST rate regardless of rates in any other provinces.

Subsequently, three of the Atlantic Provinces — New Brunswick, Nova Scotia and Newfoundland — have fully harmonized their sales taxes, as a result of the financial incentive provided by the federal government. All have eliminated their RSTs in order to participate in the *Harmonized Sales Tax* (HST). The HST operates effectively like the GST within the three provinces except at a higher rate, which is common to all three provinces. Firms making sales in one of these three provinces are charged the HST rather than the GST, and are able to claim full credit on subsequent sales. The federal government administers the tax for all three provinces. The excess of revenues collected over and above the standard GST is distributed among the three provinces in proportion to the consumption sales in the province. Note that, unlike the QST, no province has independent discretion over the tax rate charged (although they are jointly consulted on the rate). Thus, the system is effectively like a revenue sharing system.

The remaining provinces have shown little interest in joining the HST arrangement. Presumably they prefer to retain some discretion over their tax rates and even their base. Whether they can be persuaded to adopt a system like that of Quebec remains to be seen. An alternative would be to maintain their RSTs, but broaden their base to parallel that of the GST. That would have some of the advantages of harmonization but not all. For example, it would be impossible under a single stage system to purge all products of taxes on business inputs.

3. Payroll Tax Harmonization

Payroll taxes remain effectively completely non-harmonized. The provinces and the federal government use them to varying degrees, largely as earmarked taxes for social insurance programs (unemployment insurance, pensions, workers

compensation, health care). There is no common collection agreement and all governments choose their bases separately.

Despite this, harmonization of payroll taxes is not regarded as being a high priority. Tax bases do not vary widely across provinces, which is not surprising given the common interpretation of payrolls. Rates are generally flat, though with various combinations of exemptions and upper limits. The taxes are quite easy to collect using the payroll deduction system. And to the extent that they are benefit taxes, they do not give rise to standard incentives for tax competition.

4. Other Issues In Tax Harmonization

Many observers continue to argue in favour of further enhanced, or at least solidified, tax harmonization. As we have mentioned, provincial sales taxation remains far from harmonized for most provinces. There is also always some danger that the income tax harmonization arrangements will not persist in their present form. The pressures on these arrangements have increased dramatically as the provinces have become more and more important in the income tax fields. There has been some argument for harmonization of the other taxes, such as the capital taxes that are used by both levels of governments, as well as specific excise taxes.

One institutional development might be noted which might make harmonization easier to manage in the future. The federal government has created a new tax collection agency called the Canada Customs and Revenue Agency (CCRA). It is responsible for administering all federal taxes, and is available for tax federal-provincial tax collection agreements in the future. It is also available to the provinces to collect their taxes. Presumably, this should contribute to both administrative simplicity and ease of compliance of collection.

E. Analysis: Economic Aspects

1. Impacts On Economic Efficiency

There are two broad perspectives one can take to assessing economic efficiency in a federal setting. On the one hand, much of the case for decentralization of fiscal decision-making — or for multi-level fiscal systems as opposed to unitary systems — is based on the efficiency improvements to which it leads. One can therefore investigate whether the extent and nature of decentralization exploits all the potential efficiency gains. On the other hand, one can take as given the extent of decentralization, and investigate how that decentralization

compromises economic efficiency of the national economy. In the latter case, the system of fiscal arrangements is seen partly as a means of countering otherwise adverse effects of decentralization. Consider these in turn.

Decentralization as a Source of Efficiency

The fiscal federalism literature stresses the beneficial efficiency effects of decentralizing the provision of public services to the provinces. Decentralization is thought to lead to a better matching of public services to local preferences and needs, better accountability, lower cost provision, and more innovation. It is particularly relevant for local public goods and public services delivered to households, including the key areas of health, education and welfare services. But to reap the full advantages of decentralization, provincial governments must be given effective autonomy for their fiscal affairs, including the design and delivery of these public services. They should be accountable to their own legislature rather than to the federal government, and they ought to have access to sufficient own source revenues to ensure independence. It is particularly important that they control revenue raising at the margin.

The Canadian federation fares well by these criteria. Provinces have exclusive legislative responsibility in areas of health, education and social services. They raise a high proportion of their own revenues. Grants from the federal government have minimal conditions attached, leaving program design solely to the provinces. And they are responsible for determining the size of their fiscal budgets at the margin.

Some observers have suggested that decentralization could go much further on the revenue-raising side, arguing that provinces should be responsible for raising virtually all their own revenues rather than being reliant on the federal government for transfers. Indeed, the main opposition party in the federal Parliament espouses this position. They argue that this would make the provinces more autonomous and therefore fully responsible and accountable for their own actions to their electorates. Such autonomy would also minimize the potential for the federal government interfering with provincial fiscal decision-making. This school of thought tends to place considerable emphasis on inter-jurisdictional tax competition as an inducement for governments to be more efficient and responsive to the preferences of their electorates. At the same time, it de-emphasizes the role of transfers in achieving national equity and efficiency objectives.

Fiscal Arrangements as Facilitators of Decentralization

Decentralization carries with it the potential for interfering with the efficiency of the internal economic union. Part of the role of the fiscal arrangements is to offset these potential inefficiencies of decentralization. There are two main dimensions to this. The first concerns the efficiency of the internal economic union. The second concerns the effect of the provinces' fiscal position on the allocation of resources among provinces.

Efficiency in the Economic Union

Decentralized decision-making can affect the efficiency of the internal economic union by distorting the free flow of goods, services, labour and capital between provinces. Provincial tax and expenditure policies can inadvertently impose barriers to trade. Provinces may engage in explicit beggar-thy-neighbour policies to attract business and households from other provinces. Provincial policies may discriminate in favour of resident firms or households.

Various measures can be taken to mitigate the possibility that provincial policies will distort the internal economic union. Tax harmonization reduces the possibility of the tax system being used in ways that are inefficient. Conditional grants may be conditional on provincial programs being designed in ways that do not distort markets in the economic union. The political or legal systems may also be used to enforce measures that improve the efficiency of the internal economic union. Intergovernmental agreements may be negotiated that preclude provinces from engaging in distortionary or discriminatory policies. There may be constitutional provisions that preclude provincial governments from implementing such policies. Or, the federal government may have the authority to oversee provincial policies from this point of view, with enforcement coming through the power to disallow policies that violate efficiency or the power to disallow provincial legislation.

In the Canadian case, measures of varying effectiveness exist for maintaining the efficiency of the economic union. Tax harmonization is reasonably successful in the income tax area. The equalization system removes some of the need for differential tax policies among provinces. The bloc grant system of the CHST includes some general conditions that contribute to the efficiency of the internal economic union, such as the mobility/portability provisions required of provincial health and welfare systems. But, the effect of these provisions is quite limited. For example, there is little harmonization of provincial educational programs. There are also measures that deal with the potential for provincial

policies of various sorts to distort the internal economic union. The constitution itself contains very little: it does give the federal government the power to disallow provincial legislation but it has become a well established constitutional convention that this power is not used. The main vehicle for addressing efficiency in the internal economic union is an *Agreement on Internal Trade* recently signed by the federal and provincial governments. It contains provisions for both negative integration (discouraging provincial measures that distort the internal economic union) and positive integration (encouraging provinces to engage in harmonization that furthers efficiency), and covers various areas of provincial policy (e.g. procurement, labour market regulation, investment, environment). But, its effectiveness remains to be proven. Its main defect seems to be the absence of an effective enforcement and dispute resolution mechanism.

Fiscal Efficiency

Decentralization in itself inevitably leads to differences in the ability of provinces to provide public services to their residents. They will have different sizes of tax bases per capita from which to raise revenues. They will also have different needs for public expenditures since the demographic composition of their populations will differ. The consequence is that, in the absence of countervailing measures, provinces will be unable to provide comparable levels of public services at comparable tax rates. That is, there will be different net fiscal benefits (NFBs) depending on the province of residence. This will provide a purely fiscal incentive for businesses and households to locate in provinces with higher NFBs, leading to a misallocation of productive resources across provinces. This misallocation, referred to as *fiscal inefficiency*, can be corrected by a system of equalization that makes transfers selectively to provinces such that they can, if they so choose, provide comparable levels of public services at comparable tax rates.

In Canada, fiscal inefficiency is deterred by the system of Equalization transfers. This system equalizes the tax capacity of the have-not provinces up to that of the five-province standard. The result is a reasonably complete equalization of tax capacities across provinces. There is, however, no mechanism for equalizing differences in provinces' expenditure needs. To that extent the system is imperfect.

There may be other sources of policy-induced inefficient allocations of resources. For example, in Canada some federal policies systematically favour the have-not provinces (Employment Insurance, regional development grants, agricultural subsidies, etc.). Some economists have argued that the combination of Equalization and other regionally preferred policies over-compensate have-not

provinces for their NFB deficiencies. The result is that too many productive resources could be encouraged to stay in have-not provinces rather than moving to more productive use in higher-income provinces.

2. Impacts on Equity

As with efficiency, there are varying dimensions to equity. It is useful to distinguish three aspects that are particularly relevant in a federal setting. The first concerns equity achieved through the provision of public services. These especially serve the equity objectives of equality of opportunity and economic security (social insurance). The second and third are the complementary notions of vertical and fiscal equity of the tax-transfer system.

Equity and Public Services

Important public services like education, health and social services are provided through the public sector essentially because they serve equity objectives. Otherwise, they could be left to the private sector. In many federations, these services are decentralized to lower orders of government. Yet, the federal government may have an interest in seeing that they satisfy some national standards so that citizens have comparable access to such services regardless of their province of residence. Reconciling the desire to achieve national standards with the desire to decentralize provision to the provinces is one of the most important issues that federal systems must address.

In Canada, the balance has been achieved reasonably effectively until now. The provinces have considerable independence to design these programs to suit their own perceived needs. The federal government has historically exercised some oversight via its spending power. It has financially supported provincial provision of these services with grants in return for the provinces adopting certain features in their program design. The conditions attached to the transfers have been fairly general, leaving detailed program design to the provinces (as discussed above).

There is some debate about the extent to which national standards should or could be achieved in the future. As discussed above the federal government now finances a relatively small proportion of provincial public services, and there is some issue as to whether it continues to have the political and moral authority to enforce national standards. Some observers suggest that this is as it should be. They stress that the provinces are in a better position to set their programs to suit

their residents' needs and preferences, and that any harmonization to a national standard can be achieved by inter-provincial agreement.

Vertical Equity

Vertical equity refers to the progressivity of the tax-transfer system. Value judgments are necessarily involved in choosing the degree of progressivity, and reasonable observers can disagree. In a federal context, the additional problem arises as to which level of government ought to be primarily responsible for determining the progressivity of the system. On the one hand, it can be argued that provinces can better choose tax-transfer systems that reflect the preferences for redistribution of their residents. On the other, decentralizing redistribution to the provinces can give rise to destructive tax competition (a 'race to the bottom') in which redistribution gets competed away. As well, to the extent that the federal government determines redistribution, it can ensure that all citizens are subject to the same standards of redistribution throughout the country, a property that might be compatible with notions of citizenship. Economists have tended to be somewhat agnostic about assigning the responsibility for redistribution, recognizing that while the federal government might have an interest in some minimum national standards of vertical equity, there is room for the provinces to augment that in a way that suits their constituents.

In Canada, the compromise solution has been adopted. Both the federal and provincial governments have access to the main instruments for income redistribution. The federal government maintains a dominant share of the income tax room, and can choose its rate structure and credits to achieve the degree of progressivity that it thinks is appropriate from a national point of view. At the same time, the provinces can choose to abide by the federal government's rate structure. Alternatively, they can adopt their own income tax rate structures, even if they abide by the federal base. This seems to be a reasonable compromise.

Horizontal Equity

The criterion of horizontal equity suggests that persons who are equally well off ought to be treated the same by the public sector. It is of particular relevance in a regionally diverse economy where persons of similar real incomes might reside in different regions. In the fiscal federalism literature, the principle that otherwise equal persons ought to be treated similarly in different regions is referred to as *fiscal equity*. In a parallel way to fiscal inefficiency, fiscal inequity will occur in a decentralized setting if provinces have differing abilities to pro-

vide public services. Persons of any given level of income will receive higher NFBs in wealthier provinces than in less wealthy ones. As with fiscal inefficiency, this can be avoided if a system of equalization is in place that enables all provinces to provide comparable public services at comparable tax rates.

The use of fiscal or horizontal equity as a guiding principle of fiscal federalism and its implications for equalization may not be universally accepted. Those who advocate it see it as a basic principle of fairness or entitlement that comes with citizenship in a federation. It is the economic equivalent to the legal concept of equal treatment. Others do not support the argument that residents of one region have entitlements to the wealth of another, especially if regions are politically distinct entities and belong to a loosely knit federation.

In practice, most countries do have equalization systems in place, reflecting at least some commitment to the national sharing of resources. In the case of Canada, the principle of equalization is embedded in the constitution. As we have seen, the Equalization system substantially equalizes provincial differences in tax capacities. But the system is not written in stone and continues to rely on political goodwill. As the federation becomes more fiscally decentralized, the demands on Equalization and the support for it could wane. So far, the system has held up well.

3. Political Aspects

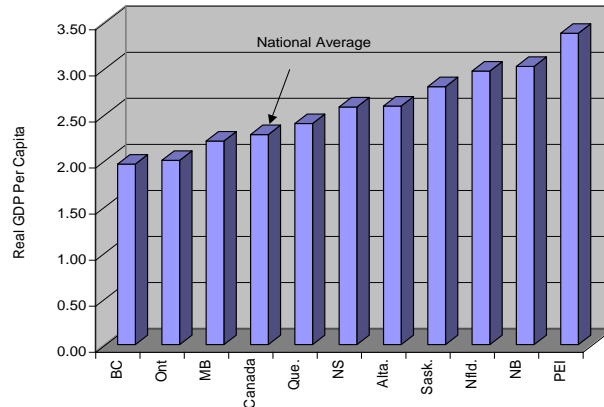
1. Impact on Stability

The processes of intergovernmental relations and fiscal arrangements have been both a stabilising influence and a source of conflict in Canada.

2. Areas of Consensus

Equalisation: One area in which there is relative political consensus is the program of fiscal equalization. All of the provinces have endorsed this system of unconditional transfers from the federal government to the seven less-wealthy provinces in order to help these provinces provide a comparable level of public services at reasonably comparable levels of taxation. Equalisation has also contributed to a narrowing of regional difference in economic conditions. Chart E-1 indicates a reduction in regional differences by comparing provincial trends in GDP per capita from 1961 to 1996.

CHART E1: AVERAGE ANNUAL GROWTH RATES BY PROVINCE, 1961-96



Source: Serge Coulombe, *Economic Growth and Provincial Disparity: A New View of an Old Problem*, (Toronto: C.D. Howe Institute, 1999), Table 1.

All of the provinces receiving equalization, except Manitoba, are above the national average for growth rate of GDP per capita.

The use of equalization transfers has also meant that social programs have developed as a cooperative project between the two orders of government.

3. Areas of Dispute

Ongoing Conflict with Quebec: Since the federal government initiated the use of its spending power in areas of exclusive provincial jurisdiction in the post-war period to establish many of the programs that are now the basis of the modern Canadian welfare state, the government of Quebec has voiced strong objections to this use of the spending power and to the role of the federal government in collecting provincial taxes through tax rental and tax collection agreements. Quebec has consistently argued that this use of the federal spending power and the role of the federal government in collecting provincial taxes was an invasion of the constitutional jurisdiction assigned exclusively to the provinces. Rather than come to an intergovernmental agreement with the federal government on the implementation of national programs within Quebec, the Quebec government has instead been able to negotiate a different set of fiscal arrangements with the federal government. These agreements allowed Quebec to opt-out of some federation-wide programs but still receive funds from the federal government

to implement its own programs that had objectives similar to the federation-wide programs²⁴⁸. This process was also flexible enough to accommodate Quebec's desire to have its own provincial tax system. While all the other provinces signed a tax collection agreement with the federal government limiting the full exercise of their constitutional right to levy and collect corporate and personal income taxes, in 1962 Quebec chose to establish its own provincial tax system and collect its own corporate and personal income tax.²⁴⁹

In this way the processes of intergovernmental negotiation between federal and provincial executives ("executive federalism") and the fiscal arrangements between the federal government and the provinces have been flexible enough to accommodate the demands of Quebec while allowing the federal government to implement federal policy objectives that would otherwise be beyond the fiscal capacity of the provinces operating on their own revenues. Intergovernmental relations have been the site for many disputes between the different orders of government (and between governments), but these processes of "executive federalism" have generally helped to maintain stability while allowing for the evolution of the federation. However, "executive federalism" and the issue of fiscal relations between Quebec and the federal government have also been the source of major political and constitutional conflicts that have threatened national unity.

Quebec's objections to the federal use of its spending power in areas of exclusive provincial jurisdiction have translated into calls for comprehensive constitutional reform to revise the division of powers in order to provide Quebec with greater fiscal revenues and expanded legislative powers. Quebec has pressed for greater fiscal autonomy that would allow it to meet its expenditure obligations under the constitution. The federal government has been reluctant to give up revenue and its ability to implement federation-wide policies. Part of the federal government's reluctance to meet Quebec's constitutional demands was that by giving Quebec expanded legislative powers and additional revenues the federal government feared that this would lead

²⁴⁸ It should be noted that Quebec did not opt-out of the two largest cost-shared programs: the *Canada Assistance Plan* or the Medical/Hospital insurance programs.

²⁴⁹ Both Quebec and Ontario set up their own corporate income tax in 1947 but Ontario signed the 1952-1957 Tax Rental Agreement with the federal government and abandoned its corporate tax, leaving Quebec as the only province outside the Tax Rental Agreements in 1952. In 1957 Ontario signed a new Tax Sharing Agreement with the federal government but this did *not* include corporate income taxes, resulting in Ontario re-establishing its corporate income tax. The result was that both Québec and Ontario collected their own corporate income taxes. In 1981 Alberta adopted its own corporate income tax system.

only to further claims for additional powers and fuel the nationalist movement in Quebec that supported Quebec's separation from the rest of Canada.

The differences with Quebec over fiscal and legislative powers led to a prolonged series of constitutional negotiations between the federal and provincial governments since 1967. These debates and an ongoing series of constitutional negotiations on these issues between the federal government, Quebec and the other provinces have at times fuelled the nationalist movement in Quebec and led to further tension between Quebec and the federal government and the other provinces. These tensions reached a crisis point when a separatist party was elected in Quebec in 1976 and proposed to hold a referendum in Quebec on the issue of "sovereignty association" in 1980. The referendum failed to obtain a majority, but another round of comprehensive constitutional negotiations from 1984 to 1993 resulted in an impasse between Quebec and the rest of Canada. That led to a second referendum in 1995 that resulted a razor-thin victory against separation. Despite losing two referendums on the issue of sovereignty association and independence the Parti Québécois (the independentist party in Quebec) has won the last two elections in Quebec. The Parti Québécois has indicated that it plans to hold another referendum in the future, although some apparent decline in support for separation since 1995 has led to deferral of the proposal.

Although the efforts at constitutional reform and the processes of executive federalism and intergovernmental agreements have resulted in considerable intergovernmental conflict between Quebec, the federal government and the other provinces, nevertheless, the pragmatic processes of executive federalism and intergovernmental negotiation have provided a method by which the federation has adapted to changing circumstance, and these processes have been more flexible and less politically divisive than attempts to amend the constitution formally.

Asymmetry of Constitutional Powers: As indicated above (and in A.4) Quebec has always sought greater fiscal and policy autonomy from Ottawa than the other provinces. In recent constitutional negotiations (1985-1993) the other provinces have been unwilling to meet Quebec's demands for greater fiscal and legislative powers that would result in increased asymmetry between the legislative and fiscal powers of Quebec and the rest of the provinces. One of the reasons that the other provinces have objected to these demands by Quebec for further asymmetry is because some of the provinces would like similar powers for their own province and therefore have objected to special favoured treatment for Quebec. The issue of asymmetry or "special status" for Quebec has been a major roadblock to formal constitutional reform and has contributed to the tensions between Quebec and the rest of Canada. Of course these same concerns have caused disagreements between Quebec and the federal government in intergovernmental negotiations.

Extending the use of the Federal Spending Power: The federal government has used its spending power to establish social programs that are within the constitutional jurisdiction of the provinces. The provinces were unable to establish these programs on their own because they lacked sufficient revenues of their own.²⁵⁰ The federal government used its spending power to share with the provinces the cost of delivering new policies in areas such as healthcare, post-secondary education, and social assistance. As described above, the initial agreements with the provinces the federal government contributed approximately half of the provinces costs for these programs. In order to receive these funds the provinces had to meet a series of modest conditions that were specified in federal legislation (there were no conditions for post-secondary education funds). In later years the amount of the transfers was subject to a formula that was determined through a process of intergovernmental negotiations.

In the years following their establishment, the costs of these cost-shared social programs increased rapidly just as governments were facing increasing financial pressures and escalating budget deficits. Both federal and provincial governments sought to reduce their expenditures while facing public pressure to maintain the level of public services. This led to continuing disputes and ongoing tensions between the federal and provincial governments. This tension came to a head in 1995 when the federal government unilaterally cut the fiscal transfers to provinces by replacing the previous system of transfers with the Canada Health and Social Transfer (CHST) in the federal budget. The unilateral decision by the federal government to cut fiscal transfers, combined with the steady reduction in transfers to the provinces before 1995, has contributed to an atmosphere of distrust between the provincial and federal governments.

The provinces argued that the federal government was not living up to its financial obligations to finance its share of jointly financed programs, and that the federal government should restore the transfers to the provinces before financing any new policy initiatives. The federal government held that unlike the old system of transfers, the CHST was at least financially sustainable and minimised unnecessary restrictions on provinces in areas of clear provincial responsibility.

Now that the federal government has eliminated its budget deficit (that had persisted for 22 years) it has expressed an interest in extending the use of the spending power to establish new or additional programs in response to social and economic changes brought on by globalisation and increased pressures from international competition. The provinces have been reluctant to cooperate with the federal government

²⁵⁰ This was because the federal government collected most of the taxation revenues under tax rental and tax collection agreements they had negotiated with the provinces. See Section D for further details.

on new or additional programs, however, because they fear that once these new programs are instituted, the federal government may at some time in the future again act unilaterally to reduce or drastically cut transfers as they have in the past. This would leave the provinces with the burden of funding programs that they lack the fiscal resources to sustain. Instead, they are pressing the federal government to restore the funds that were cut in 1995.

The signing of the Social Union Framework Agreement (SUFA) in February 1999 was an attempt by the federal and provincial governments (except Quebec) to reach an agreement on how new or additional programs might be implemented when the federal government uses its spending power. Although the signing of the Agreement indicates that some progress is being made on important issues, there are still continuing disagreements between the two orders of government that have prevented any substantial agreements on the extension of the federal spending power in areas of exclusive provincial jurisdiction.

Finally, although Quebec participated in the negotiations, Quebec did not sign SUFA because of its objections to the use of the federal spending power in areas of exclusive provincial jurisdiction and because of the lack of provisions in SUFA that would allow Quebec to opt out of new programs (financed through the spending power) and receive compensation from the federal government to implement its own provincial program. Thus, the agreement of nine provinces to the *Social Union Framework Agreement* but not Quebec has introduced a further degree of *de facto* asymmetry among the provinces.

The Introduction of New Direct Transfers to Individuals: The federal government also uses its spending power to make direct transfers to individuals and organisations for policy purposes that are within provincial jurisdiction (e.g. post-secondary education scholarships and research chairs at universities). The introduction of new direct transfers to individuals and organisations and institutions by the federal government has also been a source of considerable conflict between the federal and provincial governments, especially the government of Quebec.

Provincial governments have objected to the introduction of new direct transfers to individuals and institutions because the federal government has spent money on *new* transfers to individuals before restoring the funds to jointly financed programs that were unilaterally cut in 1995. These types of direct transfers to individuals and institutions by-pass the provincial governments and give the federal government higher visibility with citizens. The provinces have been concerned that the federal government will in future make greater use of direct transfers in order to by-pass provinces and maximise the visibility of the federal government in the delivery of program.

Ability to Adapt to Changes

Despite the considerable achievements of “executive federalism” in facilitating intergovernmental relations, these disputes between federal and provincial governments, the federal government and Quebec, and between Quebec and the other provinces point to some weaknesses in the ability of “executive federalism” as a process to respond to the need for changes in social and economic policy.

A major challenge that is hampering the ability of “executive federalism” and the use by the federal government of its spending power to respond to changing circumstances is a lack of trust between the two orders of government. The federal government’s gradual reduction in funding of existing jointly financial programs and its unilateral decision to cut dramatically transfers to the provinces left the provinces with the burden of compensating for the reductions in federal transfers. This made it increasingly difficult for the provinces to predict and plan their budgetary revenues and expenditures. As a result of the federal government reducing its commitment to maintain transfers for existing jointly financed programs the provinces have been extremely reluctant to enter any new joint agreements with the federal government. This stalemate between the federal and the provincial governments on the introduction of new joint programs represents a considerable constraint on the ability of the intergovernmental processes to respond to changing economic and social circumstances.

Another considerable constraint on the ability of the intergovernmental process to respond to changing circumstance is the continuing objections of Quebec to the use of the federal spending power in areas of exclusive provincial jurisdiction and its claims for additional fiscal and legislative powers. Quebec’s ongoing objection to this use of the federal spending power will either have the result of extending the process of negotiations and reducing the responsiveness of the intergovernmental process or it will result in Quebec continuing to be excluded from future intergovernmental agreements (such as SUFA, the *National Children’s Benefit* and the *National Children’s Agenda*). A trend towards intergovernmental agreements that consistently excludes Quebec could re-enforce the arguments of the pro-separatist forces in Quebec (including the current Quebec government) that Canadian federalism cannot accommodate Quebec’s cultural and linguistic needs.

Executive federalism is a process that involves a long series of complex negotiations between the federal government and ten provinces. The need for extensive consultation and cooperation among so many governments with a diverse set of interests means that “executive federalism” is a process that may be very slow to respond to the need for changes to social and economic policies. The result is a cumbersome and complex system of negotiations that has difficulty in responding quickly enough to changing policy needs.

These problems aside, the processes of “executive federalism” have, nonetheless, achieved some considerable successes. They have allowed the federal and provincial governments to reach agreements on a series of federation-wide programs that form the basis of the modern welfare state in Canada. Furthermore, these are programs that the provinces would not have been able to implement without the financial assistance of the federal government. These grants have allowed the federal government to establish major social policies that must operate within the broad conditions set by the federal government but also allow for differences between the provinces.

For citizens many of these policies have lowered barriers to mobility within Canada and created greater equality of opportunity. These programs have also advanced the concept that citizens have social rights and contributed to a civic nationalism in Canada.

Executive federalism and interprovincial financial agreements have also been the major method through which the federation has evolved. Attempts to reform the federation through the formal amending process of the constitution have in practice proved almost politically impossible and furthermore have contributed to events that seriously threatened the unity of the country.²⁵¹ The processes of “executive federalism” and the use of intergovernmental agreements have been flexible enough to accommodate Quebec’s demands for greater fiscal and political autonomy while at the same time allowing the federal government to use its spending power to achieve federation-wide policy objectives.

4. Transparency and Accountability Considerations

The lack of any formal constitutional status for “executive federalism” has raised concerns about the accountability for the decisions taken by governments that participate in this process. The premiers and the prime minister are not bound by any formal constitutional rules to submit agreements they make with other governments to their respective legislatures for approval or scrutiny.²⁵² The absence of this requirement

²⁵¹ Minor amendments to the constitution have not been as controversial. Indeed, two have been passed in the last several years. Both required the support of Parliament and the province affected. The Constitution Amendment, 1997 (Québec), removed the province’s requirement to provide denominational schools, facilitating the establishment of a linguistically-based system of education. A similar amendment, the Constitution Amendment, 1998 (Newfoundland Act), removed that province’s requirement to provide denominational schools and enabled the province to modernize its school system.

²⁵² There are requirements, however, that intergovernmental agreements relating to the formal amendment process of the Constitution be submitted to legislatures.

creates the impression that an agreement could have been made without consideration of important interests that are represented by other parties and interests that are democratically represented in the legislature.

One of the biggest concerns with the process of executive federalism is, therefore, is the perception that it suffers from a democratic deficit. The fact that the premiers and the prime minister negotiate among themselves intergovernmental agreements that have such wide-ranging implications for Canada's major social and economic policies creates the impression that there is a lack of representativeness and democratic accountability in these processes.

Nevertheless, it should be noted that the premiers and the prime minister, and their governments, are elected and under the rules of the parliamentary system they are accountable to their legislatures for all of their actions. Therefore, the process of "executive federalism" is in this sense entirely consistent with the Canadian tradition of representative democracy. "Executive federalism" as a process is fundamentally based on elite accommodation between governments. However, the legitimacy of traditional representative democracy is being challenged by a "decline of deference" towards political elites that is taking place in Canada and other western industrial democracies.²⁵³ The last two rounds of constitutional negotiations (1985-1993) indicated that citizens were highly suspicious of an elite process that excluded the public. Citizens want and expect to play a larger role in a process that has such significant implications for major social and economic policy decision-making and indeed the very future of the country itself. Increased mobilisation of the public and their desire to play a role in the decision-making process has constrained the ability of government elites to broker intergovernmental agreements that involve compromises and trade-offs that may not be popular with large sections of their voters. The recent SUFA (the Social Union Framework Agreement) has also attempted to address this problem by including commitments to engagement of citizens, but so far there have been no prominent examples of such initiatives taking place as a result of SUFA.

Another problem that is associated with the processes of "executive federalism" is a lack of formal decision-making rules. In the process of negotiations, although each province is equally represented, some provinces have more political power and influence than others due to their size or wealth and this may lead some participants in the process (governments), or their supporting publics, to believe (rightly or wrongly) that other provinces' or regions' interests dominate the negotiations at their expense. This has the potential to exacerbate existing tensions between governments and highlight conflict rather than agreement. Related to the concern about the lack of formal deci-

²⁵³ See Neil Nevitte, *The Decline of Deference*, (Toronto: University of Toronto Press).

sion-making rules is the power of the federal government to make unilateral decisions on its use of the spending power in areas of exclusive provincial jurisdiction.²⁵⁴ After establishing a practice of negotiating changes to fiscal transfers with the provinces, the federal government's subsequent insensitive unilateral decision in 1995 to cut transfers to the provinces drastically, has contributed to a lack of trust that now threatens the ability of the federal government to get cooperation from the provinces on new programs that are necessary to accommodate changing social and economic circumstances.

The complexity of the system of transfers between the federal and the provincial governments and the lack of transparency that applies to intergovernmental agreements is a formidable barrier preventing public understanding of how these affect the design and delivery of public services and the development of public policies. A related issue is whether a government that imposes a particular tax should also be responsible for spending it in order to ensure a measure of financial responsibility and political accountability. However, weighed against this is the need to accomplish federation-wide policy objectives and other goals such as regional and individual equity that are achieved through the use of transfers and intergovernmental collaboration.

One implication of the principle of fiscal responsibility, i.e. that the government that raises taxes should decide how these revenues are spent, is that the government making transfers should establish conditions on how the recipient government spends these in order to ensure accountability. Thus in some federations, most notably the United States, most intergovernmental transfers take the form of conditional grants. The problems with such grants is, however, that they undermine the autonomy and flexibility of the recipient governments. Canada has, therefore, over the last two and a half decades moved instead to heavy reliance primarily on unconditional or at most semi-conditional transfers, perhaps more so than any other federation. This has not meant a lack of accountability, however, since the provincial executives responsible for the spending of these transfers are in budgetary terms directly accountable to their legislatures under the system of parliamentary executives, and hence through their legislatures to the citizens.

²⁵⁴ This was the situation before the signing of the *Social Union Framework Agreement* (SUFA) in 1999. Under the terms of SUFA the federal government accepted some restrictions on the use of its spending power that may remedy this concern by the provinces. However, it should be noted that SUFA is only an intergovernmental agreement with no formal constitutional or legal status.

5. Political Culture

Canada is characterised by regional and linguistic cleavages and the processes of intergovernmental relations and fiscal arrangements both reflect and reinforce these characteristics.

In Canada the provinces do not have any direct representation within federal government institutions. There is no direct representation of the provinces in the Senate (as there is in federations such as Germany) or even the direct election of Senators to represent the residents of the provinces (as in the United States). The lack of representation for the provinces within the federal parliament has resulted in the provincial premiers becoming the primary advocates of provincial or regional interests on the federal scene. This explains why intergovernmental meetings and the processes of “executive federalism” have become the primary methods of integrating regional and linguistic interests into the federal government’s decision-making process. Thus, the process of executive federalism and the debates it has generated between governments reflects Canada’s regional and linguistic cleavages.

The fiscal arrangements between the provinces and the federal government have also had a major impact on the role of the federal and provincial governments. The rise of the welfare state in the post-war period has meant that the constitutional expenditure obligations of the provinces have become more important and provincial governments have expanded rapidly in order to deliver new services to their citizens. Many of these new programs were jointly funded by the federal government and federal funds were a major contributor to the rapid expansion of the provinces’ activities and their resources. As provincial governments expanded they developed their own political priorities that reflected their regional or provincial interests. Naturally, these provincial or regional interests were expressed through the channels of “executive federalism.” In this way, the fiscal transfers from the federal government to the provinces contributed to the expansion of the provincial governments and their increased role in articulating regional interests.

Despite the existence of regional and linguistic cleavages there is a high degree of consensus among Canadians on most social values. This consensus has supported the efforts of the federal government to pursue Canada-wide objectives and policies. Through the use of transfers the federal government has been able to develop a set of Canada-wide programs that are accessible by all Canadians, regardless of where they live. Compared to most federations these transfers have been largely unconditional or only semi-conditional in character and this has allowed considerable discretion in how the provinces deliver those programs. This has reflected the diverse regional and linguistic political culture of Canada while permitting the federal government to develop broad Canada-wide social programs and policies.

APPENDIX

TABLE 1: FEDERAL GOVERNMENT SHARE OF TOTAL PUBLIC SPENDING INCLUDING INTERGOVERNMENTAL TRANSFERS (PERCENTAGES)

| Year | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|------|-------|--------|------|------|------|------|------|-------|------|------|
| 1961 | 63.9 | 67.6 | 72.0 | 65.5 | 53.8 | 58.7 | 60.6 | 54.7 | 52.5 | 56.4 |
| 1962 | 62.2 | 72.4 | 71.2 | 64.6 | 52.9 | 57.6 | 59.6 | 55.4 | 52.2 | 54.0 |
| 1963 | 63.0 | 67.4 | 70.4 | 66.3 | 51.7 | 55.6 | 57.2 | 49.6 | 50.5 | 52.3 |
| 1964 | 59.3 | 66.0 | 69.2 | 61.0 | 50.7 | 54.6 | 56.5 | 47.7 | 49.4 | 52.0 |
| 1965 | 60.2 | 74.4 | 68.0 | 62.8 | 46.1 | 52.4 | 55.9 | 48.1 | 46.6 | 50.9 |
| 1966 | 57.6 | 63.2 | 67.9 | 62.5 | 44.9 | 52.6 | 56.6 | 48.4 | 43.5 | 50.1 |
| 1967 | 52.8 | 63.5 | 68.4 | 64.6 | 44.8 | 49.5 | 55.7 | 47.1 | 40.1 | 49.2 |
| 1968 | 54.7 | 64.0 | 67.2 | 60.9 | 44.0 | 47.7 | 54.4 | 46.9 | 42.1 | 47.8 |
| 1969 | 56.6 | 65.3 | 66.0 | 56.8 | 44.5 | 46.5 | 52.5 | 48.4 | 41.2 | 46.0 |
| 1970 | 56.4 | 63.8 | 60.7 | 60.5 | 43.4 | 45.1 | 51.6 | 49.9 | 41.3 | 45.9 |
| 1971 | 55.0 | 62.6 | 61.0 | 57.2 | 44.0 | 44.9 | 51.9 | 51.6 | 40.7 | 47.1 |
| 1972 | 55.7 | 61.8 | 62.0 | 57.2 | 45.2 | 46.5 | 51.6 | 52.3 | 41.9 | 47.8 |
| 1973 | 57.1 | 61.6 | 61.6 | 60.5 | 43.0 | 46.9 | 51.5 | 52.4 | 41.6 | 46.5 |
| 1974 | 58.8 | 61.2 | 65.3 | 62.8 | 46.8 | 47.3 | 48.8 | 50.8 | 44.1 | 45.9 |
| 1975 | 59.5 | 63.5 | 65.1 | 63.9 | 48.8 | 47.6 | 49.2 | 48.2 | 41.4 | 45.2 |
| 1976 | 55.7 | 63.4 | 65.3 | 62.4 | 44.3 | 46.9 | 48.6 | 45.4 | 41.4 | 45.5 |
| 1977 | 57.7 | 62.7 | 66.6 | 61.7 | 43.7 | 46.8 | 49.9 | 44.7 | 40.7 | 46.1 |
| 1978 | 57.3 | 65.3 | 63.9 | 62.6 | 45.3 | 46.3 | 51.4 | 46.8 | 39.4 | 45.5 |
| 1979 | 56.3 | 64.3 | 64.3 | 63.1 | 43.3 | 46.3 | 51.7 | 47.0 | 37.7 | 44.7 |
| 1980 | 56.2 | 61.8 | 66.5 | 66.2 | 43.8 | 46.6 | 51.2 | 44.3 | 35.8 | 43.0 |
| 1981 | 55.9 | 60.7 | 65.6 | 66.5 | 45.5 | 47.2 | 52.0 | 44.4 | 36.1 | 43.1 |
| 1982 | 57.7 | 63.8 | 63.8 | 61.2 | 45.5 | 48.4 | 50.7 | 45.4 | 38.9 | 45.5 |
| 1983 | 57.5 | 62.0 | 64.2 | 59.6 | 45.6 | 47.8 | 50.9 | 45.6 | 37.9 | 46.5 |
| 1984 | 58.8 | 64.4 | 64.7 | 60.1 | 45.8 | 48.3 | 51.5 | 48.7 | 42.7 | 48.2 |
| 1985 | 61.4 | 65.6 | 63.7 | 60.6 | 45.4 | 48.7 | 51.7 | 48.9 | 42.4 | 49.9 |
| 1986 | 60.0 | 65.4 | 62.3 | 59.4 | 43.8 | 47.2 | 51.0 | 49.4 | 39.0 | 48.8 |
| 1987 | 58.8 | 63.5 | 61.3 | 58.8 | 44.1 | 46.3 | 50.7 | 51.6 | 40.5 | 48.7 |
| 1988 | 58.1 | 63.7 | 61.2 | 58.4 | 44.3 | 45.5 | 51.2 | 48.9 | 41.4 | 48.4 |
| 1989 | 57.5 | 63.1 | 60.7 | 59.0 | 44.7 | 45.5 | 50.7 | 47.9 | 41.2 | 48.7 |
| 1990 | 57.6 | 62.6 | 60.9 | 58.7 | 45.0 | 45.8 | 51.0 | 47.5 | 40.5 | 48.4 |
| 1991 | 58.2 | 62.3 | 60.4 | 57.6 | 44.5 | 45.2 | 51.6 | 50.0 | 41.4 | 46.7 |
| 1992 | 59.8 | 62.2 | 59.9 | 57.7 | 43.9 | 43.7 | 49.9 | 47.1 | 41.4 | 45.2 |
| 1993 | 60.2 | 60.7 | 58.8 | 57.1 | 44.5 | 44.6 | 50.5 | 48.0 | 41.7 | 44.6 |
| 1994 | 60.2 | 61.4 | 60.8 | 56.4 | 43.4 | 44.6 | 50.2 | 47.5 | 43.2 | 43.4 |
| 1995 | 59.6 | 62.2 | 61.5 | 56.9 | 44.1 | 45.2 | 52.5 | 47.0 | 44.8 | 44.1 |

TABLE 2: FEDERAL GOVERNMENT SHARE OF TOTAL PUBLIC SPENDING EXCLUDING INTERGOVERNMENTAL TRANSFERS (PERCENTAGES)

| Year | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|-------------|--------------|---------------|-------------|-------------|-------------|-------------|-------------|--------------|-------------|-------------|
| 1961 | 53.7 | 61.3 | 68.1 | 59.3 | 49.9 | 55.3 | 55.3 | 48.6 | 46.4 | 50.0 |
| 1962 | 50.0 | 66.1 | 67.2 | 58.3 | 47.6 | 54.5 | 55.4 | 49.9 | 47.5 | 50.4 |
| 1963 | 52.2 | 60.6 | 66.9 | 60.7 | 46.3 | 52.2 | 52.9 | 44.2 | 45.7 | 48.6 |
| 1964 | 47.7 | 59.5 | 65.5 | 54.3 | 44.3 | 51.7 | 51.7 | 42.4 | 45.2 | 48.6 |
| 1965 | 46.0 | 67.6 | 63.2 | 54.6 | 40.2 | 49.1 | 50.4 | 42.0 | 41.9 | 46.9 |
| 1966 | 44.5 | 55.2 | 62.5 | 54.8 | 39.1 | 49.0 | 50.3 | 41.8 | 38.5 | 46.1 |
| 1967 | 38.6 | 55.0 | 61.8 | 56.1 | 38.5 | 45.9 | 49.4 | 40.6 | 34.9 | 45.3 |
| 1968 | 40.1 | 55.7 | 60.3 | 51.4 | 37.4 | 43.6 | 48.2 | 40.4 | 36.5 | 43.4 |
| 1969 | 41.7 | 55.0 | 59.1 | 46.7 | 37.9 | 42.2 | 45.7 | 41.9 | 35.1 | 41.4 |
| 1970 | 41.0 | 53.7 | 54.0 | 50.6 | 35.7 | 40.2 | 44.1 | 43.2 | 34.7 | 40.9 |
| 1971 | 38.2 | 50.6 | 54.1 | 45.9 | 34.9 | 39.7 | 43.4 | 42.0 | 33.7 | 41.5 |
| 1972 | 42.2 | 50.7 | 54.7 | 47.0 | 37.7 | 41.6 | 43.6 | 42.1 | 35.2 | 43.2 |
| 1973 | 44.3 | 50.7 | 54.1 | 50.6 | 36.0 | 42.5 | 43.5 | 42.6 | 35.5 | 42.1 |
| 1974 | 46.8 | 50.5 | 59.3 | 54.2 | 39.9 | 42.7 | 40.9 | 42.5 | 35.4 | 41.1 |
| 1975 | 48.3 | 52.1 | 58.7 | 55.7 | 42.3 | 42.7 | 40.3 | 41.0 | 34.2 | 40.1 |
| 1976 | 44.6 | 52.0 | 59.5 | 54.5 | 37.8 | 41.6 | 40.1 | 39.3 | 34.7 | 39.9 |
| 1977 | 46.5 | 52.4 | 60.1 | 53.5 | 36.1 | 41.9 | 41.3 | 38.7 | 34.4 | 40.5 |
| 1978 | 45.5 | 55.4 | 57.4 | 53.8 | 37.5 | 41.6 | 43.2 | 40.3 | 33.5 | 40.5 |
| 1979 | 44.4 | 54.1 | 58.2 | 54.7 | 35.9 | 41.5 | 43.2 | 40.8 | 32.5 | 39.5 |
| 1980 | 45.3 | 50.9 | 60.9 | 60.2 | 36.9 | 42.2 | 42.6 | 38.1 | 31.1 | 38.1 |
| 1981 | 45.3 | 51.0 | 60.0 | 60.7 | 39.2 | 43.2 | 44.7 | 38.4 | 31.6 | 38.8 |
| 1982 | 48.0 | 54.7 | 58.0 | 53.9 | 38.6 | 45.2 | 43.9 | 40.2 | 34.4 | 41.7 |
| 1983 | 49.2 | 53.5 | 58.6 | 51.9 | 38.3 | 44.2 | 44.5 | 41.3 | 34.2 | 42.4 |
| 1984 | 50.4 | 56.0 | 59.2 | 52.6 | 38.6 | 44.4 | 44.8 | 44.4 | 38.9 | 43.8 |
| 1985 | 52.7 | 58.4 | 58.3 | 52.8 | 38.7 | 44.7 | 45.2 | 44.4 | 37.8 | 45.3 |
| 1986 | 51.3 | 58.5 | 56.8 | 51.6 | 37.6 | 43.5 | 45.3 | 45.1 | 34.6 | 44.3 |
| 1987 | 49.4 | 56.3 | 55.4 | 50.6 | 37.9 | 42.5 | 44.5 | 46.8 | 35.8 | 44.2 |
| 1988 | 48.1 | 56.3 | 54.8 | 50.1 | 38.1 | 41.7 | 44.1 | 43.7 | 36.5 | 43.9 |
| 1989 | 47.6 | 55.4 | 54.3 | 50.8 | 38.8 | 42.1 | 43.7 | 42.1 | 36.8 | 44.5 |
| 1990 | 47.8 | 54.7 | 54.5 | 50.5 | 39.5 | 42.5 | 44.0 | 40.9 | 36.2 | 44.7 |
| 1991 | 49.6 | 55.3 | 54.5 | 50.3 | 39.5 | 41.9 | 44.5 | 43.5 | 37.3 | 43.4 |
| 1992 | 51.4 | 55.3 | 53.9 | 49.6 | 38.6 | 40.2 | 43.1 | 40.5 | 36.3 | 41.4 |
| 1993 | 51.9 | 54.1 | 52.8 | 49.3 | 38.9 | 40.6 | 43.6 | 41.3 | 37.0 | 40.6 |
| 1994 | 52.2 | 54.3 | 54.4 | 48.8 | 38.0 | 40.7 | 43.0 | 40.8 | 39.0 | 39.6 |
| 1995 | 50.9 | 55.1 | 54.5 | 48.7 | 38.2 | 41.4 | 45.0 | 41.9 | 41.0 | 40.2 |

TABLE 3: FEDERAL GOVERNMENT SHARE OF TOTAL GOVERNMENT REVENUES INCLUDING INTERGOVERNMENTAL TRANSFERS (PERCENTAGES)

| YEAR | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|-------------|--------------|---------------|-------------|-------------|-------------|-------------|-------------|--------------|-------------|-------------|
| 1961 | 35.8 | 37.8 | 45.1 | 40.6 | 58.8 | 61.8 | 49.5 | 34.0 | 45.8 | 49.6 |
| 1962 | 31.1 | 30.0 | 41.0 | 37.9 | 55.6 | 58.3 | 46.9 | 30.2 | 42.4 | 48.7 |
| 1963 | 32.8 | 27.9 | 41.9 | 38.5 | 54.2 | 58.0 | 45.6 | 30.5 | 41.2 | 48.1 |
| 1964 | 32.5 | 29.5 | 43.2 | 39.2 | 53.6 | 59.3 | 47.4 | 31.6 | 43.2 | 49.1 |
| 1965 | 29.4 | 23.5 | 41.8 | 37.7 | 51.2 | 58.8 | 44.1 | 31.5 | 41.5 | 48.0 |
| 1966 | 29.8 | 28.1 | 40.8 | 37.8 | 49.5 | 57.0 | 44.1 | 31.8 | 42.7 | 47.2 |
| 1967 | 26.7 | 25.8 | 38.9 | 36.6 | 47.2 | 55.0 | 43.7 | 32.2 | 42.4 | 47.2 |
| 1968 | 27.4 | 28.6 | 39.2 | 36.3 | 45.9 | 53.7 | 42.7 | 31.4 | 42.7 | 46.8 |
| 1969 | 27.9 | 26.5 | 40.3 | 37.9 | 46.8 | 54.1 | 42.9 | 31.7 | 43.8 | 48.2 |
| 1970 | 26.6 | 27.6 | 41.9 | 38.0 | 45.2 | 51.7 | 41.2 | 31.2 | 42.6 | 47.5 |
| 1971 | 26.0 | 25.4 | 41.8 | 37.0 | 43.5 | 51.9 | 41.4 | 31.0 | 41.9 | 47.8 |
| 1972 | 28.5 | 27.6 | 41.3 | 37.6 | 43.1 | 53.0 | 42.0 | 32.1 | 42.9 | 48.7 |
| 1973 | 27.9 | 26.2 | 41.6 | 37.8 | 42.5 | 54.2 | 43.4 | 34.4 | 44.1 | 48.7 |
| 1974 | 27.9 | 28.1 | 43.6 | 38.4 | 42.9 | 54.8 | 44.4 | 41.7 | 53.6 | 48.5 |
| 1975 | 25.3 | 28.6 | 41.5 | 37.7 | 41.1 | 53.7 | 42.5 | 39.6 | 50.5 | 46.2 |
| 1976 | 27.2 | 28.9 | 43.1 | 38.7 | 40.9 | 52.6 | 41.5 | 38.5 | 46.3 | 45.6 |
| 1977 | 23.6 | 27.3 | 38.9 | 34.3 | 37.0 | 50.2 | 38.2 | 34.9 | 41.7 | 42.6 |
| 1978 | 21.4 | 25.7 | 38.2 | 32.4 | 35.4 | 49.3 | 37.7 | 32.0 | 35.7 | 41.0 |
| 1979 | 22.7 | 26.5 | 38.3 | 34.0 | 35.3 | 48.7 | 36.6 | 35.3 | 37.6 | 41.1 |
| 1980 | 22.9 | 26.2 | 37.8 | 35.1 | 36.7 | 49.9 | 37.5 | 37.0 | 37.4 | 43.2 |
| 1981 | 29.4 | 31.8 | 43.3 | 43.0 | 38.3 | 51.3 | 40.7 | 42.7 | 43.9 | 44.3 |
| 1982 | 27.7 | 31.7 | 41.4 | 37.6 | 32.8 | 50.1 | 39.2 | 41.0 | 44.5 | 42.9 |
| 1983 | 27.8 | 32.2 | 40.7 | 36.7 | 34.2 | 48.9 | 37.4 | 37.3 | 41.5 | 41.3 |
| 1984 | 27.9 | 31.1 | 41.3 | 36.0 | 35.4 | 47.8 | 36.6 | 36.9 | 42.0 | 40.6 |
| 1985 | 26.6 | 32.1 | 41.4 | 34.6 | 36.0 | 48.4 | 36.6 | 36.1 | 42.8 | 40.9 |
| 1986 | 28.3 | 37.1 | 42.4 | 37.3 | 38.0 | 50.1 | 38.8 | 37.2 | 41.0 | 42.6 |
| 1987 | 29.0 | 35.9 | 42.7 | 37.9 | 38.4 | 49.8 | 36.7 | 34.5 | 40.5 | 43.3 |
| 1988 | 29.2 | 35.5 | 42.9 | 38.2 | 38.0 | 49.5 | 35.4 | 33.5 | 40.6 | 42.6 |
| 1989 | 29.4 | 34.8 | 42.8 | 38.2 | 38.3 | 49.0 | 35.3 | 31.3 | 41.2 | 43.0 |
| 1990 | 29.7 | 35.4 | 42.2 | 38.3 | 38.7 | 48.9 | 36.4 | 31.3 | 41.0 | 43.9 |
| 1991 | 33.4 | 38.0 | 44.3 | 39.7 | 38.7 | 49.1 | 37.2 | 35.1 | 43.0 | 46.3 |
| 1992 | 33.4 | 37.7 | 45.0 | 39.8 | 38.8 | 49.4 | 38.1 | 34.5 | 43.2 | 45.6 |
| 1993 | 32.5 | 37.8 | 45.0 | 40.7 | 37.9 | 47.6 | 36.7 | 32.8 | 43.5 | 43.6 |
| 1994 | 32.9 | 37.8 | 43.4 | 40.2 | 37.9 | 47.4 | 36.4 | 33.2 | 43.6 | 42.8 |
| 1995 | 33.3 | 38.6 | 43.2 | 40.1 | 37.6 | 47.7 | 37.2 | 35.7 | 45.5 | 43.3 |

TABLE 4: FEDERAL GOVERNMENT SHARE OF TOTAL GOVERNMENT REVENUES EXCLUDING INTERGOVERNMENTAL TRANSFERS (PERCENTAGES)

| YEAR | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|-------------|--------------|---------------|-------------|-------------|-------------|-------------|-------------|--------------|-------------|-------------|
| 1961 | 58.1 | 56.0 | 57.8 | 53.4 | 62.8 | 66.1 | 58.1 | 40.4 | 52.3 | 56.9 |
| 1962 | 52.3 | 46.2 | 52.0 | 49.5 | 60.6 | 61.8 | 53.2 | 35.2 | 46.9 | 52.4 |
| 1963 | 52.2 | 42.9 | 51.6 | 48.9 | 59.1 | 61.5 | 51.4 | 34.6 | 45.5 | 51.7 |
| 1964 | 50.8 | 44.8 | 52.8 | 50.6 | 59.2 | 62.2 | 53.5 | 35.5 | 46.9 | 52.1 |
| 1965 | 50.0 | 37.5 | 53.2 | 50.7 | 55.9 | 61.8 | 50.3 | 35.7 | 45.2 | 51.2 |
| 1966 | 48.2 | 44.4 | 53.5 | 50.0 | 54.0 | 60.2 | 51.6 | 36.6 | 46.7 | 50.3 |
| 1967 | 46.4 | 42.5 | 53.3 | 50.9 | 52.0 | 58.2 | 50.9 | 36.7 | 46.5 | 50.1 |
| 1968 | 45.7 | 44.9 | 54.1 | 50.5 | 50.8 | 57.1 | 49.0 | 36.0 | 47.1 | 50.1 |
| 1969 | 46.5 | 43.3 | 53.6 | 52.3 | 51.7 | 57.5 | 49.2 | 36.5 | 48.4 | 51.4 |
| 1970 | 44.4 | 45.3 | 53.5 | 51.6 | 50.9 | 55.6 | 48.1 | 36.6 | 47.3 | 51.4 |
| 1971 | 44.8 | 42.9 | 54.0 | 52.4 | 50.3 | 56.0 | 49.5 | 38.8 | 46.8 | 52.1 |
| 1972 | 46.0 | 46.5 | 53.4 | 51.7 | 49.0 | 57.2 | 49.6 | 41.1 | 47.6 | 52.4 |
| 1973 | 44.4 | 43.0 | 53.8 | 52.5 | 47.7 | 57.9 | 51.4 | 42.9 | 48.1 | 51.9 |
| 1974 | 44.4 | 46.3 | 56.1 | 52.5 | 48.6 | 58.7 | 52.0 | 48.4 | 58.3 | 52.1 |
| 1975 | 40.8 | 49.0 | 55.8 | 53.8 | 47.2 | 58.5 | 51.6 | 45.5 | 54.2 | 50.2 |
| 1976 | 41.2 | 50.6 | 56.5 | 54.1 | 46.4 | 57.5 | 49.8 | 42.9 | 49.7 | 50.0 |
| 1977 | 36.7 | 46.6 | 53.6 | 48.4 | 43.0 | 54.7 | 46.5 | 39.0 | 44.6 | 46.7 |
| 1978 | 34.3 | 44.7 | 52.0 | 46.7 | 41.5 | 53.4 | 46.4 | 36.4 | 37.9 | 44.7 |
| 1979 | 35.8 | 44.7 | 51.5 | 48.4 | 41.0 | 52.8 | 45.4 | 39.7 | 39.6 | 44.7 |
| 1980 | 35.7 | 43.8 | 51.2 | 48.7 | 42.5 | 53.8 | 46.6 | 41.1 | 39.1 | 46.8 |
| 1981 | 43.6 | 48.8 | 56.9 | 56.9 | 43.8 | 55.0 | 48.8 | 47.1 | 45.7 | 47.5 |
| 1982 | 42.4 | 49.6 | 54.5 | 52.1 | 38.4 | 53.3 | 47.1 | 45.6 | 46.7 | 46.2 |
| 1983 | 40.9 | 48.5 | 52.9 | 49.9 | 40.3 | 52.4 | 44.7 | 41.0 | 43.5 | 45.0 |
| 1984 | 40.8 | 47.0 | 53.6 | 48.4 | 41.4 | 51.5 | 44.4 | 41.0 | 44.3 | 44.7 |
| 1985 | 40.8 | 47.9 | 52.7 | 47.6 | 41.8 | 52.1 | 44.0 | 40.6 | 45.6 | 45.4 |
| 1986 | 41.7 | 52.2 | 53.0 | 49.2 | 43.0 | 53.3 | 45.4 | 42.2 | 44.2 | 46.9 |
| 1987 | 42.5 | 49.8 | 53.2 | 49.7 | 43.2 | 52.9 | 43.4 | 39.6 | 43.7 | 47.6 |
| 1988 | 43.0 | 49.7 | 54.1 | 50.0 | 42.6 | 52.4 | 42.5 | 38.6 | 44.1 | 46.5 |
| 1989 | 43.1 | 49.0 | 54.0 | 50.1 | 42.9 | 51.7 | 42.4 | 35.8 | 44.5 | 46.5 |
| 1990 | 43.2 | 49.8 | 53.1 | 50.2 | 43.1 | 51.6 | 43.6 | 36.6 | 44.0 | 47.0 |
| 1991 | 46.4 | 51.1 | 54.6 | 50.4 | 42.8 | 52.1 | 45.0 | 41.8 | 46.1 | 49.3 |
| 1992 | 46.8 | 50.3 | 55.2 | 51.4 | 43.2 | 52.7 | 45.4 | 40.5 | 47.1 | 48.9 |
| 1993 | 45.6 | 49.6 | 55.4 | 51.6 | 42.6 | 51.2 | 43.8 | 38.4 | 47.0 | 46.9 |
| 1994 | 45.5 | 49.8 | 54.1 | 50.2 | 42.3 | 50.7 | 43.5 | 38.3 | 46.5 | 45.7 |
| 1995 | 46.1 | 50.7 | 54.8 | 50.5 | 42.2 | 50.9 | 44.5 | 39.9 | 48.2 | 46.2 |

TABLE 5: TRANSFER PAYMENTS FROM FEDERAL TO PROVINCIAL GOVERNMENT AS A SHARE OF PROVINCIAL GOVERNMENT REVENUES (PERCENTAGES)

| Year | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|-------------|--------------|---------------|-------------|-------------|-------------|-------------|-------------|--------------|-------------|-------------|
| 1961 | 59.8 | 52.2 | 40.0 | 40.5 | 15.6 | 17.0 | 29.2 | 23.9 | 23.1 | 25.6 |
| 1962 | 58.7 | 50.0 | 35.9 | 37.8 | 18.8 | 13.4 | 22.1 | 20.3 | 16.7 | 13.6 |
| 1963 | 55.3 | 48.4 | 32.4 | 34.5 | 18.2 | 13.7 | 20.9 | 17.1 | 16.1 | 13.2 |
| 1964 | 53.2 | 48.4 | 32.1 | 37.2 | 20.4 | 11.3 | 21.8 | 16.1 | 14.0 | 11.6 |
| 1965 | 58.3 | 48.7 | 36.8 | 41.2 | 17.1 | 11.8 | 22.3 | 17.2 | 14.0 | 12.1 |
| 1966 | 54.5 | 51.2 | 40.1 | 39.4 | 16.4 | 12.4 | 25.9 | 19.0 | 15.0 | 11.8 |
| 1967 | 57.9 | 53.1 | 44.3 | 44.3 | 17.6 | 11.9 | 24.9 | 18.2 | 15.2 | 11.3 |
| 1968 | 55.1 | 50.9 | 45.2 | 44.2 | 17.8 | 12.9 | 22.7 | 18.6 | 16.0 | 12.5 |
| 1969 | 55.5 | 52.8 | 41.4 | 44.3 | 17.8 | 12.8 | 22.4 | 19.1 | 16.7 | 12.2 |
| 1970 | 54.6 | 53.9 | 37.5 | 42.5 | 20.5 | 14.4 | 24.4 | 21.5 | 17.5 | 14.3 |
| 1971 | 56.8 | 54.6 | 38.7 | 46.8 | 24.0 | 15.3 | 28.0 | 29.1 | 17.8 | 15.8 |
| 1972 | 53.3 | 56.2 | 38.5 | 43.5 | 21.0 | 15.4 | 26.5 | 32.1 | 17.5 | 13.6 |
| 1973 | 51.6 | 52.9 | 38.8 | 45.1 | 19.0 | 14.1 | 27.6 | 30.1 | 14.9 | 12.0 |
| 1974 | 51.6 | 54.5 | 39.5 | 43.5 | 20.3 | 14.8 | 26.5 | 23.9 | 17.6 | 13.4 |
| 1975 | 50.9 | 58.3 | 43.7 | 47.9 | 21.8 | 17.8 | 30.7 | 21.5 | 13.9 | 15.0 |
| 1976 | 46.6 | 60.3 | 41.8 | 46.3 | 20.3 | 18.1 | 28.4 | 16.8 | 12.6 | 15.9 |
| 1977 | 46.7 | 56.8 | 44.8 | 44.3 | 22.0 | 16.4 | 29.1 | 16.0 | 11.0 | 15.5 |
| 1978 | 47.8 | 57.2 | 42.9 | 45.5 | 22.6 | 15.3 | 30.1 | 17.9 | 9.0 | 13.8 |
| 1979 | 47.3 | 55.4 | 41.6 | 45.1 | 21.3 | 15.0 | 30.6 | 17.4 | 8.1 | 13.6 |
| 1980 | 46.4 | 54.4 | 41.9 | 43.0 | 21.3 | 14.4 | 31.2 | 15.9 | 7.0 | 13.5 |
| 1981 | 46.2 | 51.0 | 42.0 | 42.9 | 20.4 | 13.7 | 28.0 | 16.2 | 7.0 | 12.2 |
| 1982 | 47.9 | 52.8 | 41.0 | 44.7 | 21.9 | 11.9 | 27.4 | 17.0 | 8.5 | 12.7 |
| 1983 | 44.6 | 49.5 | 39.1 | 41.8 | 22.9 | 13.0 | 26.2 | 14.3 | 8.0 | 14.1 |
| 1984 | 43.9 | 49.2 | 39.1 | 40.1 | 22.5 | 13.5 | 27.5 | 15.9 | 9.1 | 15.3 |
| 1985 | 47.4 | 48.6 | 36.5 | 41.6 | 21.7 | 13.9 | 26.6 | 17.4 | 10.8 | 16.5 |
| 1986 | 45.0 | 46.0 | 34.8 | 38.4 | 18.8 | 12.1 | 23.8 | 18.8 | 12.0 | 15.9 |
| 1987 | 44.7 | 43.7 | 34.5 | 38.3 | 18.0 | 11.7 | 24.2 | 19.7 | 12.5 | 15.6 |
| 1988 | 45.2 | 44.4 | 36.3 | 38.1 | 17.4 | 10.9 | 25.9 | 19.8 | 13.1 | 14.4 |
| 1989 | 44.8 | 44.5 | 36.3 | 38.6 | 17.2 | 10.1 | 25.7 | 18.4 | 12.5 | 13.2 |
| 1990 | 44.6 | 44.7 | 35.4 | 38.5 | 16.6 | 10.3 | 26.2 | 21.2 | 11.5 | 11.9 |
| 1991 | 42.1 | 41.4 | 34.0 | 35.1 | 15.6 | 11.4 | 27.6 | 24.5 | 11.7 | 11.4 |
| 1992 | 43.0 | 40.3 | 33.7 | 37.5 | 16.6 | 12.3 | 25.9 | 22.9 | 14.5 | 12.2 |
| 1993 | 42.6 | 38.3 | 34.0 | 35.8 | 17.5 | 13.6 | 25.8 | 21.5 | 13.3 | 12.4 |
| 1994 | 41.2 | 39.0 | 34.9 | 33.3 | 16.6 | 12.5 | 25.5 | 20.1 | 10.9 | 10.8 |
| 1995 | 41.7 | 38.8 | 37.2 | 34.5 | 17.5 | 12.2 | 26.3 | 16.4 | 10.3 | 11.0 |

TABLE 6: VERTICAL IMBALANCE - PROVINCIAL GOVERNMENT, BEFORE INTERGOVERNMENTAL TRANSFERS $[((\text{EXPENDITURES} - \text{TRANSFERS}) - (\text{REVENUES} - \text{TRANSFERS RECEIVED})) / (\text{EXPENDITURES} - \text{TRANSFERS})] \times 100$

| Year | NFLD. | P.E.I. | N.S. | N.B. | QUE. | ONT. | MAN. | SASK. | ALB. | B.C. |
|------|-------|--------|------|------|------|------|------|-------|-------|-------|
| 1961 | 58.9 | 54.2 | 35.2 | 35.3 | 8.8 | 8.9 | 26.6 | 17.4 | 19.6 | 14.9 |
| 1962 | 54.8 | 33.3 | 25.0 | 30.1 | 8.4 | -3.8 | 18.3 | 3.7 | 6.2 | -1.3 |
| 1963 | 50.5 | 42.9 | 24.3 | 19.4 | 7.8 | -0.3 | 18.4 | 6.7 | 6.1 | -0.9 |
| 1964 | 52.2 | 50.0 | 27.5 | 35.8 | 8.9 | -3.0 | 18.1 | 7.9 | 8.1 | -7.9 |
| 1965 | 52.6 | 13.0 | 29.4 | 30.7 | 11.9 | -1.5 | 11.4 | 3.3 | 6.6 | -11.9 |
| 1966 | 53.7 | 53.5 | 32.5 | 29.8 | 11.9 | -4.3 | 16.3 | 6.2 | 18.1 | -10.5 |
| 1967 | 64.3 | 54.0 | 31.7 | 31.7 | 12.1 | 2.0 | 16.3 | 7.4 | 26.2 | -8.2 |
| 1968 | 56.4 | 50.0 | 36.1 | 37.2 | 13.5 | 5.4 | 11.0 | 10.2 | 20.7 | -4.4 |
| 1969 | 52.9 | 41.4 | 30.3 | 44.4 | 11.0 | 5.6 | 9.3 | 8.6 | 20.3 | -5.6 |
| 1970 | 50.2 | 48.5 | 37.8 | 31.7 | 18.5 | 10.4 | 13.5 | 13.7 | 17.8 | 5.1 |
| 1971 | 54.3 | 46.3 | 38.9 | 44.6 | 20.8 | 13.5 | 19.7 | 16.6 | 18.1 | 2.9 |
| 1972 | 53.8 | 54.0 | 31.9 | 41.4 | 17.1 | 13.3 | 18.8 | 21.9 | 17.0 | 2.8 |
| 1973 | 50.0 | 48.6 | 32.8 | 38.0 | 18.0 | 11.4 | 24.3 | 17.3 | 7.4 | -3.5 |
| 1974 | 48.7 | 53.6 | 35.1 | 34.5 | 15.9 | 12.2 | 27.1 | 7.3 | -12.9 | 2.3 |
| 1975 | 48.5 | 53.6 | 43.0 | 44.5 | 20.9 | 23.6 | 33.4 | 14.1 | -15.0 | 11.6 |
| 1976 | 47.9 | 57.3 | 42.6 | 46.2 | 26.1 | 21.9 | 31.0 | 9.4 | -20.6 | 10.1 |
| 1977 | 43.2 | 55.9 | 39.7 | 41.6 | 25.4 | 18.4 | 29.4 | 8.3 | -31.5 | 3.8 |
| 1978 | 45.1 | 52.4 | 43.2 | 39.0 | 22.5 | 18.0 | 31.0 | 6.0 | -45.3 | 2.9 |
| 1979 | 45.6 | 49.8 | 42.3 | 38.4 | 25.4 | 13.3 | 29.5 | 6.1 | -39.7 | 0.8 |
| 1980 | 47.3 | 51.5 | 41.2 | 40.8 | 28.2 | 15.5 | 32.7 | 4.6 | -38.2 | 10.5 |
| 1981 | 48.6 | 51.6 | 44.2 | 40.8 | 25.4 | 15.3 | 29.1 | 9.8 | -37.0 | 10.5 |
| 1982 | 51.9 | 50.5 | 45.1 | 49.6 | 26.6 | 17.9 | 35.2 | 22.5 | -20.5 | 17.1 |
| 1983 | 52.1 | 51.2 | 41.3 | 44.9 | 27.1 | 18.3 | 33.6 | 18.6 | -4.4 | 18.9 |
| 1984 | 47.8 | 44.8 | 40.3 | 40.6 | 26.5 | 13.6 | 33.6 | 20.0 | -10.2 | 16.2 |
| 1985 | 46.6 | 46.6 | 37.9 | 41.3 | 26.9 | 14.0 | 32.1 | 24.3 | -4.9 | 15.5 |
| 1986 | 45.1 | 43.5 | 36.7 | 36.6 | 23.5 | 9.6 | 31.8 | 33.4 | 18.4 | 17.3 |
| 1987 | 44.0 | 41.6 | 34.2 | 34.6 | 18.2 | 7.5 | 29.2 | 24.1 | 14.1 | 14.6 |
| 1988 | 44.3 | 41.5 | 35.4 | 34.6 | 14.1 | 4.6 | 25.2 | 26.2 | 13.1 | 7.7 |
| 1989 | 45.4 | 41.7 | 37.1 | 35.3 | 16.6 | 3.1 | 27.5 | 14.9 | 16.1 | 4.0 |
| 1990 | 44.7 | 42.8 | 34.6 | 35.7 | 17.2 | 8.5 | 28.8 | 20.8 | 11.4 | 4.0 |
| 1991 | 44.2 | 41.2 | 35.8 | 35.7 | 19.6 | 18.8 | 31.4 | 28.9 | 15.3 | 14.0 |
| 1992 | 43.3 | 39.8 | 36.8 | 36.5 | 22.3 | 25.2 | 32.2 | 29.1 | 20.0 | 15.1 |
| 1993 | 41.6 | 40.8 | 40.6 | 35.6 | 22.2 | 22.6 | 28.7 | 20.1 | 15.6 | 12.3 |
| 1994 | 39.9 | 36.9 | 33.0 | 32.0 | 22.1 | 17.6 | 26.1 | 15.2 | 1.8 | 7.2 |
| 1995 | 38.9 | 33.4 | 32.6 | 30.0 | 19.4 | 15.2 | 20.2 | 13.7 | -1.6 | 5.9 |