

# FISCAL DEVOLUTION

## INTRODUCTION

This chapter presents an overview of the mechanisms states use to allocate revenues and expenditure authority between their central and provincial governments. This chapter also outlines the Darfur Peace Agreement provisions relating to fiscal devolution and provides sample language parties may wish to consider when drafting fiscal devolution provisions in a peace agreement. State practice illustrates a range of mechanisms for devolving fiscal authority to provincial governments and mitigating fiscal imbalances. Core elements that states may consider when devolving fiscal authority may include the structure of the fiscal authority, mechanisms to prevent and mitigate imbalances, and methods to adjust current fiscal policy.

The degree of fiscal authority allocated to provincial governments is usually a balance of two factors: (1) the degree of expenditure authority allocated to provincial governments to provide public services and (2) the types and degree of revenue raising (also known as self-financing) conducted by provincial governments. Fluctuations in revenue-raising capacity and need often create imbalances between the fiscal resources available to various provinces. To prevent or mitigate imbalances, states often establish one or more systems to transfer revenues from the central government to the provincial governments. States that devolve fiscal authority to provincial governments must also develop mechanisms to adjust fiscal policy when necessary. Common mechanisms used to adjust fiscal policies include expert commissions, intergovernmental councils, central government decision including provincial representation, and central government decision without provincial representation

The 2006 Darfur Peace Agreement (DPA) provides both the central and the provincial governments with expenditure and revenue raising authority. In addition to its revenue raising authority, the DPA grants the authority to borrow funds from external sources as long as it reported all the funds it received to the central government. To address imbalances, the DPA establishes the Fiscal and Financial Allocation and Monitoring Commission to develop formulas for the allocation of resources between the central and the provincial governments and for the allocation of resources among the provincial governments.

## CORE ELEMENTS

### Structure of Fiscal Devolution

The structure of devolved fiscal authority comprises three core authorities including expenditure authority, revenue collection authority, and stabilization policy. One of the central issues in structuring fiscal devolution is creating an effective balance among these authorities. Many states allocate to different provinces differing levels of authority in each of these areas. This is particularly true in states where different provinces have different capacities to exercise fiscal authority.

#### *Expenditure Authority*

Expenditure authority is authority over specific policy areas or services allocated to central and provincial governments. Generally, expenditure authority follows the devolution of political authority between state and provincial governments. Many states establish the division of political and fiscal authority in the national constitution, in national legislation, or in negotiated agreements between central government and provincial government executives.<sup>1</sup> The central government usually holds expenditure authority in areas of national security and defense, public debt, immigration, regulation of trade and commerce, foreign affairs, and some social programs. Provincial governments usually hold expenditure authority in areas of education, provincial law enforcement, transportation, communication, housing, and healthcare services.<sup>2</sup> In some states, the central and provincial governments share expenditure authority over certain policy areas.

In addition to expenditure authority, some state constitutions grant the central government a separate “spending power.” In many states, the degree of authority provided by spending power varies widely, depending on the prevailing constitutional interpretation.

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<sup>1</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, *FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS* (2003), at 6, 25. The process of determining allocations of authority by negotiation between provincial and national executives is “executive federalism.” Although executive federalism can increase institutional flexibility, its success is dependent on the relationship between the executives and is therefore uncertain.

<sup>2</sup> OECD REPORT, *FISCAL DECENTRALISATION IN EU APPLICANT STATES AND SELECTED EU MEMBER STATES* (2002), ch. 1, Table 1.4.1, *available at* <http://www.im.dk/publikationer/decentralisation/kap01.htm> (last accessed Sept. 14, 2007).

## Centralized Expenditure Authority

In states with centralized expenditure authority, the central government usually holds more expenditure authority, or holds expenditure authority over more policy areas, than do provincial governments. Venezuela, for example, had a highly centralized expenditure system from 1978 to 1996. During that period, provincial spending constituted only 12 percent of national spending.<sup>3</sup> Central government grants financed 94 percent of provincial spending.<sup>4</sup> Similarly, provincial spending in Spain and Austria were 14 and 17 percent of national spending, respectively.<sup>5</sup>

Vesting the central government with more authority may enable greater national coordination of fiscal policy. However, centralizing expenditure authority can become complicated when central and provincial governments have conflicting policy priorities. During the 1990s, Mexican provincial governments relied heavily on the central government for funding.<sup>6</sup> Provincial governments began to borrow heavily against future income from the central government. This complicated relations between the central and provincial governments, in part because the central government would be forced to assume the provincial governments' debt if they defaulted.<sup>7</sup>

## Decentralized Expenditure Authority

In states with decentralized expenditure authority, provincial governments often control spending in a greater number of policy areas than does the central government. Argentina, for example, has a highly decentralized expenditure

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<sup>3</sup> Jonathan Rodden and Erik Wibbels, *Beyond the Fiction of Federalism: Macroeconomic Management in Multi-tiered Systems*, WORLD POLITICS, July 2002, Table 1, at 504, available at <http://web.mit.edu/jrodden/www/materials/fiction.worldpolitics.pdf> (last accessed Sept. 14, 2007).

<sup>4</sup> Jonathan Rodden and Erik Wibbels, *Beyond the Fiction of Federalism: Macroeconomic Management in Multi-tiered Systems*, WORLD POLITICS, July 2002, at 506.

<sup>5</sup> Jonathan Rodden and Erik Wibbels, *Beyond the Fiction of Federalism: Macroeconomic Management in Multi-tiered Systems*, WORLD POLITICS, July 2002, Table 1, at 504.

<sup>6</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 47-48.

<sup>7</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 47-48.

system, with provincial spending making up approximately half of total government spending.<sup>8</sup>

In some states with decentralized expenditure systems, provincial governments still rely on the central government for revenue. From 1985 to 1995, Argentinean provincial governments depended on the central government for 65 percent of their budgets.<sup>9</sup> Two-thirds of the transfers from the central government to the provincial governments were legislatively pre-determined, preventing provincial financial dependence from affecting the relationship between the provincial and central governments.<sup>10</sup>

Decentralized expenditure authority allows provincial governments to have greater flexibility in the amount and nature of their spending. However, when central and provincial policy objectives are in conflict, decentralized expenditure authority may complicate national policy coordination or strain relations between the central and provincial governments. For example, in Canada, consensus on economic policy objectives can be difficult to achieve, in part because of significant inter-provincial wealth disparities and policy priorities.<sup>11</sup>

### *Revenue Collection Authority*

Devolution of revenue collection authority enables provincial governments to collect revenues independent of, or in cooperation with, the central government. States may establish revenue collection authority in the national constitution, in national legislation, or in negotiated agreements between central government and provincial government executives. State practice varies considerably in the implementation of devolved revenue collection systems; the primary distinction is

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<sup>8</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, WHY IS ARGENTINA'S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH (1999), *available at* [http://www.isr.umich.edu/cps/pewpa/archive/archive\\_99/19990003.pdf](http://www.isr.umich.edu/cps/pewpa/archive/archive_99/19990003.pdf) (last accessed Sept. 14, 2007).

<sup>9</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, WHY IS ARGENTINA'S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH (1999).

<sup>10</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 44. These transfers are “co-participation transfers” and are automatic, non-discretionary transfers that come from income taxes, excise taxes, and value-added taxes. This system is in place because provinces abdicated tax revenue collection authority in exchange for a pre-determined transfer system.

<sup>11</sup> PAUL BOOTHE, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 37-38.

generally over which level of government collects the majority of the tax revenue. Tax revenue constitutes the majority of revenues collected by the government. Even in states with highly devolved revenue collection systems, neither central nor provincial governments are completely self-financing.<sup>12</sup>

### Centralized Revenue Collection System

In centralized revenue collection systems, the central government holds the majority of revenue collection authority. Many states initially granted revenue collection authority to the provincial governments. In some states, however, the provincial governments have abdicated their revenue collection authority to the central government. For example, although the Mexican Constitution grants revenue collection authority to the provinces, the central government exercises a great deal of revenue collection authority.<sup>13</sup> This is because Mexican provincial legislatures gave up this authority in exchange for the implementation of an automatic transfer system.<sup>14</sup>

A benefit of centralized revenue collection systems is the coordination of tax revenue allocation. However, centralization without mechanisms for effective redistribution of funds to the provinces can lead to fiscal imbalances between the central and provincial governments. For example, Australia has a highly centralized revenue collection system that results in large fiscal imbalances

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<sup>12</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 11.

<sup>13</sup> MEXICO CONST. art. 124. Allocates all of the authorities not explicitly given to the central government or the municipalities to the state governments. INTERNATIONAL MONETARY FUND, MEXICO: REPORT ON THE OBSERVANCE OF STANDARDS AND CODES – FISCAL TRANSPARENCY MODULE (2002), available at <http://www.imf.org/external/pubs/ft/scr/2002/cr02200.pdf> (last accessed Sept. 14, 2007).

<sup>14</sup> INTERNATIONAL MONETARY FUND, MEXICO: REPORT ON THE OBSERVANCE OF STANDARDS AND CODES – FISCAL TRANSPARENCY MODULE; Jonathan Rodden and Erik Wibbels, *Beyond the Fiction of Federalism: Macroeconomic Management in Multi-tiered Systems*, WORLD POLITICS, July 2002, Table 1, at 504. The Mexican Fiscal Coordination Law (2000) establishes that the government must transfer funds to the states through the General-Revenue Sharing Fund, which is distributed between provinces (1) according to population (45.17 percent); (2) in proportion to their share in collection of central taxes earmarked for states (45.17 percent); and (3) in inverse proportion to the amounts established under the previous two calculations (9.66 percent). The General-Revenue Sharing Fund is composed of 20 percent of “shareable” national revenues, such as revenues from taxes and royalties on petroleum and mining operations. Provincial spending in Mexico between 1978 and 1996 was only 16 percent of government spending.

between the central and provincial governments.<sup>15</sup> The central government mitigates these imbalances with conditional and unconditional grant programs.<sup>16</sup>

### Decentralized Revenue Collection System

In decentralized revenue collection systems, provincial governments hold the majority of revenue collection authority. Decentralized revenue collection systems provide provincial governments with greater flexibility in collection and budgetary spending implementation at the provincial level. In the Philippines, provincial governments have the authority to set their own tax rates, enact their own budgets, and determine their own borrowing policy.<sup>17</sup> The provincial governments have significant control over the amount and type of public services they are able to offer because they determine their own tax rates and thus, create revenue.

Decentralized revenue collection systems can also result in an unequal distribution of funds among provinces, particularly in states where different provinces have disparate economic capacities. In Canada, provincial governments collect more than half of all tax revenue.<sup>18</sup> Because Canada's provinces have significantly different revenue-raising capacity, however, relative wealth varies significantly among the provinces.<sup>19</sup> Canada addresses this disparity by using a gross equalization mechanism in which the central government evaluates the needs of the provinces and transfers funds between provinces to meet those needs.<sup>20</sup>

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<sup>15</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 12.

<sup>16</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 12. Since the tax reform of 2000, the unconditional grant program has turned into funds transfers totaling a percentage of the centrally administered goods and services tax.

<sup>17</sup> Robertson Work, UNITED NATIONS DEVELOPMENT PROGRAM, OVERVIEW OF DECENTRALISATION WORLDWIDE: A STEPPING STONE TO IMPROVED GOVERNANCE AN HUMAN DEVELOPMENT (2002).

<sup>18</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 10. Provincial and local governments in Canada collect 53 percent of all tax revenue collected.

<sup>19</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 38.

<sup>20</sup> For more information on gross equalization mechanisms, see the section on Gross Equalization of this chapter.

## *Stabilization Policy*

Establishing a stabilization policy is another important element of structuring a devolved fiscal system. Stabilization policies are measures that states adopt to stabilize the economy, particularly during economic recessions or depressions. Effective stabilization policies allow states to balance long-term fiscal stability, achieved through the maintenance of a balanced budget, and address short-term economic fluctuations. Like expenditure and revenue collection authority, control over stabilization policy may be centralized or decentralized. In many states, both the central and provincial governments share control of stabilization policy due to the economic interdependence of the two authorities.<sup>21</sup>

## **Preventing Imbalances**

Fluctuations in provincial financial needs and revenue-raising capacity often create imbalances between and among central and provincial governments. These imbalances between central and provincial governments are vertical imbalances. Imbalances among provincial governments are horizontal imbalances. State governments usually mitigate vertical and horizontal imbalances through a system of grants and fund transfers.

State governments use various processes to determine how much funding will go to which provinces. Some states provide guidelines for transfers in the national constitution. In other states, representatives of central and provincial executives conduct informal negotiations to determine transfer amounts and recipients. When attempting to prevent or mitigate imbalances, many states implement more than one transfer system.

## *Vertical Imbalances*

Vertical imbalances occur when the central government collects and retains more revenue than it needs to meet expenditures while, at the same time, provincial governments are not able to collect the revenue necessary to meet their needs. State governments usually offset vertical imbalances by transferring a portion of state tax revenue to one or more provincial governments. These transfers generally take one of two forms, which are conditional transfers and unconditional transfers.

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<sup>21</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 49.

## Conditional Transfers

In conditional transfer systems, provincial governments must usually meet pre-determined conditions to receive funding from the state government. Some states use a system of “conditional eligibility,” in which provincial governments must meet certain standards before the central government will transfer funds. Other states use a system of “conditional spending,” in which provincial governments are required to spend the transferred revenue in a pre-determined way.

Central governments often use conditional grant programs to enable or assist provincial governments to provide social services. Conditional grant programs also enable central governments to exert influence in specific policy areas where they may not have the authority to act directly. In South Africa, the central government has institutionalized conditional grants that finance public service programs in the provinces, primarily in the areas of health, finance, housing, and transportation.<sup>22</sup>

## Unconditional Transfers

When a central government makes an unconditional transfer of revenue to a provincial government, the provincial government may spend the funds at its own discretion. Central governments generally administer such transfers based on need, as determined by the central government. The Australian government uses unconditional Federal Assistance Grants to create inter-provincial equity, as quantified and determined by the Commonwealth Grants Commission.<sup>23</sup>

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<sup>22</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, FISCAL DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD (2000), *available at* <http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/smoke.pdf> (last accessed Sept. 14, 2007). In 1999 and 2000, unconditional grant programs composed 13 percent of vertical transfers. These program areas are typically the responsibility of the provincial governments.

<sup>23</sup> ANDREW WORTHINGTON AND BRIAN DOLLERY, THE DEBATE ON AUSTRALIAN FEDERALISM: LOCAL GOVERNMENT FINANCIAL INTERRELATIONSHIPS WITH STATE AND COMMONWEALTH GOVERNMENTS (2000), AT 22, *AVAILABLE AT* <HTTP://WWW.UNE.EDU.AU/ECONOMICS/PUBLICATIONS/ECONWP00-1.PDF> (LAST ACCESSED SEPT. 14, 2007). Federal Assistance Grants are unconditional grants that mitigate provincial revenue-raising capacity disparities.

In addition to unconditional transfers, many central governments make use of revenue-sharing programs, which govern the division of common revenue sources between the central and provincial government. Germany divides revenues from its value-added tax between the central and provincial governments.<sup>24</sup>

### *Horizontal Imbalances*

Horizontal imbalances occur when provinces have disparate revenue-raising capacity, particularly in relation to each province's expenditure needs. As with vertical imbalances, the central government can mitigate horizontal imbalances by transferring central government funds to one or more provincial governments. However, the fund-transfer mechanisms to address horizontal imbalances are often more complicated than those to address vertical imbalances.

### Net Equalization Systems

In net equalization systems, transfers come from a single, fixed source of revenue. States divide these funds according to a pre-established system for determining need. By using a pre-allocated pool of funds, central governments are able to limit the risk of economically over-extending themselves to mitigate inter-provincial economic disparity. The size of fund transfers in net equalization systems are generally determined by either automatic transfers or discretionary transfers.

### Automatic Transfers

An automatic transfer is one mechanism for distributing central government tax revenue to provincial governments. States make automatic transfers according to pre-determined guidelines, without a case-by-case review. When the central government collects revenues, it automatically distributes them to provincial governments according to the pre-determined guidelines. During its 1994 fiscal reforms, China created an automatic transfer system that divided revenue sources

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<sup>24</sup> THE COMMISSION ON FISCAL IMBALANCE, INTERGOVERNMENTAL FISCAL ARRANGEMENTS (2001), at 7, *available at* [http://www.desequilibrefiscal.gouv.qc.ca/en/pdf/international\\_ang.pdf](http://www.desequilibrefiscal.gouv.qc.ca/en/pdf/international_ang.pdf) (last accessed Sept. 14, 2007). In Germany, the government distributes 49.75 percent of the value added tax by demographic weight among the Länder, with 50.25 percent going to the national government. The remaining funds go to the administration of the pension plan and the Communes.

into three categories: central, local and shared.<sup>25</sup> The central government then determined the percentages of distribution between provinces, and imposed the division on provincial governments to reduce negotiation costs.<sup>26</sup> These percentages determined the annual revenue allocations from the central government to provincial governments.<sup>27</sup>

Some states prefer automatic transfers because the system can eliminate the time and cost of negotiating the amounts of funds to be transferred. If the automatic transfer is the only net equalization mechanism used, however, the central government may lack flexibility to address provincial needs.

### Discretionary Transfers

A discretionary transfer is another mechanism for distributing central government tax revenue to provincial governments. The central government allocates discretionary transfers to provincial governments as needed. State practice varies considerably on the mechanisms used for determining provincial need. Some states include provisions for these mechanisms in their constitution or national legislation. Australia uses a complex system that measures forty-one expenditure and eighteen revenue categories to determine the need of each province relative to the others.<sup>28</sup> The central government bases the amount of these transfers on the provinces' fiscal capacity and expected expenditures. A non-partisan group, the Commonwealth Grants Commission, oversees this system. The

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<sup>25</sup> Shaoguang Wang, *China's 1994 Fiscal Reform: An Initial Assessment*, ASIAN SURVEY (Sept. 1997), available at [http://www.cuhk.edu.hk/gpa/wang\\_files/1994.pdf](http://www.cuhk.edu.hk/gpa/wang_files/1994.pdf) (last accessed Sept. 14, 2007). Central revenues went to the national government, local revenues went to the provincial governments, and the government distributed shared revenues according to a pre-determined percentage. For example, 75 percent of China's value-added tax went to the central government, and 25 percent went to provincial governments.

<sup>26</sup> Shaoguang Wang, *China's 1994 Fiscal Reform: An Initial Assessment*, ASIAN SURVEY (Sept. 1997). China also used two parallel tax revenue collection authorities: a national system to collect central and shared taxes, and the pre-existing local authority to collect local taxes.

<sup>27</sup> Shaoguang Wang, *China's 1994 Fiscal Reform: An Initial Assessment*, ASIAN SURVEY, September (Sept. 1997).

<sup>28</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, *FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS* (2003), at 32-33. The Commonwealth Grants Commission, a non-partisan, politically appointed body that continuously reviews provincial economics, performs this analysis every five years. Although this body has no any policy-making authority outside of this review, the government often consults it for policy advice.

Commission monitors the fairness of the process and reviews the methodology every five years.<sup>29</sup>

Other states use a combination of mechanisms that are more informal.<sup>30</sup> One method that Argentina uses to prevent horizontal imbalances is purely discretionary transfers, which the state distributes “as necessary.”<sup>31</sup> Argentina also provides transfers from the central government through “co-participation transfers that provide automatic, non-discretionary transfers”<sup>32</sup> from income taxes, excise taxes, and the Value-Added Tax. The central government also provides automatic transfers that divide revenues from fuel taxes, energy taxes, and wage taxes between the central and provincial governments.

### Gross Equalization Systems

Unlike net transfer systems, which use a pre-established system for determining need, in gross equalization systems, the central government assesses provincial needs and transfers funds it considers necessary to meet those needs. One criterion the central government uses in determining provincial need is the province’s relative ability to raise its own revenues. The central government compares the revenue available in each province. From these comparisons, the central government establishes a median “standard of capacity.” The provinces that fall below this standard are awarded unconditional cash transfers from the central government. The provinces that are above the standard retain their respective tax revenues but do not receive transfers from the central government.

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<sup>29</sup> PAUL BOOTHE, TAXING, SPENDING AND SHARING IN FEDERATIONS: EVIDENCE FROM AUSTRALIA AND CANADA, IN FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 5.

<sup>30</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 36-37.

<sup>31</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, WHY IS ARGENTINA’S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH (1999), at 14-15. The central government and the treasury jointly decide which provincial government requests qualify as needs. Argentina also has other imbalance mitigation mechanisms, such as automatic transfers of funds allocated for specific purposes.

<sup>32</sup> BRADFORD G. REID, FISCAL MANAGEMENT AND STABILIZATION POLICY IN FEDERAL SYSTEMS: THE EXPERIENCE OF ARGENTINA AND MEXICO, IN FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 41.

This standard is subject to review every five years.<sup>33</sup> This scheme helps to equalize available finances among provinces.<sup>34</sup>

Generally, gross equalization systems do not limit the funds that the central government can transfer to provincial governments. This can lead to provincial dependence on national transfers. To prevent or resolve this potential problem, states may enact measures to limit the year-to-year variation of gross equalization payments or develop ad hoc measures to limit the financial liability of the central government.

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<sup>33</sup> PAUL BOOTHE, TAXING, SPENDING AND SHARING IN FEDERATIONS: EVIDENCE FROM AUSTRALIA AND CANADA, IN FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 5.

<sup>34</sup> PAUL BOOTHE, TAXING, SPENDING AND SHARING IN FEDERATIONS: EVIDENCE FROM AUSTRALIA AND CANADA, in FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 5. In addition, there are major transfers of revenue from the central government to provincial governments through “shared-cost programs.” The government designed these programs to help the provinces provide these services with funding from the federal government. The largest of them relate to education and healthcare. Because the central government can link certain policy requirements to the funding, these programs have allowed the central authorities to affect policy in areas traditionally under the jurisdiction of the provinces. Cost-sharing programs are at the center of current debate in Canada.

### *Shared System of Horizontal and Vertical Equalization*

The German Constitution designed the fiscal system in Germany to balance and equalize resources between the central and provincial governments<sup>35</sup> as well as among the provinces themselves.<sup>36</sup> The German Constitution specifically divides income and corporate taxes between the central and provincial governments. In addition, the central government redistributes the value-added tax to the federal and provincial governments based on need. If a province's tax revenue is greater than its budgetary needs, it must transfer some of this revenue directly to less fiscally stable provinces.<sup>37</sup> The central government calculates the amount of funds to transfer from province to province based on a complex evaluation of economic capacity and political negotiations between the central government and the provinces.

Taxation in Germany is generally centralized. Only the central government has the authority to institute additional taxes or change the rates of existing taxes. The provincial governments have no independent tax authority and can only collect taxes at rates set by the central government.<sup>38</sup> In addition, the provincial governments are constitutionally responsible for implementing federal legislation. The provinces are therefore obligated to fulfill fiscal responsibilities over which they have little direct control.

### **Policy Adjustment Mechanisms**

Policy adjustment mechanisms are another integral element of sustainable fiscal devolution. There are four key types of formal policy adjustment mechanisms, including expert commissions, intergovernmental councils, central government decision with provincial representation, and central government decision without provincial representation. Some states also use a variety of informal mechanisms to adjust existing fiscal policy.

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<sup>35</sup> The "vertical" equalization between Germany's federal government and provincial governments appears in Articles 91 and 106 of the German Constitution.

<sup>36</sup> The "horizontal" equalization between Germany's provinces appears in Article 107 of the German Constitution.

<sup>37</sup> GERMANY CONST. art. 107 (1949).

<sup>38</sup> GERMANY CONST. art. 105 (1949).

### *Expert Commissions*

Many states that have devolved fiscal systems establish independent commissions of experts to review existing policy and make recommendations for adjustments. These commissions may be standing or ad hoc. The recommendations of expert commissions usually require the approval of an element of the central government.<sup>39</sup> Australia, for example, developed the Commonwealth Grants Commission, an independent, standing panel of experts to advise the government on fiscal policy adjustment.<sup>40</sup> The Commonwealth Grants Commission determines the proportions by which the central government can distribute shared-revenue among states.<sup>41</sup>

Advocates for independent commissions argue that because such commissions are independent from the political process, they are more likely to produce economically focused policy recommendations. Others claim that a commissions' political independence may lead to the disenfranchisement of individual provinces or economic needs.

### *Intergovernmental Councils*

States also may adjust fiscal policy through a council composed of both central and provincial government representatives. Intergovernmental councils meet at pre-determined intervals to negotiate modifications to existing fiscal policy. The presence of central and provincial representatives on intergovernmental councils might help to increase the legitimacy of any policy decisions reached. Before Malaysia's central government may adjust its fiscal policy, it is constitutionally required to consult with the National Finance Council,

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<sup>39</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 21. Usually, the national parliament approves these recommendations.

<sup>40</sup> RONALD L. WATTS, COMPARING FEDERAL SYSTEMS, 2<sup>nd</sup> Edition (1999), at 54-55; Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 32-33. In 1973, the role of the Commonwealth Grants Commission changed from recommending supplemental equalization grants to creating and administering the quantitative review process for determining per capita relativities, and thus the percentages of revenue distribution.

<sup>41</sup> RONALD L. WATTS, COMPARING FEDERAL SYSTEMS, 2<sup>ND</sup> EDITION (1999), at 54-55; Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 32-33.

which is composed of members of provincial governments.<sup>42</sup> Similarly, in Spain, fiscal arrangements are determined based on negotiations between representatives of the central government and the Autonomous Communities, with the central government making final decisions.<sup>43</sup>

### *Legislative Decision with Provincial Representation*

Some states adjust fiscal policy by vesting the adjustment authority in the national legislature, which then coordinates with provincial executives to determine necessary changes. The representative nature of this mechanism, in addition to its formalized rules governing process, may help to foster the legitimacy of decisions reached. However, under such systems, the need to consider other priorities and interests can compromise provincial economic objectives. In Germany, fiscal arrangements annually require the approval of the Bundesrat, the upper house of the legislature.<sup>44</sup> Similarly, Switzerland determines its fiscal arrangements through negotiations between the Federal Council and the Parliament, at times with the assistance of commissions.<sup>45</sup>

### *Executive Decision*

Another mechanism for the adjustment of fiscal policy grants sole authority to the central executive without the involvement of provincial governments. This system can create or exacerbate vertical imbalances or intergovernmental tensions.<sup>46</sup> Canada vests exclusive authority over fiscal policy in the executive. However, informal intergovernmental negotiations influence the decision-making

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<sup>42</sup> RONALD L. WATTS, *COMPARING FEDERAL SYSTEMS*, 2<sup>ND</sup> EDITION (1999), at 53-54.

<sup>43</sup> Paul Boothe, *FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS* (2003), at 53-54.

<sup>44</sup> THE COMMISSION ON FISCAL IMBALANCE, *INTERGOVERNMENTAL FISCAL ARRANGEMENTS* (2001), at 11, *available at* [http://www.desequilibrefiscal.gouv.qc.ca/en/pdf/international\\_ang.pdf](http://www.desequilibrefiscal.gouv.qc.ca/en/pdf/international_ang.pdf) (last accessed Sept. 14, 2007). The Bundesrat consists of the delegates of Land executives, allowing for direct state government participation within the national approval framework.

<sup>45</sup> RONALD L. WATTS, *COMPARING FEDERAL SYSTEMS*, 2<sup>ND</sup> Edition (1999), at 54-55. The Swiss Parliament consists of representatives of the Cantons.

<sup>46</sup> Paul Boothe, *FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS* (2003), at 21-22. Canada implemented this system, and it has been the source of significant controversy.

process.<sup>47</sup> Provinces in Canada may opt-out of central-provincial intergovernmental agreements without penalty.<sup>48</sup>

## COMPARATIVE STATE PRACTICE

### Argentina

Argentina is a federal republic comprised of twenty-four provinces and one autonomous district. It is also the most fiscally decentralized economy in Latin America, with approximately 50 percent of total public spending coming from the provincial level.<sup>49</sup> The Argentine Constitution established the state's fiscal system. Argentina has made significant complicating adjustments to the system since its inception, causing inconsistencies in long-term fiscal policy. These inconsistencies have affected Argentinean economic stability.

#### *Revenue Collection Authority*

Argentina's fiscal devolution structure, initially established in the 1934 constitution, adopts a tax-revenue sharing model.<sup>50</sup> The constitution granted the central government the authority to collect tariffs from foreign trade and provincial governments the authority to collect taxes on the consumption and production of specific goods. However, in practice, provincial governments have returned a significant percentage of their revenue collection authority to the central government.<sup>51</sup>

The current law, passed in 1988, divides federally collected taxes between levels of government, with forty-two percent of collected revenue allocated to the

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<sup>47</sup> RONALD L. WATTS, *COMPARING FEDERAL SYSTEMS*, 2<sup>ND</sup> EDITION (1999), at 53-54.

<sup>48</sup> Paul Boothe, *FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS* (2003), at 27.

<sup>49</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, *WHY IS ARGENTINA'S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH* (1999), at 2.

<sup>50</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, *WHY IS ARGENTINA'S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH* (1999), at 8.

<sup>51</sup> Federico Sturzenegger and Rogerio L.F. Werneck, *WORLD BANK, FISCAL FEDERALISM AND PROCYCLICAL SPENDING: THE CASES OF ARGENTINA AND BRAZIL* (2006), at 5, *available at* <http://200.32.4.58/~fsturzen/version%20final%20august.pdf> (last accessed Sept. 14, 2007). This delegation also includes the determination of tax rates, tax bases and other regulatory aspects.

central government and fifty-seven percent of collected revenue distributed among the provinces.<sup>52</sup>

### *Expenditure Authority*

The Argentine Constitution required provincial governments to provide a majority of public services and therefore, requires the provinces to have a high degree of expenditure authority. Provinces have exclusive responsibility over primary and secondary education, health, poverty programs, and housing.<sup>53</sup> The central and provincial governments share responsibility for other public programs, although the tendency in the past two decades has been for the central government to delegate this authority to the provinces.<sup>54</sup>

### *Fiscal Imbalance Mitigation Mechanisms*

The high degree of revenue collection authority vested in the central government combined with the decentralized expenditure authority vested in provincial governments has created sharp intergovernmental fiscal imbalances in Argentina. From 1985 to 1995, provincial governments relied on the central government to finance sixty-five percent of expenses.<sup>55</sup> Within the same period, ten provinces self-financed less than fifteen percent of their expenses and sixteen provinces self-financed less than twenty percent of their expenses.<sup>56</sup>

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<sup>52</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, WHY IS ARGENTINA'S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH (1999), at 9. The most recent law is the "Ley de Coparticipación Federal de Impuestos," and allocates the remaining 1 percent of federally collected tax revenue to be set aside for "unforeseen circumstances."

<sup>53</sup> Federico Sturzenegger and Rogerio L.F. Werneck, WORLD BANK, FISCAL FEDERALISM AND PROCYCLICAL SPENDING: THE CASES OF ARGENTINA AND BRAZIL (2006).

<sup>54</sup> Sebastián Saiegh, Pablo Sanuinetti, and Mariano Tommasi, *Fiscal Federalism in Argentina: Policies, Politics, and Institutional Reform*, ECONOMIA, Spring 2001, at 149 available at [http://webudesa.udes.edu.ar/departamentos/economia/mariano\\_tommasi/cedi/dts/dt49.pdf](http://webudesa.udes.edu.ar/departamentos/economia/mariano_tommasi/cedi/dts/dt49.pdf) (last accessed Sept. 14, 2007). The provincial governments maintain primary responsibility for education, health services, poverty programs, social security, housing, roads, ports, the environment, and natural resources.

<sup>55</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, WHY IS ARGENTINA'S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH (1999), at 8.

<sup>56</sup> SEBASTIÁN SAIEGH AND MARIANO TOMMASI, WHY IS ARGENTINA'S FISCAL FEDERALISM SO INEFFICIENT? ENTERING THE LABYRINTH (1999), at 8.

To mitigate these imbalances, Argentina has adopted three types of intergovernmental revenue transfers, including co-participation transfers that provide automatic non-discretionary transfers as part of the tax-sharing system, automatic transfers derived from fuel, energy, and wage taxes, and discretionary transfers.<sup>57</sup> Using one or more of these systems, the central government may reallocate revenues to the provincial governments, thus enabling them to exercise the powers devolved to them under the constitution.

Argentina has significantly complicated its devolution system with additional legislation. One of the most significant laws in this area enables the central government to divert shared revenues toward other purposes.<sup>58</sup> However, the central government also created minimum transfer guarantees and transfers that match the cost of decentralized service responsibilities to provincial governments in an effort to provide more stability.

## **Canada**

Canada is a federation of ten provinces and three territories of varying size and revenue-raising capacity. Canada's decentralized fiscal devolution structure originates from its 1867 Constitution Act, although the 1982 Constitution Act substantially modified it.<sup>59</sup> One of these modifications established the principle of inter-provincial equality in public services and taxation.<sup>60</sup>

### *Revenue Collection Authority*

In Canada, both central and provincial governments have broad taxation powers, which often overlap. The central government is dominant in areas of

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<sup>57</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 44.

<sup>58</sup> Sebastián Saiegh, Pablo Sanuinetti, and Mariano Tommasi, *Fiscal Federalism in Argentina: Policies, Politics, and Institutional Reform*, ECONOMIA, Spring 2001, at 149. The Argentinean government reduced tax sharing with provincial governments by 15 percent in 1992 and 1993 to finance the pension system.

<sup>59</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 7.

<sup>60</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 8.

personal and corporate income taxes, whereas provincial governments collect the majority of payroll and property taxes.<sup>61</sup>

This division of revenue collection means that provincial governments have collected more revenue than the central government in recent decades.<sup>62</sup> For example, in 1999, provincial governments collected 52.7 percent of national tax revenue, compared to the central government's 47.3 percent.<sup>63</sup>

### *Expenditure Authority*

The Canadian Constitution Acts establish exclusive expenditure authority for either the central or the provincial government, with the exception of four issue areas.<sup>64</sup> Canada's Constitution Acts allocate exclusive authority over economic development, currency, postal service, and national defense to the central government.<sup>65</sup> Canadian courts have also interpreted the Constitution Acts to grant the central government a more broadly defined "spending power," which it uses to mitigate fiscal imbalances and pursue specific policy objectives.<sup>66</sup>

The Constitution Acts provide provincial governments with exclusive control over the administration of justice, local institutions, health, education, welfare, and other matters of a "local nature."<sup>67</sup> Provincial government responsibilities, largely due to the growth of the welfare system, have become predominant in terms of importance and spending.<sup>68</sup> As a result, sub-national

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<sup>61</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 10.

<sup>62</sup> ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 40, available at [http://www.fiscalreform.net/library/pdfs/fiscal\\_federalism\\_in\\_canada.pdf](http://www.fiscalreform.net/library/pdfs/fiscal_federalism_in_canada.pdf) (last accessed Sept. 14, 2007).

<sup>63</sup> ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 40.

<sup>64</sup> ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 7. Those four areas of concurrent jurisdiction are the exportation of non-renewable natural resources, pensions, agriculture, and immigration.

<sup>65</sup> ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 7.

<sup>66</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 8; ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 16.

<sup>67</sup> ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 7.

<sup>68</sup> ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 8.

spending makes up the majority of national spending in Canada; in 2001 sub-national spending was sixty-three percent of total national spending.<sup>69</sup>

### *Imbalance Mitigation Mechanisms*

In light of a 1982 court decision establishing the priority of inter-provincial equality, Canada has several mechanisms in place to mitigate fiscal imbalances between the central and provincial governments as well as among provinces. One of these mechanisms is the gross equalization system, which is a system of objective evaluation of inter-provincial revenue raising capacity.<sup>70</sup> Under this system, the state evaluates the revenue-raising capacity of each province according to 33 criteria to establish a mean.<sup>71</sup> Provinces whose revenue raising capacity is below that mean receive equalization transfers from the central government to compensate for the disparity.<sup>72</sup> Provinces whose revenue-raising capacity is above that mean do not receive equalization transfers.<sup>73</sup>

Canada's central government also uses a loosely regulated program called the Canadian Health and Social Transfer, several smaller cost-share programs, and its constitutional "spending power" to mitigate fiscal imbalances or pursue specific policy objectives.<sup>74</sup>

### **South Africa**

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<sup>69</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 8.

<sup>70</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 14. Under this system, the government evaluates provincial revenue raising capacity by thirty-three criteria among all ten provinces, to establish a mean. Provinces whose revenue raising capacity is below that mean receive transfers that compensate for the disparity and provinces above that mean do not receive equalization transfers.

<sup>71</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 14.

<sup>72</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 14.

<sup>73</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 14. Canada has adopted ad hoc measures to limit its compensatory equalization responsibility.

<sup>74</sup> Paul Boothe, FORUM OF FEDERATIONS AND INSTITUTE FOR PUBLIC ECONOMICS, FISCAL RELATIONS IN FEDERAL COUNTRIES: FOUR ESSAYS (2003), at 14-15; ROBIN BROADWAY AND RONALD WATTS, FISCAL FEDERALISM IN CANADA (2000), at 15.

The South African Constitution of 1996 and subsequent legislation contained several provisions to devolve fiscal authority to its provincial and municipal governments. The Constitution uniquely establishes the principle of cooperative governance, requiring the various orders of government—central, provincial, and local—to collaboratively derive solutions to political and budgeting issues.<sup>75</sup>

### *Revenue Collection Authority*

South Africa based its revenue collection system primarily on a revenue-sharing model. Although all three levels of government (central government, provincial governments, and municipal governments) technically retain some taxation authority, provincial taxation authority is subject to central government approval.<sup>76</sup> The Constitution entitles the provincial governments to an “equitable share” of national revenue.<sup>77</sup> These two provisions have made provincial governments highly dependent on the central government to finance their budgets.<sup>78</sup> For example, in 1999-2000, provincial governments on average raised only four percent of their own budgets.<sup>79</sup>

In contrast, municipal governments have the authority to tax the provision of public goods and user services, such as water, electricity, and municipal

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<sup>75</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER’S PERSPECTIVE, at 3-4, *available at* <http://www1.worldbank.org/wbiep/decentralization/afrib/Momoniat.pdf> (last accessed Sept. 14, 2007). This cooperation often takes place in the Budget Council and the Budget Forum—two bodies made up of central, provincial, and local government officials that facilitate the budgetary negotiation process.

<sup>76</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER’S PERSPECTIVE, at 7. The central government has not approved of provincial taxation to date.

<sup>77</sup> SOUTH AFRICA CONST. ch. 13, sec. 214 (1996), *available at* <http://www.info.gov.za/documents/constitution/index.htm> (last accessed Sept. 14, 2007).

<sup>78</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD (2000), at 13.

<sup>79</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD (2000), at 12.

maintenance.<sup>80</sup> This has made municipalities largely fiscally independent from the central government. For example, in 1999-2000 municipalities raised ninety-two percent of their total revenues.<sup>81</sup>

### *Expenditure Authority*

South Africa has a highly decentralized expenditure authority, with sub-national governmental spending accounting for seventy-one percent of national spending in 2000-2001.<sup>82</sup> Provincial governments spend the largest share of the national budget, followed by the central government and then municipal governments.<sup>83</sup> The central government allocates most of its funding to the administration of justice and national defense, with smaller budgets for social services and infrastructural improvements.<sup>84</sup>

The central and provincial governments share responsibility for social services such as education, health, welfare, and housing. In practice, however, this means that the central government determines policy, which the provincial governments implement.<sup>85</sup> Provincial governments' budgets and expenditure authority vary, but they are primarily responsible for health, education, housing,

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<sup>80</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE, at 5.

<sup>81</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD (2000), at 13.

<sup>82</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD (2000), at 12.

<sup>83</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE, at 5. For 2000 and 2001, provincial government spending comprised 46 percent of national spending, compared to central government spending of 29 percent and municipal government spending of 25 percent.

<sup>84</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE, at 5.

<sup>85</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE, at 3.

and welfare.<sup>86</sup> Municipal governments are responsible for water and sanitation, electricity, local infrastructure, roadways, and garbage collection.<sup>87</sup>

### *Fiscal Imbalance Mitigation Mechanisms*

South Africa's fiscal devolution structure incorporates three primary processes for addressing imbalances: (1) a tri-annual budgetary consulting process that establishes baseline revenue allocations and annually modifies those allocations by variations in need; (2) an equitable share of an unconditional grant determined by an objective, formulaic evaluation of relative wealth and administrative capacity; and (3) a conditional grant program focusing on the provision of public services.<sup>88</sup>

The tri-annual budgetary consulting process analyzes provincial and local governments according to ten criteria, incorporating fiscal capacity, expenditure efficiency, development needs, and emergency funding.<sup>89</sup> The national Cabinet of Ministers then consults with provinces through the intergovernmental Budget Council and Budget Forum before submitting the final transfer proposal to national Parliament.<sup>90</sup>

Equitable share allocations are determined at the provincial level by seven criteria, focusing on education, health, and welfare needs.<sup>91</sup> This system favors poorer provinces, intending to foster inter-provincial equality.<sup>92</sup>

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<sup>86</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, *DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD* (2000), at 12.

<sup>87</sup> Ismail Momoniat, WORLD BANK, *FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE*, at 3.

<sup>88</sup> Ismail Momoniat, WORLD BANK, *FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE*, at 20.

<sup>89</sup> Ismail Momoniat, WORLD BANK, *FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE*, at 9. Baseline allocations are determined every three years and include the revenue-sharing percentages, meaning that annual consultations determine additional allocations of resources based on shifting policy priorities.

<sup>90</sup> Ismail Momoniat, WORLD BANK, *FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE*, at 9.

<sup>91</sup> Ismail Momoniat, WORLD BANK, *FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE*, at 11. This approach also includes the consideration of previous equitable share allocations as determinative information, in order to incorporate historical disparities into the decision-making process.

The conditional grant program permits the South African central government to allocate funding toward the pursuit of specific policy objectives.<sup>93</sup> This program is the primary source of central government funding for municipal governments, constituting sixty percent of intergovernmental transfers to local governments.<sup>94</sup> The program's lack of clearly defined objectives and transparent administration has led to some criticism.<sup>95</sup>

Intergovernmental transfers constituted 96 percent of provincial revenue in 1999-2000, with 83 percent of that funding coming from the unconditional revenue-sharing system and 13 percent coming from the conditional grant programs.<sup>96</sup>

## China

In 1994, China adopted sweeping fiscal reforms that centralized revenue collection authority and decentralized a regulated form of expenditure authority to provincial governments. Prior to these reforms, provincial governments had retained significant revenue collection authority, including the power to set tax rates and create tax exemptions.<sup>97</sup> However, China's financial reforms did not

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<sup>92</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE, at 11.

<sup>93</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE, at 11.

<sup>94</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD (2000), at 21.

<sup>95</sup> Ismail Momoniat, WORLD BANK, FISCAL DECENTRALISATION IN SOUTH AFRICA: A PRACTITIONER'S PERSPECTIVE, at 11. Momoniat notes that conditional grants "may lead to budget game-playing and create confusion about accountability." Further, the central government may abuse the use of conditional grants and use them as a way of forcing its policies on provincial governments.

<sup>96</sup> Paul Smoke, INTERNATIONAL MONETARY FUND, DECENTRALIZATION IN EAST AND SOUTHERN AFRICA: A SELECTIVE REVIEW OF EXPERIENCE AND THOUGHTS ON MOVING FORWARD (2000), at 12.

<sup>97</sup> Shaoguang Wang, *China's 1994 Fiscal Reforms: An Initial Assessment*, ASIAN SURVEY, September 1997, at 1-2. The power for provincial governments to set tax rates and grant tax exemptions created significant complications for the central government in terms of adopting national policy and ensuring transparent compliance with tax laws.

address extra-budgetary expenditures, which have increased since 1994, enabling provincial governments to operate outside the budgetary system.<sup>98</sup>

### *Revenue Collection Authority*

The 1994 fiscal reform standardized China's tax rates at 33 percent. China's revenue collection system divides revenue into three categories: central, provincial, and shared.<sup>99</sup> The central government collects taxes designated for centralized and shared expenditures, according to predetermined percentages. Provincial governments collect taxes allocated to provincial expenditures.<sup>100</sup> Following the 1994 fiscal reform, China has increasingly centralized its revenue collection. Provincial governments collected 51.2 percent of revenue in 1997, compared with seventy-eight percent in 1993.<sup>101</sup>

The central government derives a majority of its tax revenue from a consumption tax; an income tax on centrally owned enterprises; turnover taxes on railways, banks, and insurance companies; income taxes from financial institutions; and customs duties.<sup>102</sup> The provincial governments derive a majority of their tax revenue from business tax, income tax on locally owned state enterprises, and personal income tax.<sup>103</sup> The primary shared taxes are the value added tax, the securities trading tax, and the natural resources tax.<sup>104</sup>

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<sup>98</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 8, *available at* <http://www.imf.org/external/pubs/ft/seminar/2000/idn/china.pdf> (last accessed Sept. 14, 2007).

<sup>99</sup> Shaoguang Wang, *China's 1994 Fiscal Reforms: An Initial Assessment*, ASIAN SURVEY, September 1997, at 1-2.

<sup>100</sup> Shaoguang Wang, *China's 1994 Fiscal Reforms: An Initial Assessment*, ASIAN SURVEY, September 1997, at 1-2.

<sup>101</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 5.

<sup>102</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 5.

<sup>103</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 5.

<sup>104</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 5. Approximately 75 percent of the value added tax goes to the central government with 25 percent going to provincial governments. The government divides the securities tax revenue equally, and the natural resources tax revenue largely goes to provincial governments.

### *Expenditure Authority*

China has gradually decentralized its expenditure authority over the past few decades, with 72.6 percent of expenditures occurring at the provincial level in 1997, compared to 48.9 percent in 1979.<sup>105</sup> However, China's central government annually establishes acceptable spending limits for provincial governments from a "base figure"—the expenditure of the province in a "base" year—and modifies it according to policy priority, price reform, and inflation.<sup>106</sup>

The central government is primarily responsible for spending on national defense; foreign relations; capital construction on state-owned enterprises; agriculture, forestry, and water conservation; industrial, transportation, and commercial operations; and some education, health, and social services.<sup>107</sup> The provincial governments are responsible for locally owned enterprises; rural production assistance; agricultural development; water conservation; urban maintenance and construction; education, health, culture, and social services; and administrative expenditures.<sup>108</sup> China does not have a law that clearly delegates expenditure authorities and this has been a source of significant controversy.<sup>109</sup>

### *Fiscal Imbalance Mitigation Mechanisms*

The centralization of revenue collection authority combined with the decentralization of expenditure authority has created a fiscal imbalance between central and provincial governments. In addition to the revenue-sharing mentioned above, China has adopted three types of intergovernmental transfers including: (1) transfers based on the system in 1993, accounting for two-thirds of

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<sup>105</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 5.

<sup>106</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 3; Shaoguang Wang, *China's 1994 Fiscal Reforms: An Initial Assessment*, ASIAN SURVEY, September 1997, at 4. The variations of spending limits primarily account for changes in the cost of living and the central government's interest in developing the region. In order to pass the 1994 reforms, the central government guaranteed that provincial revenues would not fall below their level in 1993.

<sup>107</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 2.

<sup>108</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 2.

<sup>109</sup> Shaoguang Wang, *China's 1994 Fiscal Reforms: An Initial Assessment*, ASIAN SURVEY, September 1997, at 7.

intergovernmental transfers; (2) specific purpose grants, accounting for nearly one-third of transfers,; and (3) transfers to mitigate regional disparities., which as of 1996, accounted for 0.5 percent of transfers.<sup>110</sup>

Guaranteed transfers made based on the intergovernmental transfer levels in 1993 preserved the continuity of the revenue streams and contractual obligations made prior to the 1994 fiscal reforms.<sup>111</sup> The central government distributes specific purpose grants for individual projects according to its policy priorities.<sup>112</sup> Though these intergovernmental transfers mitigate some imbalance, inter-provincial wealth disparities are a growing concern.<sup>113</sup>

## DARFUR PEACE AGREEMENT

### Fiscal Devolution Structure

The 2006 Darfur Peace Agreement (DPA) provides both the central and the provincial governments with expenditure authority and revenue collection authority.<sup>114</sup> The DPA allocates expenditure authority to the central government for those elements that affect the national economy and to the provincial governments for those elements that affect the provincial economies.<sup>115</sup> The DPA grants each level of government the authority to raise revenues to pay for the programs under its expenditure authority.<sup>116</sup>

The DPA outlines the competencies over which the central and provincial governments have authority. The central government has competence over income tax, corporate taxes, import taxes, sales tax, and other taxes for which the national

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<sup>110</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 7.

<sup>111</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 7.

<sup>112</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 7.

<sup>113</sup> Jun Ma and John Norregaard, INTERNATIONAL MONETARY FUND, CHINA'S FISCAL DECENTRALIZATION (1998), at 7; Shaoguang Wang, *China's 1994 Fiscal Reforms: An Initial Assessment*, ASIAN SURVEY, September 1997, at 8.

<sup>114</sup> Darfur Peace Agreement, art. 18, sec. 113, May 5, 2006, available at [http://www.unmis.org/english/2006Docs/DPA\\_ABUJA-5-05-06-withSignatures.pdf](http://www.unmis.org/english/2006Docs/DPA_ABUJA-5-05-06-withSignatures.pdf) (last accessed Sept 20, 2007).

<sup>115</sup> Darfur Peace Agreement, art. 18, para. 113, sec. a.

<sup>116</sup> Darfur Peace Agreement, art. 18, para. 113, sec. b.

legislature may enact laws.<sup>117</sup> The provincial governments have competence over property tax, stamp tax, agricultural taxes, excise taxes, and other taxes as their provincial legislatures may provide.<sup>118</sup>

In addition to the competencies of all provincial governments to raise revenues, the DPA provides Darfur with the authority to borrow funds from external sources.<sup>119</sup> The Darfur provincial governments must report any external loans or grants to the central government.<sup>120</sup>

## **Fiscal Equalization**

To address vertical and horizontal resource imbalances, the DPA establishes the Fiscal and Financial Allocation and Monitoring Commission.<sup>121</sup> The Fiscal and Financial Allocation and Monitoring Commission consists of an independent panel of experts appointed by the President and approved by the national legislature.<sup>122</sup> The Fiscal and Financial Allocation and Monitoring Commission develops formulas for the allocation of resources between the central and provincial governments and for allocation of resources among provincial governments.<sup>123</sup> The Fiscal and Financial Allocation and Monitoring Commission submits its recommendations to the President, who must obtain the approval of the national legislature.<sup>124</sup> Upon approval of the national legislature, the Fiscal and Financial Allocation and Monitoring Commission becomes responsible for the implementation of its formulas for resource allocation.<sup>125</sup> The DPA provides that Darfur must have appropriate representation on the Fiscal and Financial Allocation and Monitoring Commission.<sup>126</sup>

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<sup>117</sup> This is a non-exhaustive list of the central government's competencies. For the full list of competencies, see the Darfur Peace Agreement, art. 18, para. 117.

<sup>118</sup> This is a non-exhaustive list of the regional governments' competencies. For the full list of competencies, see the Darfur Peace Agreement, art. 18, para. 118.

<sup>119</sup> Darfur Peace Agreement, art. 18, para. 130.

<sup>120</sup> Darfur Peace Agreement, art. 18, para. 131.

<sup>121</sup> Darfur Peace Agreement, art. 18, para. 120.

<sup>122</sup> Darfur Peace Agreement, art. 18, para. 121.

<sup>123</sup> Darfur Peace Agreement, art. 18, para. 121.

<sup>124</sup> Darfur Peace Agreement, art. 18, para. 122.

<sup>125</sup> Darfur Peace Agreement, art. 18, para. 122.

<sup>126</sup> Darfur Peace Agreement, art. 18, para. 129.

The DPA also provides that the central government may not withhold the transfer of funds to the provinces of Darfur or any other provinces in Sudan.<sup>127</sup> If the central government withholds funds from Darfur, then the affected provinces may seek redress in the Constitutional Court.<sup>128</sup>

### **Policy Adjustment Authority**

The DPA grants the Fiscal and Financial Allocation and Monitoring Commission with ultimate responsibility to determine the allocation of funds between the central and provincial governments and among the provincial governments, although the decisions of the Fiscal and Financial Allocation and Monitoring Commission are subject to approval of the national legislature.<sup>129</sup> The DPA requires Darfur to report to the central government periodically on all of its expenditures and revenues.<sup>130</sup> The parties require this reporting as a mechanism to help determine allocations by the central government each year.<sup>131</sup>

### **SAMPLE LANGUAGE**

#### **Article XXX**

#### **Revenue Collection**

- (1) Revenue from the following taxes shall accrue to the central government: [taxes are specified, such as income tax, corporate taxes, customs duties, and freight taxes].
- (2) Revenue from the following taxes shall accrue to the provincial governments: [taxes are specified, such as inheritance tax, property tax, and the motor vehicle tax].
- (3) Revenue from certain taxes [specified here] shall accrue jointly to the central and provincial governments based on the extent of their expenditures and a desire to maintain a balance among all levels of government.<sup>132</sup>

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<sup>127</sup> Darfur Peace Agreement, art. 18, para. 126.

<sup>128</sup> Darfur Peace Agreement, art. 18, para. 127.

<sup>129</sup> Darfur Peace Agreement, art. 18, para. 121.

<sup>130</sup> Darfur Peace Agreement, art. 18, para. 133.

<sup>131</sup> Darfur Peace Agreement, art. 18, para. 133.

<sup>132</sup> This language is drawn from the GERMANY CONST. art. 106 of the German Constitution.(1949). The Philippine Constitution also provides for a decentralized system of

**OR**

All revenues or moneys raised or received by the Republic of Sudan shall form one Consolidated Revenue Fund, to be appropriated for the purposes of the Republic in the manner and subject to the charges and liabilities imposed by the Constitution.<sup>133</sup>

**Article XXX**

**Vertical Imbalance Mitigation Mechanisms**

- (1) An Act of the legislature must provide for:
  - (a) The equitable division of revenue raised nationally among the central, provincial, and local spheres of government;
  - (b) The determination of each province's equitable share of the provincial share of that revenue; and
  - (c) Any other allocations to provincial or local governments from the central government's share of that revenue, and any conditions on which those allocations may be made.<sup>134</sup>

**OR**

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revenue collection, providing, “Each local government unit shall have the power to create its own sources of revenues and to levy taxes, fees, and charges subject to such guidelines and limitations as the Congress may provide, consistent with the basic policy of local autonomy. Such taxes, fees, and charges shall accrue exclusively to the local governments. Local government units shall have a just share, as determined by law, in the national taxes which shall be automatically released to them.” PHILIPPINES CONST. art. 10, secs. 5, 6 (1987), *available at* <http://www.gov.ph/aboutphil/constitution.asp> (last accessed Sept. 15, 2007).

<sup>133</sup> This language is drawn from the AUSTRALIA CONST. art. 81 (1900). Venezuela also has a centralized revenue collection system. The Venezuelan Constitution provides that regional governments’ revenues come from “their property and the management of their assets,” “[c]harges for the use of their goods and services, fines and penalties, and any charges allocated to them,” “[p]roceeds from the sale of State-owned commodities,” and “[t]he resources to which they are entitled by virtue of constitutional revenue share.” VENEZUELA CONST. art. 167 (1999), *available at* [http://www.analitica.com/bitbliblioteca/venezuela/constitucion\\_ingles.pdf](http://www.analitica.com/bitbliblioteca/venezuela/constitucion_ingles.pdf) (last accessed Sept. 15, 2007).

<sup>134</sup> This language is drawn from the SOUTH AFRICA CONST. art. 214 (1996). Venezuela also has a conditional system in that it requires that the regions invest 50% of their tax revenue shares each fiscal year. VENEZUELA CONST. art. 167 (1999).

The respective shares of the central and provincial governments in the tax revenue shall be apportioned anew whenever the ratio of revenues to expenditures of the central government becomes substantially different from that of the provincial governments. If a federal law imposes additional expenditures on or withdraws revenue from the provinces, the additional burden may be compensated for by federal grants pursuant to a federal law requiring the consent of the Legislature, provided the additional burden is limited to a short period of time. This law shall establish the principles for calculating such grants and distributing them among the provinces.<sup>135</sup>

### **Article XXX**

#### **Horizontal Imbalance Mitigation Mechanisms**

A federal law requiring the consent of the legislature may provide for the grant of supplementary shares of revenue not exceeding one quarter of a province's share to provinces whose per capita revenue from regional taxes and from its share of federal taxes is below the average of all the provinces combined.<sup>136</sup>

**OR**

- (1) The legislature may enact legislation to provide for the equitable division of revenue raised nationally among the central, provincial, and local spheres of government. Such Act must take into account:
  - (a) The national interest;
  - (b) Any provision that must be made in respect of the national debt and other national obligations;
  - (c) The needs and interests of the central government, determined by objective criteria;

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<sup>135</sup> This language is drawn from the GERMANY CONST. art. 106 (1949). The Philippine Constitution also provides for an unconditional transfer of tax revenue from the central to the regional governments. It provides, "Local government units shall have a just share, as determined by law, in the national taxes which shall be automatically released to them." PHILIPPINES CONST. art. 10, sec. 6 (1987).

<sup>136</sup> This language is drawn from the GERMANY CONST. art. 107 (1949). Venezuela also uses a net equalization system for allocating funds among the regions. VENEZUELA CONS. art. 167 (1999) (providing, "The [regional] revenue share is equivalent to up to 20% of total ordinary revenues as estimated annually by the National Treasury, which is to be distributed among the [regions] and the Capital District as follows: 30% of the aforementioned percentage in equal shares, and the remaining 70% in proportion to the population of each of such entities.").

- (d) The need to ensure that the provincial and local governments are able to provide basic services and perform the functions allocated to them;
- (e) The fiscal capacity and efficiency of the provincial and local governments;
- (f) Developmental and other needs of provincial and local governments;
- (g) Economic disparities within and among the provinces;
- (h) Obligations of the provincial and local governments in terms of federal legislation;
- (i) The desirability of stable and predictable allocations of revenue shares; and
- (j) The need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria.<sup>137</sup>

### **Article XXX**

#### **Fiscal Policy Adjustment Mechanisms**

- (1) There shall be a National Finance Council consisting of the President, such other officials as the President may designate, and one representative from each of the provinces.
- (2) The National Finance Council shall be summoned to meet at least once in every twelve months.
- (3) It shall be the duty of the central government to consult the National Finance Council in respect of:
  - (a) The making of grants by the central government to the provincial and local governments;
  - (b) The assignment to the provincial and local governments of the whole or any portion of the proceeds of any federal tax or fee;
  - (c) The annual loan requirements of the central government and the provincial governments and the exercise by the central government and the provincial governments of their borrowing powers;
  - (d) The making of loans to any of the provinces; and

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<sup>137</sup> This language is drawn from the SOUTH AFRICA CONST. art. 214 (1996). The Swiss Constitution also uses a gross equalization system in that it provides for the distribution of subsidies to the regions based on their financial capacity and need, rather than on a fixed distribution formula. SWITZERLAND CONST. art. 135 (1999), *available at* <http://www.admin.ch/ch/e/rs/1999/2556.pdf> (last accessed Sept. 15, 2007).

(e) The making of development plans.<sup>138</sup>

**OR**

A federal law requiring approval of the legislature may alter a province's share of tax revenue from the central government.<sup>139</sup>

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<sup>138</sup> This language is drawn from the MALAYSIA CONST. art. 108. Similarly, South Africa also has a Fiscal and Financial Commission that makes recommendations to the legislature and the regional governments in the allocation and use of tax revenue in the central and regional governments. SOUTH AFRICA CONST. arts. 220-222 (1996).

<sup>139</sup> This language is drawn from GERMANY CONST. art. 107 (1949). The German Constitution requires that the Legislature approve adjustments to a region's share of tax revenue. Similarly, in Canada, the legislature has the power to levy taxes and apportion revenues, and all tax bills must originate in the House of Commons, or the lower house of the legislature. Canada's Constitution Act of 1867, art. 53, *available at* [http://laws.justice.gc.ca/en/const/c1867\\_e.html](http://laws.justice.gc.ca/en/const/c1867_e.html) (last accessed Sept. 15, 2007). The Philippines also use this procedure. PHILIPPINES CONST. art. 6, sec. 24 (1987).