

Defining Fiscal Federalism

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1 Ongoing Trends in Fiscal Federalism

The subject of fiscal federalism is a topical and central issue on political agendas and in academic debate due to its importance for the very existence of any federal system.¹ The allocation of financial resources to each tier of government is typically a dynamic process that frequently undergoes formal and informal changes. Changes to this process can shift powers and responsibilities in favour of either the central or the decentralised tiers of government. Indeed, both centralisation (or re-centralisation) and decentralisation can occur simultaneously in this area.

This holds particularly true against the backdrop of the ongoing economic and financial crisis. Countries' constitutional design and institutional settings in fiscal and financial matters continue being revised in order to better adapt to current challenges that result from both the supranational and domestic spheres of economic governance. All in all, financial stability has to be achieved while boosting economic performance. Federal systems achieve this either by adjusting existing legal frameworks or by attempting to overhaul the entire system starting from its principles and foundations.² In any case, the rationale behind these processes lies in the struggle between global competitiveness and autonomy claims. Multilevel systems have to come to terms with the challenges that arise from the interdependence of governments and governance actors. Who is in charge of adopting decisions in this field? Who is responsible for their implementation? Which tier of government is better at attributing legislative and executive powers in financial and fiscal

¹ The notion of "federal system" is used according to the definition provided in "Introduction: Methodological Approach and Structure of This Book" in this volume, at fn no. 3.

² On ongoing reform processes and debates, see H. Blöchliger and C. Vammalle, *Reforming Fiscal Federalism and Local Government: Beyond the Zero-Sum Game* (Paris: OECD Fiscal Federalism Studies, 2012); E. Alber and A. Valdesalici, "Reforming Fiscal Federalism in Europe: Where Does the Pendulum Swing?" *L'Europe en Formation*, 1 (2012) 325–366; and also, S. Ortino *et al.* (eds.), *The Changing Faces of Federalism: Institutional Reconfiguration in Europe from East to West* (Manchester: Manchester University Press, 2005).

matters? How can a state best achieve stability and meet redistributive objectives, while remaining a competitive player in the international arena? How can it reduce public expenditure and public debt, while still allowing for an allocation of responsibilities that matches citizens' needs and preferences best? How can it respond effectively to the increasing democratic deficit, which has a particular impact on decision-making processes in financial matters at all levels and in all contexts?

The prevailing opinion holds that decentralisation of public services enhances efficiency.³ At the same time, however, the public sector is specialising and becoming more complex, while the functions performed by the various tiers of government are increasingly overlapping. Many federal systems have failed to perform these functions, as is shown by the existence of rampant public debt and the weakening of the welfare state. As a result, the need to rethink existing structures is stronger than ever. Growing pressures for change are emerging that require a flexible approach whereby territorial entities make claims for more autonomy on both the expenditure and the revenue side (at least at the margin),⁴ while equality and solidarity remain for the sake of territorial cohesion and unity.

As this scenario suggests, there is permanent friction between supranational integration, national (fiscal) sovereignty and subnational autonomy that challenges the classical paradigms of fiscal federalism.

2 Going Back to the Origins of the Concept

In the beginning, this topic was within the purview of economic studies and of scholars of public finance, in particular, whose investigations referred to the phenomenon in terms of federal finance.⁵ Only later did the expression *fiscal*

³ At the same time, the literature warns of the need to put certain constraints on decentralisation; otherwise, efficiency gains could vanish. See W.E. Oates, *Fiscal Federalism* (New York: Harcourt Brace Jovanovich, 1972) 4–11.

⁴ On the importance of vesting subnational entities with at least a marginal power over their financing, see, among others, M.F. Ambrosiano and M. Bordinon, "Normative vs Positive Theories of Revenue Assignments in Federations", in E. Ahmad and G. Brosio (eds.), *Handbook of Fiscal Federalism* (Cheltenham: Edward Elgar, 2006) 306–338; and also R. Bird, "Tax Assignment Revisited", in J.G. Head *et al.* (eds.), *Tax Reform in the 21. Century: A Volume in Memory of Richard Musgrave* (The Hague: Kluwer Law International, 2009) 441–470, at 453.

⁵ In this respect, see R.A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw-Hill, 1959).

federalism appear in the literature,⁶ and it was referred to as the “assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions”.⁷

The wording itself expresses the strong link between fiscal federalism and the federal state. In this respect, the United States of America represented the prototype. Due to the aggregative nature of the American federation, the debate focused primarily on the need to grant certain financial independence to the federal level.⁸ This perspective was only later reversed, when so-called holding-together federations (e.g. Belgium and Spain) or those systems that resulted from a combination of aggregative and devolutionary processes (e.g. India and Canada) were considered. In these cases, research has concentrated mostly on the margin of autonomy conferred upon the subnational levels of government.

The first generation of studies on fiscal federalism addressed the topic by essentially adopting a theoretical approach. They laid out a general normative framework that considers decision makers to be “benevolent social planners” in the way that they allocate public functions and resources and that uses a standard three-branch model to describe this allocation.⁹

While these models prevailed in the 1950s and 1960s, they did not actually find any correspondence in practice. First of all, there is no single system that fully reflects all of the assumptions about the assignment of functions and resources. Second, it soon became clear that decision makers could not be treated as “custodian[s] of the public interest”.¹⁰

6 Emblematic is the work of Oates, *Fiscal Federalism*, *supra*.

7 In this sense, see W.E. Oates, “An Essay on Fiscal Federalism”, *Journal of Economic Literature*, 37 (1999) 1120–1149, at 1121.

8 See “Federalist No. 30–36”, in A. Hamilton *et al.*, *The Federalist Papers* (New York: McLean, 1788).

9 This refers to macroeconomic stabilisation, redistribution and allocation. In this regard, see Musgrave, *The Theory of Public Finance*, *supra*; and the famous “decentralization theorem” elaborated by Oates, *Fiscal Federalism*, *supra*, at 35–38 and 54, as later revisited by the author in Oates, “An Essay on Fiscal Federalism”, *supra*, at 1122–1123. Partially in contrast with the above-mentioned approach, the theory of Public Choice—traditionally developed in USA between the 1960s and the 1970s—considers decision makers as rational actors acting in their own interests. Accordingly, voters will be inclined to support those candidates that are more in line with their own interests and politicians will adopt decisions with the primary purpose of being re-elected. Among its most prominent scholars see: G. Brennan and J.M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980).

10 W.E. Oates, “Toward a Second-Generation Theory of Fiscal Federalism”, *International Tax and Public Finance*, 12 (2005) 349–373, at 350.

It is not by chance, therefore, that the field of investigation has expanded in recent decades. The second generation of studies on fiscal federalism progressively enriched the scope of analysis by taking into consideration systems of incentives generated by political and fiscal institutions.¹¹ The underlying rationale is that forms and procedures of vertical and horizontal revenue distribution play a role in meeting the above-outlined objectives.¹² This goes back to the assumption that different taxation systems and dissimilar political structures result in diverse incentives that influence public choices in different ways.¹³

Many factors appear to support this more expansive approach, including the tendency in the field of economics to address problems that are not necessarily confined to the borders of a single state,¹⁴ to apply a more and more interdisciplinary approach to the topic and to separate the notion of fiscal federalism from the federal state.

The first factor is linked to the growing complexity of economic processes, which implies the need to redraw jurisdictional lines and to redefine fiscal responsibilities of different levels of government.¹⁵

The second is a consequence of the changing perspective of second-generation scholars. Their new point of view has proven rather successful in expanding the field of examination, as it entails different disciplines, such as political science. One of its major attractions is that it combines the strengths and weaknesses of a variety of approaches that can provide in-depth insights into the subject matter and its critiques. Varied approaches of investigation pursue diverse objectives and, most importantly, can find different solutions to common problems. Put simply, one can assume that economists tend to put a major emphasis on efficiency and equity issues, political scientists stress the importance of responsabilisation and coordination, while public-law scholars

11 Among others, see the following studies: B.R. Weingast, "Second Generation Fiscal Federalism: Political Aspects of Decentralization and Economic Development", *World Development*, 53 (2014) 14–25; B.R. Weingast, "Second Generation Fiscal Federalism: The Implications of Fiscal Incentives", *Journal of Urban Economics*, 65 (2009) 279–293.

12 A comparison of the different theoretical approaches to the topic is offered by Oates, "Toward a Second-Generation Theory", *supra*; as well as by Weingast, "Second Generation Fiscal Federalism: Political Aspects", *supra*.

13 In this respect, see Weingast, "Second Generation Fiscal Federalism: The Implications", *supra*; and J.A. Rodden *et al.*, *Fiscal Decentralization and the Challenge of Hard Budget Constraints* (Cambridge: MIT Press, 2003).

14 In this case, the USA, as the place in which the economic notion of fiscal federalism the first came to light in the middle of the 19th century.

15 In this sense, see Oates, *Fiscal Federalism*, *supra*, at 9.

provide a critical assessment of existing legal frameworks and their functioning in light of the fundamental constitutional principles of autonomy and solidarity.¹⁶

The emancipation of the concept from the US paradigm—encouraged by the transformation of the role of the state—has itself contributed to the enrichment of the debate. Indeed, the importance of the issue and the wide reach of the phenomenon have championed the inclusion of systems exhibiting features of both federal and unitary states (so-called hybrids) in the analysis.¹⁷ The fact that fiscal federalism is no longer limited to classical federal states but now also involves all cases characterised by any form of “power de-concentration on a territorial base”¹⁸ has favoured the circulation of the related theories and the flourishing of comparative studies on the topic. The latter in particular has worked effectively in attracting more and more the interest on the part of other disciplines, including that of constitutional lawyers.¹⁹ Initially, legal studies on federalism focused almost exclusively on the vertical distribution of legislative and administrative competencies and on the institutional dimension. With a few exceptions of a non-comparative nature,²⁰ financial regimes have only become subject to comparative legal analysis in the last few decades. A change was prompted by the fact that the reform of financial systems has become more frequent since the end of the 1990s, thus attracting the attention of legal scholars. It soon became clear that this subject matter represents an

- 16 See J. Edwin Kee, “Fiscal Decentralization: Theory as Reform”, in A. Khan and W.B. Hildreth (eds.), *Financial Management Theory in the Public Sector* (Westport: Praeger, 2004) 165–186, at 165 ff.; and also S.H. Beer, “A Political Scientist’s View of Fiscal Federalism”, in W.E. Oates (ed.), *The Political Economy of Fiscal Federalism* (Toronto: Lexington Books, 1997) 21–46, at 21 ff., where the political science standpoint is well portrayed.
- 17 In this respect, see the all-encompassing classification of different types of states offered by R.L. Watts, “Federalism, Federal Political Systems, and Federations”, *Annual Review of Political Science*, 1 (1998) 117–137.
- 18 F. Palermo, “Stato regionale”, in L. Pegoraro (ed.), *Glossario di diritto pubblico comparato* (Roma: Carocci, 2009) 252–255, at 253.
- 19 G.G. Carboni, “Fiscal Federalism and Comparative Law”, *Comparative Law Review*, 5 (2014) 1–20, at 7. All in all, studies of comparative constitutional law have flourished starting in the 21st century thanks to the increasing weight assumed by constitutional courts as decision makers on key issues of a social and economic nature. This change in their role has awoken an ever more interdisciplinary interest (e.g. legal, political sociological and economic scholars are engaged in studies in this field). In this regard, see T. Ginsburg and R. Dixon, “Introduction”, in T. Ginsburg and R. Dixon (eds.), *Comparative Constitutional Law* (Cheltenham: Edward Elgar, 2011) 1–15.
- 20 Among others, see K.W. Dam, “The American Fiscal Constitution”, *The University of Chicago Law Review*, 44 (1977) 271–320, in which the author deals with the US case.

essential condition for the functioning of any federal system on the basis of its twofold nature. On the one hand, the financial endowment of the different levels of government is instrumental for the discharge of their competencies; on the other hand, there exists a strong mutual interdependence between financial and institutional components.²¹ The latter, in particular, is a two-way relationship. Assuming that revenue follows functions, financial arrangements are conditioned by the institutional structure of the state as a whole. But the contrary also holds true. The allocation of powers in financial and fiscal matters is instrumental for the allocation of legislative and administrative responsibilities, as it is intended to ensure that subnational entities can make use of their constitutionally guaranteed margin of autonomy. With regard to this second aspect, financial rules have frequently impacted institutional systems and their functioning, and in some cases can be considered responsible for their formal or informal change.²² This holds particularly true if one observes the integration process that is taking place within the EU member states that belong to the Eurozone and the impact it has on both the national and subnational tiers of government.²³

Finally, since the early 1990s, the field of fiscal federalism has expanded greatly in the context of developing countries and has generated rampant interest in its understandings and explanations of the respective systems.²⁴ The idea that fiscal federalism refers in very general terms to “the public finances of the various orders of government in a federal system”²⁵ has been crucial in this respect.

Even though there is no unanimous agreement on a common definition, this broader picture outlines a common object of investigation, which involves

21 Carboni, “Fiscal Federalism and Comparative Law”, *supra*, at 8.

22 In this respect, see F. Palermo, “Comparare il federalismo fiscale: cosa, come, perché”, in F. Palermo and M. Nicolini (eds.), *Federalismo fiscale in Europa: Esperienze straniere e spunti per il caso italiano* (Napoli: Edizioni Scientifiche Italiane, 2012) 1–11, at 2 and 10; and also, G. Brosio, *Equilibri instabili: politica ed economia nell'evoluzione dei sistemi federali* (Torino: Bollati Boringhieri, 1994) 146.

23 See G. Färber's chapter “Taxing Powers of Subnational Entities: Between Domestic and Supranational Constraints” in this volume, particularly part 4, and the literature mentioned in the footnotes.

24 D.E. Wildasin, “Fiscal Federalism”, in S.N. Durlauf and L.E. Blume (eds.), *The New Palgrave Dictionary of Economics* (2nd edn., Basingstoke: Palgrave Macmillan, 2008), http://www.dictionaryofeconomics.com/article?id=pde2008_F000118 (accessed 10 January 2017).

25 A. Shah, “Comparative Conclusions on Fiscal Federalism”, in A. Shah (ed.), *The Practice of Fiscal Federalism: Comparative Perspectives* (Montreal: McGill-Queen's University Press, 2007) 370–393, at 370.

an analysis of “the respective roles and interaction of governments [...] with a particular focus on the raising, borrowing and spending of revenue”.²⁶ All in all, the examination thus includes the allocation of taxing and spending powers, as well as of regulatory and revenue responsibilities.

In addition, the emphasis given to both “the respective roles and interaction of governments” redirects attention beyond the mere allocation of powers and responsibilities and takes into consideration the functioning of the system by means of intergovernmental relations. This enrichment can be connected to the theory of federalism as a process²⁷ and appears to be particularly appropriate for addressing the phenomenon and its causes. At the same time, it is shown to be indispensable for understanding how different systems actually work.

Beyond stressing the importance of a dynamic approach to this field of study, this evolution of the concept of fiscal federalism results in an inclusive spectrum of analysis that makes it feasible to embrace systems that have very few traits in common: among these, the existence of two or more orders of government and a vertical distribution of powers and responsibilities.

3 Revising Fiscal Federalism

The above-illustrated evolution has progressively led to a revision of the significance and the borders of the subject of fiscal federalism.

On the one hand, the literal meaning of the words is far too simplistic and misleading, while, on the other hand, the need to rethink its significance as a result of growing worldwide complexity is emerging.

Own taxes of the subnational entities exemplify this phenomenon. From the very beginning, studies on fiscal federalism have focused predominantly on the distribution of taxing powers in federal systems. The so-called tax assignment problem has been one of the focal points of discussion and analysis,²⁸ as the substance of the issue has been explored by studies of both the first

²⁶ G. Anderson, *Fiscal Federalism: A Comparative Introduction* (Oxford: Oxford University Press, 2010), at 2.

²⁷ See C.J. Friedrich, “Federal Constitutional Theory and Emergent Proposals”, in A.W. Macmahon (ed.), *Federalism: Mature and Emergent* (New York: Russell & Russell, 1962), at 528 ff.

²⁸ The first explicit reference to “tax assignment” can be found in R.A. Musgrave, “Who Should Tax, Where and What?” in C.E. Mclure (ed.), *Tax Assignment in Federal Countries* (Canberra: Australian National University, 1983) 2–19.

and second generation, as well as by scholars of all disciplines.²⁹ Emblematic is also the interest that legal scholars pay to this aspect. At an earlier stage, in fact, a minimalistic approach to fiscal federalism prevailed, and the analysis was limited to the distribution of the power to tax and to assessments of the existing margin of tax autonomy vested in the different tiers of government.³⁰

However, this picture was soon revealed to be unsatisfactory, as it failed to capture the actual scope of the phenomenon.³¹ It is undeniable that the power to tax represents the milestone of intergovernmental financial relations, but the latter cannot be reduced to this aspect only. If it were for the degree of tax autonomy—in the strict sense—vested with subnational entities, systems of fiscal federalism would hardly be found anywhere in practice. In fact, the exclusive power of subnational entities to impose and regulate their own sources of taxation appears to be a marginal feature in most federal systems. The wide distribution of the welfare model has accentuated this pattern. Calling for the redistribution of wealth, a new pattern emerged in which taxing powers became progressively centralised, although each to a different extent.³²

This overall picture holds true particularly when it comes to European case studies, with the sole exception of Switzerland.³³ That said, this scheme is being adopted in emerging federations as well, in which subnational financing is more the result of revenue-sharing schemes rather than tax-base sharing.³⁴ However, a centralising trend can also be found in mature non-European federations. Although Canada represents one of the most fiscally decentralised states in the world, its intergovernmental financial relations are based more and more on tax collection agreements,³⁵ which *de facto* reduce the room for manoeuvre that is vested in the provincial level. From a formal point of view, Canadian provinces are vested with significant taxing power. For instance, each province has the power to set its own personal income tax rate and to determine its tax base. Despite this, the system has become more coordinated

29 A review of the tax assignment problem that bridges theory and practice can be found in Bird, "Tax Assignment Revisited", *supra*.

30 Carboni, "Fiscal Federalism and Comparative Law", *supra*, at 2.

31 In this regard, see Palermo, "Comparare il federalismo fiscale", *supra*, at 6–7.

32 For details on subnational taxes, see, among others, the examination conducted by D. King, "Allocation of Taxing Powers", *OECD Journal on Budgeting*, 6 (2007).

33 With reference to European federal systems, the scope of subnational tax autonomy is examined from a comparative and legal perspective in Alber and Valdesalici, "Reforming Fiscal Federalism in Europe", *supra*, at 334 ff.

34 Nigeria, Pakistan and South Africa could be examples.

35 B. Alarie and R.M. Bird, "Canada", in G. Bizioli and C. Sacchetto (eds.), *Tax Aspects of Fiscal Federalism* (Amsterdam: IBFD, 2011) 79–137, at 107 ff.

than ever before. This is partly due to the practice of signing federal-provincial agreements for tax collection. The rationale behind this system of federal-provincial diplomacy is to increase coordination. This goal, however, is pursued by means of tax harmonisation at the expense of territorial differentiation and subnational autonomy.³⁶

Furthermore, formal and informal reforms of existing financial agreements are gaining momentum, and the need to cope with problems related to the democratic deficit and economic and financial stability, combining local players with global actors, is becoming more and more apparent. As it always involves a balance of opposites, the outcome is unpredictable. Nevertheless, these trends demonstrate the failure of traditional categories to describe the phenomenon. Comparative studies of federalism are familiar with this dynamic approach, yet changing contexts require new institutional solutions and approaches to cope with emerging trends and problems. This represents one of the major challenges for studies of fiscal federalism and requires a comparative approach and an interdisciplinary perspective.

4 Towards a Working Definition

Along the path paved by the overall expansive trend characterising the object of investigation and mostly inspired by practices from all over the world, this book adopts a broad conception of fiscal federalism. In this respect, the old minimalist meaning proves not to be very useful in understanding the contemporary world and its emerging issues. It was able to provide only far too partial insights that were limited to a handful of so-called classical federations, but it was unable to grasp the dynamics of today's reality.

However, an extended point of view has to cope with the lack of a global theory: as with the general concept of federalism, there is no one-size-fits-all definition of fiscal federalism. To some degree, the notion of *financial constitution* could be considered a common point of reference. The term is a literal translation of

³⁶ This is the case of Australia and the USA. Another example could be the German Federal Republic, where the power to tax is fully in the hands of the federal level, disregarding the fact that the Basic Law includes most of the taxing powers under the concurrent Federal-*Länder* competence catalogue. In terms of how the system functions, in fact, these powers fall within the sphere of influence (and decision) of the federal tier. Although every federal law on tax matters requires the *Länder*' consent via the *Bundesrat* if the law stipulates regulations concerning taxes whose revenue accrue fully or partly to them.

the term *Finanzverfassung*,³⁷ coined by Austrian and German scholars and referring to those constitutional provisions that establish the principles and rules of the system of public finance, and having particular regard to the determination, distribution and use made of financial resources by the different levels of government.³⁸ The concept, in fact, could be considered an evolution of the notion of *fiscal constitution* that first appeared in 1977 in *The University of Chicago Law Review* thanks to a contribution by Professor Kenneth W. Dam (law and economics),³⁹ and later used by two famous American economics scholars—James Buchanan and Richard Wagner—to refer to those written or unwritten rules that guide fiscal decisions in the United States.⁴⁰ As such, the expression is linked to those theories that rely on the nexus between fiscal federalism and the federal state; however, it takes credit for including not only rules “formally incorporated in some legally binding and explicitly constitutional document”, but also unwritten rules like “customary, traditional, and widely accepted precepts”.⁴¹

This approach entails three key consequences that are relevant for our purposes. First of all, it gives relevance to political facts and economic rules that have an impact on the interpretation and implementation of the rules, as well as on the way in which a system functions and evolves.⁴² Second, it justifies the inclusion of all those sources of law that deal with the subject matter but do not have formal constitutional status. In this case, substance prevails over form, as these “deserve to be thought of as quasi-constitutional” in nature. Third, it stresses the importance of “[contemplating] the Constitution as a

37 This is the terminology used, with little variation, by Italian and Spanish scholars as well. See, among others, M. Salerno, “Riflessioni sulla nuova costituzione finanziaria”, *Federalismo Fiscale*, 1 (2007) 119–138, at 123; M. Medina Guerrero, “Financiación autonómica y control de constitucionalidad (algunas reflexiones sobre la STC 13/2007)”, *Revista d'Estudis Autònoms i Federals*, 6 (2008) 92–124, at 98. The latter, indeed, makes specific reference to the “territorial financial constitution”.

38 With regard to the Austrian system, see P. Pernthaler, *Österreichische Finanzverfassung: Theorie—Praxis—Reform* (Wien: Wilhelm Braumüller, 1984), at 21 ff. In a similar way, with reference to the case of Germany, see, among many others, J. Hellermann, “Artikel 104a”, in H. von Mangoldt *et al.* (eds.), *Kommentar zum Grundgesetz* (6th edn., München: Franz Vahlen, 2010), at 1099–1186. Along the same line: BVerfGE 55, 274 (300)—*Berufsausbildungsabgabe*.

39 Dam, “The American Fiscal Constitution”, *supra*, 271–320.

40 J.M. Buchanan and R.E. Wagner, *Democracy in Deficit: Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

41 In this sense, *ibid* at 24.

42 Carboni, “Fiscal Federalism and Comparative Law”, *supra*, at 3.

whole, considering provisions not specifically directed [at] fiscal matters and taking into account the federal structure created by the Constitution".⁴³ This advocates the idea of taking into consideration the general principles and values that inspire the constitutional order as a whole, as well as those provisions that tangentially intersect with financial rules. The principles of the national tax system or economic and financial policies, together with national budgetary policies, could represent examples in this regard. Only this broader picture can reveal the "imposing edifice of powers and limitations" that constrains fiscal decisions.⁴⁴ The only precondition is found in the need to test the impact of these rules on the financial system and its functioning.⁴⁵

The latter assumption supports a dynamic understanding of fiscal federalism as inclusive of intergovernmental financial relations. As a matter of fact, only if rules and actors are observed in their interactions within the frame of reference can such an extended scenario be deemed to result in a wide-ranging understanding of the phenomenon. This is even more relevant when it comes to constitutional areas, such as financial constitutions, which show a wide gap between the law in books and the law in action.

43 In this sense, Dam, "The American Fiscal Constitution", *supra*, at 272.

44 *Ibid.*

45 This broader interpretation is supported by, among others, Anderson, *Fiscal Federalism*, *supra*, at 2.