Self-enforcing fiscal federalism: Germany, Australia, and Switzerland compared

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FIRST DRAFT! DO NOT QUOTE!

1 INTRODUCTION

The second, institutionalist wave of economic studies on federalism (Weingast 1995; Bednar, Eskridge, and Ferejohn 2001; Kelemen 2003; Filippov, Ordeshook, and Shvetsova 2004; Iaryczower, Saiegh, and Tommasi 2004) has addressed the question to what extent one can design a self-enforcing federal order. The theory treats actors in federalism as resource-maximising and opportunistic. Self-enforcing then means an order that gives incentives to accept the existing arrangements and to not exploit the order for own purposes at the expense of others. Though Weingast has attempted to define such an order for federalism by developing a model of “market-preserving federalism” (Weingast 1995), fiscal federalism as such has not been focused upon. Neither have other studies dealt in particular with fiscal federalism.

By referring to the economic literature on federalism, I will endeavour to fill this gap and develop a first sketch of a model of fiscal federalism that is efficiency-enhancing and self-enforcing. The basic components of this model are then used to evaluate three “real-life” federal orders, Germany, Australia, and Switzerland. My basic question is to what extent these orders fail or succeed to correspond to the ideal model of self-enforcing fiscal
federalism. The comparison of countries serves to learn by what institutional means various countries have attempted to deal with inefficiencies. The background for this discussion are recent reform attempts in Germany that envisage to introduce a more efficient fiscal federal order.

2 THE MODEL

I need three analytical components to deal with fiscal federalism: the self-enforcing model (categorical and appliance rules); the various revenue resources that play a role; and actor constellations and interests.

2.1 The self-enforcing model

The following rules are based both on the older, neo-classical economic theory of federalism (Tiebout 1956; Musgrave 1959; Olson 1969; Oates 1972) and on the institutionalist version of the economic theory of federalism (see above). The main rationale of these rules is to reduce the likelihood that any actor in federalism (which I limit to the federal government and member states for reasons of simplicity) has reason to be opportunistic, i.e. abuse the system for his or her own purposes, and, hence, achieve a stable, self-enforcing and efficient fiscal order. I distinguish between five categorical rules and four application rules.

Categorical rules

(1) A standard argument in the economic literature is to avoid rent-seeking by behaviour and the creation of “distributive coalitions”. Any fiscal order that would give the opportunity to actors to obtain resources without productive effort fosters opportunism and reduces efficiency. Distributive coalitions can be considered as a coalition of two or more actors that can obtain rents at the cost of other actors.

(2) Avoid predatory behaviour is the second rule. This alludes to the possibility, most of the time of the federal government, to use its (superior) financial resources in order to encroach upon domains of other actors (citizens, interest groups, member states). Predatory behaviour is in conflict with one of the main values of “market-preserving federalism”, a “delineated scope of authority” with constitutionally guaranteed autonomy that may not be interfered with by the federal government (Weingast 1995; Braun 2005).

(3) Closely linked to predatory behaviour is the rule to avoid fiscal illusion. Predatory
behaviour in fiscal federalism is most of the time in terms of financial incentives the government offers to member states. Such incentives can break the link between the connectivity of revenue and expenditures in member states (Olson 1969) and lead to waste, overspending and “flypaper effects”. And, of course, it can foster rent-seeking behaviour.

(4) Any disincentives for productive and efficiency-enhancing activities should be avoided. This rule is not just rent-seeking seen from another angle. It refers to those actors in the system that cannot seek rents but which have nevertheless no incentive to engage in productive behaviour because, for example, marginal tax rates are so high that the costs involved in productive behaviour seem to be higher than the benefits one can expect from such activities.

(5) The literature on self-enforcing institutions is somewhat one-sidedly focused upon the efficiency of institutional orders. Especially in fiscal federalism, however, the typical trade-off between efficiency and equity holds (Okun 1975). Obviously, a fiscal federal order cannot survive on efficiency alone. Stability in federalism is essentially also based on equilibrating forces and reducing economic and social disparities between member states. A federal order must also be considered as a “just” fiscal order. This means that it needs some measure of “equity”, of fairness, that will be applied. The precise definition of such a measure will vary but at a minimum it seems that a fiscal federal order must guarantee equal chances to member states. If there is a trade-off, as Okun suggests, federal states have therefore to choose their mix between equity and efficiency and there will be constant struggle among potential losers and winners how to define this mix (Ahmad and Craig 1997). As a rule that attempts to combine equity and efficiency, one can say that a fiscal federal order should guarantee equity without violating rules 1, 3, and 4, i.e. without creating rent-seeking, fiscal illusion or disincentives for productive behaviour.

How to apply the rules:

(A) Hard budget constraints are usually considered as a conditio sine qua non for avoiding negative effects as sketched above (see Weingast 1995; Rodden, Eskeland, and Litvack 2003).

(B) A main condition for achieving an efficient fiscal order is according to market-preserving federalism a clearly delineated and autonomous competence area for
member states. Member states must have sufficient rights to act and sufficient resources to work with. Only then they are able to act responsibly and in an accountable way, which avoids opportunism.

(C) From this follows, and the rule on predatory behaviour has already signalled it, that encroaching activities of the federal government should be avoided as good as possible.

(D) Finally, a fiscal federal order should promote the connectivity of revenue and expenditures as only then there is cost consciousness which avoids rent-seeking and fiscal illusion.

These categorical rules and application rules serve as a reference for our discussion of existing fiscal federal orders. There are two other analytical points one should treat before entering the discussion.

2.2 Revenue sources

The first point concerns the different revenue sources in fiscal federalism. In order to understand the working, efficiencies and inefficiencies, one must distinguish between the four kinds of possible revenue sources of member states and the federal government, i.e. taxes, vertical transfers (which usually means transfers from the federal government to member states but not always), equalisation payments and borrowing. I will proceed by discussing fiscal federalism for each revenue category.

2.3 Actor constellations and interests

The second point treats actor constellations and actors’ interests in fiscal federalism. I will be as short as possible.

The basic assumption for an understanding of interests are revenue-maximising and opportunistic actors. I will start from the idea that there are basically three kinds of actors in federalism: the federal government, richer and poorer member states. The distinction between rich and poor is pertinent as different interests emerge from these positions. In the following table I have attempted to give a short sketch of the different likely positions concerning the use of the four revenue sources:
<table>
<thead>
<tr>
<th></th>
<th>Taxes for Member States</th>
<th>Vertical Transfers from the federal government</th>
<th>Equalisation payments</th>
<th>Borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal government</strong></td>
<td>NEGATIVE (as it reduces possibility for predatory action)</td>
<td>POSITIVE (as it gives the opportunity to encroach upon policy areas of member states)</td>
<td>POSITIVE (as federal government is responsible for stabilisation of the federal system)</td>
<td>NEGATIVE (for member states as it reduces macro-economic stability and own action)</td>
</tr>
<tr>
<td><strong>Poor States</strong></td>
<td>NEGATIVE (as economic positions is seen as too weak to survive autonomously)</td>
<td>POSITIVE (as it allows to deliver comparable services to its voters and can hide own failure before voters)</td>
<td>POSITIVE (as it allows to deliver comparable services to its voters and can hide own failure before voters)</td>
<td>POSITIVE (flexible instrument that allows to deliver comparable services to its voters and can hide own failure before voters)</td>
</tr>
<tr>
<td><strong>Rich States</strong></td>
<td>POSITIVE (as it strengthens autonomous action and can further improve economic strength)</td>
<td>NEGATIVE (as it gives the federal government too much influence on own policy areas)</td>
<td>NEGATIVE (as usually rich states are the payer states and lose resources)</td>
<td>POSITIVE (flexible instrument that can help to more easily develop own economic strengths)</td>
</tr>
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The overview demonstrates that easily a “robbers coalition” can be formed on the basis of basic interests of actors. It is rather the federal government and poor states that have usually converging interests in fiscal federalism. The resulting order would, of course, violate most of the categorical and application rules sketched above. It needs therefore self-enforcing
institutions that can give incentives to all actors to respect those rules. To what extent have the three federal countries discussed here, succeeded in developing such an order?

3  FISCAL FEDERALISM COMPARED

3.1  Taxes

The distribution of taxes is the basic and most fundamental decision in a fiscal federal order. It decides according to the economic theory of federalism about the degree of autonomy and responsibility. Usually, member states are supposed to have a substantial number of own tax resources to determine their own policies and act as autonomous and responsible actors. How can we summarise briefly the basic structure in this respect in these three countries?

(1) Germany has a tax-sharing system for growth taxes (income, corporate, VAT). Income and corporate tax are shared in an equal way. The distribution key is fixed in the Constitution and revision would need a two-third majority in the two chambers. This can be considered as a quite rigid arrangement. There is, of course, the possibility and also a certain incentive (Braun 2002) for all actors to augment these taxes because everyone would profit from it but that does not concern the distributive key. The VAT tax can be manipulated by majority decisions in the two chambers and is therefore negotiable. The reason for the somewhat stronger flexibility in distributing the VAT is the consideration that in a functional federalism, where States are usually executing federal laws, it needs a flexible resource to adapt changing administrative costs for the state. The flexibility creates, of course, on the negative side of the balance the possibility for political conflict and distributive struggle, which indeed has often been the case in the history of German federalism.

The quintessence of this tax order is that member states have not, as demanded in application rule B, a sufficient degree of self-determination regarding the use of taxes. In fact, until recently, there were for very few and minor exceptions no tax autonomy at all. Only recently, it became possible to levy surtax on the tax of land acquisition ("Grunderwerbssteuer"), the revenues of which have always been in the hands of the German member states, the Länder.

The German tax system has positive elements in that it guarantees a security about the distribution of resources (but not the flow of resources as this depends on the decisions of economic subjects) in the system but it also demonstrates a strong rigidity in adapting to new circumstances. This is also valid for the VAT, which only after considerable negotiation and windows of opportunity, can be manipulated. This inflexibility is an incentive for actors to
resort to other means to find resources if taxes turn out insufficient, most notably to borrowing and vertical transfers. With as a consequence an opening for rent-seeking and distributive coalitions as well as the possibility for predatory behaviour.

The German tax system does, therefore, violate application rule B (sufficient own rights and resources for member states) and categorical rule 1. It is above all conducive to rent-seeking.

(2) Australian States have more own taxes at their disposition than the German Länder but the bulk of resources and all growth taxes are in the hands of the federal government, which creates a system with strong vertical fiscal imbalances (VFI). Though recently, the newly created GST is completely distributed among member states, the federal government keeps the “property right” on this tax and can also take it away from the States.

Application rule B is therefore partly respected as the States can behave autonomously in some tax areas but the amounts of money remain limited (about 20-30% of resources). On the other hand, the property rights concerning growth taxes gives the federal government clear opportunities to violate categorical rule 2, as it has all financial possibilities to engage into encroaching (application rule C) and predatory behaviour. We will demonstrate below, that nevertheless there are limits to this behaviour.

The GST tax does not allow for more autonomous action as its distribution is built into the equalisation procedures and very strict and equalising criteria prevail to distribute the money. Neither member states nor the federal government has discretion to manipulate these distribution criteria, which contributes to the security of revenue income to the States but does not augment their autonomy.

All in all, the Australian system can be considered being a tax system inclining towards predatory behaviour, which of course, raises the danger of its corollary, rent-seeking. We will come back to this point later on.

(3) Switzerland is certainly, together with Canada, which I will not include in this article, the federal country, which respects the most application rule B. The member states, the cantons, have access to all tax resources except for the VAT, which is exclusively in the hands of the federal government and which is also the main income of the federal government. The difference with other federal states can easily be seen by the fact that even this tax is only temporarily conceded to the federal government and can in principle, be taken away by the people. A regular referendum (every eight years) is needed to confirm the rights of the federal government on this point. The fear of predatory behaviour, which is clearly built into Swiss
political culture, becomes clearly visible on this point.

Nevertheless, the federal government has, having also its share in the income tax, sufficient resources to develop a predatory behaviour and encroach upon the policy domains of the cantons. This is above all due to the fact that most cantons are quite small and suffer from insufficient fiscal capacity and structural deficiencies. Such vulnerability opens the door for the federal government. Though there is tax autonomy, the development of a quite developed transfer system has taken place, creating considerable dependence of the cantons on the subsidies from the federal government. Both predatory behaviour and rent-seeking have been part of Swiss fiscal federalism until recently, when a major reform has completely restructured the existing system. This reform has not changed the basic tax structure but above all the transfer and equalisation system. We will come back later to this point.

This having said, one should be clear about the fact that own resources of cantons in Switzerland have been much higher than in Germany or Australia and tax competition can unfold. The Swiss tax system reduces therefore to considerable degree incentives for rent-seeking and predatory behaviour of the federal government. It fosters application rule D by creating connectivity between revenues and expenditures. And there are no possibilities for the federal government to encroach upon such tax autonomy of the cantons. It is therefore a fairly secure system for member states and a favourable base for developing efficient fiscal federalism. The problem to be solved is above all equity because of the large differences in economic capacity. Tax property rights and tax competition are apparently not enough to settle this problem. Until recently, the Swiss system has not been considered as having solved this problem. Equalisation has not contributed to a reduction of differences between regions. We will come back to this point later on.

3.2 Borrowing

Debt-making is a most attractive instrument for governments as it can be quickly arranged and flexibly used for the financing of different purposes (Rodden 2002). Urgent demands can be satisfied without making the future costs visible. And other, more unpleasant measures like tax increases or cuts in services can be avoided. Borrowing has therefore advantages for the re-election of governments. In using this instrument, governments are, of course, behaving opportunistically.

Specific context conditions can induce governments further to make use of this instrument in
an extensive way. The most important incentive is, without any doubt, the knowledge for member states, that the federal government (paternal help) and/or other member states (fraternal help) will “bail out”, i.e. will stand in with own money if the member state government declares that it is unable to pay interests for debts or pay back its debts. Bailing out undermines the willingness of actors to act in an accountable way and fosters rent-seeking and fiscal illusion.

A fiscal federal order with bailing out avoids responsible behaviour because both voters are deceived about the performance of governments and creditors lend money because they can count on the collective responsibility of all actors to pay back debts. In a system without bail out, the chances that creditors will grant money to a state in desolate conditions will be very low and therefore borrowing needs to be restricted. Market discipline restricts rent-seeking behaviour of actors, though Ter-Minassian and Craig (Ter-Minassian and Craig 1997) warn that the market as the only sanction mechanism might not be sufficient to achieve responsible fiscal behaviour.

Irresponsible behaviour in borrowing can create serious deficiencies as it may erode the capacity of the federal government to “formulate and implement a monetary policy consistent with macroeconomic stability” (Gandhi 1995: 44).

One should stress again that poor states will be particularly inclined to use borrowing as they most of the time lack sufficient fiscal capacity and economic strength. And those actors who must bail out will attempt to reduce such opportunistic behaviour.

Solutions to the borrowing problem are generally sought for by moral appeals, setting restraining rules, using collective coordination or enforcing market discipline. A “self-enforcing system of fiscal federalism” would, according to Rodden (2002), attempt to abolish bailing out and introducing a system of market discipline, which, however, needs a sufficient degree of tax autonomy and connectivity of revenues and expenditures.

(1) Germany has established a borrowing system that is considered as highly inefficient and that demonstrates several failures with regard to our rules: there are no hard budget constraints; there is a collectively organised bail out system; there are strong incentives for rent-seeking; there are chances for the federal government to use predatory behaviour; connectivity between revenues and expenditures is not respected.

In detail: First of all, Germany has not introduced a law that would forbid to make debts. Member states are allowed to engage in borrowing. Rules, however, do apply: By
constitution, all actors must take into account the macro-economic equilibrium (Art. 109, 2). There are constitutional possibilities for the federal government to regulate maximum amounts of budgets in the Länder if a serious economic disadvantage may arise, with the consent of the chamber of the States, the Bundesrat (109,3). The European Monetary System demands, moreover, that government borrowing is restricted to the “amount of projected outlays for investment purposes in the budget” (the so-called “golden rule”). In addition, Länder cannot lend money from the central bank. But all this is not sufficient as recent developments show. Member states behave in an opportunistic way: 12 of 16 member states have a deficit breaking therefore constitutional rules. Three Länder have declared to be in a state of budget emergency. In accordance to expectations, one finds that poor states demonstrate a much more aggressive behaviour to engage in debt-making than the other member states.

The point is that rules and regulations as a disciplinary instrument are not self-enforcing if there are no sanctions involved. One of the difficulties is that it is difficult to introduce pure market mechanisms as there are no municipal bond markets that could serve as a market control mechanisms. The Länder lend money directly from banks to finance their deficits. This explains the need for regulations (Spahn and Föttinger 1997: 238). But these rules and regulations are in the end “soft” (Kretschmann and Kaiser forthcoming).\(^1\) They can be interpreted in many ways and Länder use this for their advantage. The lack of concrete sanctions limits the pressure of the federal government to create disciplinary behaviour.

In addition, Germany leans on a system of solidarity among all actors: Above all the federal government but also other member states are obliged to bail out member states in difficulties. In the recent first part of the reform process, it was attempted to reduce incentives for borrowing: In the new “stability pact” (Art. 109,5) it was spelled out that, in case of violating the Maastricht rules, payments to the European Union must be made not only by the federal government as before but also by the Länder that have to pay 35% of the total sum. This sum is divided in a collective part (35%) in which all member states participate according to the number of inhabitants, and in an individual part, in which those member states that have contributed to the deficit must pay according to their share of deficit-spending.

\(^1\) See also Ter-Minassian and Craig (1997: 159): “In practice, there are weaknesses in both the formulation and application of the Länder laws. The investment requirements are specified ex ante rather than ex post and the interpretation of what constitutes investment is flexible.
This introduces some responsibility for the Länder, but does not abolish the bail out principle. The Länder can still get help, if they have excessive debts or manifest a serious crisis in their budget.2

The structural problem behind the opportunistic behaviour of member states is that there is a serious mismatch between available revenues and expenditure tasks. The determination of both are not in the hands of individual member states as they cannot determine tax rates according to local circumstances and they are obliged to execute implementation tasks for the federal government. Only recently it was decided that the federal government needs approval by the member states if it wants tasks executed that cause considerable costs for member states. Given the inflexible tax sharing system and also an inflexible equalisation system, member states are almost obliged to resort to borrowing as the only means to overcome the mismatch. There are therefore built-in incentives in the system to use borrowing in an extensive manner.

In sum, the borrowing system in Germany creates incentives above all for member states to use borrowing in an extensive manner instead of trying to solve their structural problems by productive behaviour. The bail out system creates irresponsible behaviour and a mentality of rent-seeking. Rules and regulations do not create hard budget constraints.

(2) Australia has been able during the last 10 years to constantly lower the deficits of federal government and member states. This is without any doubt due to the strong economic growth but in part also because Australia has switched from a system combining rules and cooperative control to a system of market discipline and cooperative control reducing considerably opportunistic behaviour.

It is interesting to look into the history of borrowing in Australia because it reveals some patterns of opportunism:

The peculiar feature of Australia is the existence of a coordinating body for borrowing, the

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2 Recently, the Federal Court of Justice has restricted the possibilities of the Länder to claim such a situation, though: member state Berlin failed to win a case in court when claiming a state of budget emergency and asking for bail out by the federal government. It could not convince the Court that its deficits have been not a consequence of failed management but “beyond its influence”. The point is that this does not change anything in the opportunistic behaviour Berlin as it continues to make debts. Creditors know that in the end, there is collective responsibility and individual member states profit from this situation.
Loan Council that underwent a number of changes. The Loan Council is a Commonwealth body that unites the Treasurers of the federal government and the States. Decisions are taken with qualified majority. The setting up of this Council in the 1920s served to avoid a crowding out of the capital market by competitive lending of the federal government and the States. In the beginning, participation was voluntary. Some years later it became statutory (1927). At this point of time, the federal government received sole authority to borrow and it borrowed on behalf of the states that lost authority to do so. Borrowing needs were discussed and decided within the Loan Council. A “National Debt Sinking Fund” was created to redeem debt. Everyone had to pay into this fund. The federal government could give grants to help States pay interest payments and contributions.

This solved some of the opportunism problems (and the crowding out problem): the States lost their individual rights in borrowing, which became subject to a collective coordination process. It gave the federal government more grips on borrowing behaviour as far as it could influence the decisions in the Council. Given the variety in fiscal needs of States, the building of winning coalitions was almost always possible for the federal government but in this case it was more the coalition with the richer states which had to contribute above average to the Sinking fund. In this way therefore borrowing became like in Germany a collective action system: States had to respect the limits set in the Council but if there were serious difficulties bailing out was prepared by both the federal government and the Fund. The federal government provided funds if member states were unable to raise, through the issue of securities, any borrowing that the Loan Council had approved. Bailing out was therefore not unlimited but within the confines defined in collective negotiation processes which is more restrictive than the German system.

But even with this system, success was limited and a change was decided in 1984. States had found a number of techniques that helped to circumvent the restrictions of the Loan Council, which demonstrates that the system applied, was not self-enforcing. There were still considerable incentives to use borrowing in an opportunistic way. In the revised system, borrowing rights were given back to the States. The federal government did not any longer borrow for the States. To cope with foreseeable difficulties, it was decided to introduce “Global Borrowing Limits”, which took all kind of borrowing activities into consideration and which were defined within the Loan Council. Again, opportunism prevailed under this regime as the States invented other means to overcome such limits. The obvious problem of making such a system self-enforcing is that the setting of such limits raises considerable control and
monitoring costs and technical problems. This is one of the major limitations of a system of rules and regulations, even if set up by collective coordination.

In the 1990s then, a new and still valid arrangement was set up, which changed the regime completely. There was no more approval of borrowing by the Loan Council and no more restrictions for States to borrow. The capital market should work as the major disciplinary mechanism. But the Loan Council continued to exist: Each state and the federal government have to present their “Loan Council allocations”, i.e. the net financing requirement for the coming fiscal year. The per capita formula that existed before to calculate borrowing limits was abandoned, as it took neither into account the fiscal needs nor fiscal capacities. For the determination of the net financing requirement there is now a formula calculating the fiscal position and reasonable infrastructure needs, “as well as the macroeconomic implications of the aggregate picture revealed by the Loan Council allocations” (Craig 1997: 187). Any adjustments to new circumstances are negotiated within in the Loan Council. The Council now serves above all to create individual responsibility: States and the federal government are obliged to justify their requirements or changes. There are stringent reporting requirements. Deviations from the presented “allocation” must be reported and explained. This explanation is made public. The Loan Council cannot formally approve but it can go public and can reprimand a state. This is, of course, only a light version of control. But Australia is now much more counting on the force of the market (creditors) and the force of the voters (transparency) than on top-down or collective limits, rules and regulations.

It is evident that such a system can only work if member states have sufficient tax autonomy and can take sufficient expenditure decisions to be held accountable on the economic and electoral market. This is the case in Australia.

In sum, we see a shift from a system of rules and regulations with centralised coordination to a system of market and public responsibility. It is interesting that this system seems to work better than the previous one where all states attempted to find a leeway in order to cheat on the system. Incentives by the economic and electoral market have a self-enforcing effect. The Loan Council is still important in order to create transparency and coordinate to some extent borrowing activities in order to avoid negative macro-economic effects.

The system applied reduces rent-seeking and does not create fiscal illusion. It introduces harder budget constraints than before.

(3) Switzerland’s borrowing system is characterised by an almost complete freedom of
cantons to use credits, with the exception that no actor can lend money from the central bank. This freedom corresponds to the large degree of tax autonomy. The federal government has no regulatory powers in borrowing. The system depends on market discipline: the credit credibility of cantons is judged by the capital market with the result that interest rates can differ considerably between cantons (Feld forthcoming: 192).

There are a number of additional institutional constraints that can have a self-enforcing effect on borrowing behaviour:

- A system of tax competition, which can punish unsound fiscal policies with the “exit” of above all enterprises (Dafflong 1999: 276).

- Though the question was never decided in court, the federal government does not need to bail out. ³

- The “sound financing” of the public budget is “firmly entrenched in people’s minds” (Spahn 1997: 334).

- Direct democracy is another constraining factor: in many cases a financial referendum against budget decisions of the cantonal government is possible. As citizens are reluctant to pay, the existence of such a financial referendum in a canton is judged positively by banks and leads to inferior interest rates (Feld forthcoming, p. 193). This puts pressure on other cantons.

- Like in Germany the “golden rule” applies in many cases, permitting borrowing only for investment purposes on a pay-as-you-use basis. Germany has demonstrated that this rule as a “stand alone rule” is not sufficient. In Switzerland it adds to other existing rules and institutional constraints.

- There are other rules valid in cantons like the need for a balanced budget for providing goods and services (Dafflon 1999) and a limitation to debt financing: in most cantons net lending is only allowed for financing capital expenditures and if interest and amortisation of the debt can be paid out of the current budget. This rule maintains accountability and budgetary responsibility of governments (Dafflon 1999).

Despite of these many constraints, deficits soared in the 1990s, though above all for the

³ There was one analogous case of a municipality trying to win the support of the canton in the Court. It lost the case and was considered to be responsible for its deficits. A similar judgment could be expected on the federal level.
federal government. It seems that cyclical aspects have played an important role here. Since 2000, the situation has continually improved on all territorial levels. The federal parliament has introduced the so-called “brake on debts” (“Schuldenbremse”) in order to get a grip on the deficit rates of the federal government (introduced by a referendum in 2001): this rule demands that expenditures must be balanced against revenues during an economic business cycle. Extraordinary revenues are not taken into account in the calculation but serve to pay back debts. Such a “brake” did already exist in some of the cantons before.

Taken together, one can attest Switzerland a considerable degree of self-enforcing mechanisms that are supposed to control debt making. The cornerstone is tax autonomy and a working bond and capital market that limits unsound fiscal behaviour. In addition, many member states have themselves introduced a large number of rules that seem to work better compared with Germany and Australia because (a) there is tax competition (b) because of own responsibility on the capital market (c) and because there is no bail out by the federal government.

This is still no guarantee that we will not find cantons with considerable debts but this seems to be a business cycle phenomenon and not a structural one.

All in all, one can say that opportunism in borrowing is constrained. Market forces prevail. In contrast to Australia, Switzerland has not opted for a collectively organised coordination mechanism. This grants even more autonomy and responsibility to individual member states and demands even more strongly a functioning bond and capital market. Categorical and application rules seem to be respected in the Swiss system.

4 EQUALISATION

No federal state can do without equalisation payments in order to achieve a legitimate degree of equity among its members. The problem is to avoid opportunism linked to wrong incentives often built in redistribution procedures of federal states and leading to inefficiencies.

There are different ways to define the basic norm that should inform equalisation mechanisms:

- compensation, helping to compensate certain member states to cope with structural deficiencies that are not under the control of the member state;
- equality to achieve the same level and quality of public services to citizens throughout the federal state;

- equity in the sense of creating equal chances to act;

Whatever formula chosen, it is clear that equalisation payments should not be in conflict with categorical rules 1, 3, and 4 (see above), i.e. they should not lead to consumption behaviour, overspending and irresponsible fiscal behaviour.

(1) Germany’s equalisation formula – a long time this was equality and has now become “comparable and similar living conditions” (“gleichwertige Lebensverhältnisse”) – violates categorical rules 1 (rent-seeking), 2 (predatory behaviour), 3 (fiscal illusion) and application rules B (sufficient rights and resources) and D (connectivity principle).

Germany has a very strong equalising and harmonising tradition. This is expressed in the criterion that guides the equalisation process: fiscal capacities of all member states should attain a level of 99.5% of the average fiscal capacity. This principle was not given up though there were considerable differences in economic and fiscal capacities among western countries and the system was quite expensive, when the Eastern Länder joined West-Germany. These Länder had and still have considerable infrastructural deficiencies and large sums of money had and have to be injected into the equalisation system to maintain the high standard of equalisation.

Germany was for a long time the only federation with a “fraternal component” in the equalisation system, i.e. the main equalisation payments come from member states themselves (horizontal equalisation). In the meantime Switzerland has also adopted this specific feature. It is the fraternal component that creates tensions with categorical rule 4 (disincentive for productive behaviour): Given the high level of equalisation, marginal tax rates of rich states are very high (70% (was 80%) for those having a fiscal capacity of 120% and more (was 100% and more before the so-called Solidarity pact II that became valid in 2005). This means that the benefits from productive investments are quickly lower than the costs that are involved in productive investment. The recent adjustments intend to reduce the disincentive effect for productive investments but these steps seem to be too small steps in the right direction in order to change reluctance among rich states to prefer productive investment instead of borrowing or inactivity.

\[4\] In addition, 12% of all revenue above the average will not be integrated in the equation.
There are three steps of horizontal equalisation:

A quarter of the VAT that is given to the Länder (today 49.5% of the total sum of money) goes immediately to weaker member states. The rest is distributed according to the number of inhabitants of member states. In this process all states should reach at least the level of 92% of the average. The second step of horizontal equalisation are direct payments from the states with a strong fiscal capacity to those with lower than average capacity (according to the population of the states).

The final step are supplementary grants by the federal government that intend to fill up fiscal gaps between member states until 99.5% of the average. These supplementary grants contribute significantly to rent-seeking, fiscal illusion and expectations about bail out (Rodden 2001). They are discretionary and can be negotiated. States, which are far below the average of fiscal capacity, have no incentive to change their situation because they can count on the obligation of the federal government to fill in the gap between 95% and 99.5% of fiscal capacities. On the contrary, these transfers “stimulate much more spending than would increases in local income” (ibid., 11). Rent-seeking and fiscal illusion is the outcome.

These negative incentives were recognised in a judgment by the Federal Court in 2003, where a restriction of these supplementary grants was demanded. Above all the negative effects on productive activities of the rich states were underlined and it was decided that the equalisation process could not lead to a different ranking in the ordering of member states before and after the equalisation process, which was a result of the former equalisation process. This protected again the richer states in some way and reduced marginal tax rates without, however, leading

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5 Today, “one will no longer provide full compensation up to 92% of the average Länder fiscal capacity, but rather a graded tariff which provides 95% compensation of shortfalls up to 97% of the average, and then falls degressively to compensate only 60% of the final increment less than 100% of the average. By removing any element of full compensation, this change represents a first attempt to introduce incentives for Länder to raise their tax revenues” Jeffery, Charlie. 2003. Cycles of Conflict: Fiscal Equalization in Germany. Regional and Federal Studies 13 (4):22-40.

6 “The process starts from a definition of a state and local fiscal capacity measure for each state, which is roughly the sum of state tax revenues….This measure is then related to an equalization standard for the same state, which is derived from the average per capita fiscal capacity of all participating states multiplied by the population of that state”. This leads up to a level of 95% of the average” (Spahn and Föttinger 1995: 235).

7 Supplementary grants (Bundesergänzungszuweisungen) are given to financially weak states. They are designed to make up for the shortfall in revenue, after interstate equalisation. Grants are given to some of the western states in order to offset losses they suffer as a result of the inclusion of the eastern states. Another type of grants is for “special needs” of some of the states (special high costs of political administration of small states and the still enormous deficiencies of eastern states as to their public infrastructure). Additionally, those states with a recognised budget emergency, Saarland and Bremen, receive financial aid to pay their debts, which demonstrates the bailing out mechanism by way of equalisation arrangements. (Spahn and Föttinger 1997: 235-6).
to a substantial change.

Jeffery aptly summarises the German equalisation system (2003: 30):

“The “rich south” wanted to pay less into the system, and had particular concerns about the “over-levelling” effect of equalisation. From their perspective the siphoning-off of their surplus fiscal capacity was punitive. The system also had perverse incentive structures. Recipient Länder would always be brought up to around the average fiscal capacity. They had no incentive to improve their economic performance and in that way increase the tax revenues collected on their territory. Boosting fiscal capacity in this way would only mean they received an equivalent drop in equalisation income. At the same time the rich had no great incentive to get richer given that they faced a kind of “marginal tax rate” of 80% once they exceeded 110% of average fiscal capacity”.

Rent-seeking on the one hand and disincentives for productive investment seem to be the main problems of the German equalisation system. By contrast, though the federal government has some discretion in dealing with supplementary grants, this is in general not seen as a problem of predatory behaviour. Renzsch, for example (Renzsch 2002), sees no opportunism by the federal government in form of the “golden leash” or the “golden reign”:

“There were no disputes about sanctions or cross-over sanctions like in the US or about the encroachment of the federal government on the provinces like in Canada.” This statement seems to be quite true as the main problem of the Germany fiscal federal order before the major reform in 1969 was precisely predatory behaviour of the federal government. The “sharing” system was conceived to reduce this danger. Unfortunately, it has been replaced by other problems.

Given the bail out system, it is not astonishing that poor member states in Germany do resist in the current debate any transfer of authority rights on taxes to member states. A situation of tax autonomy creates uncertainty about the future position and administrative costs are seen as an extra burden (Scharpf 2006).

Scharpf demonstrates (ibid., p. 11) that any tax autonomy does not make sense with an equalisation system like the German one, as any positive deviation from the average fiscal capacity would immediately be skimmed off. A reform of the equalisation system that is going further than the marginal changes applied until now, seems therefore to be a precondition for the establishment of a self-enforcing system in Germany.

(2) Australia has probably less problems to find a self-enforcing equalisation system than Germany or Switzerland because it is rather homogeneous in terms of GDP per capita and in fiscal capacity (Spahn and Shah 1995). This may be conducive to a system that is considered
to be the most equal after equalisation (McLean 2002). Australia does even equalise more than Germany but in a different way: by vertical transfers, at least until recently. However, this never meant that the federal government could use these transfers according to its own discretion. There was no mix of categorical and equalisation purposes in the transfer of grants as we find in Switzerland before the federal reform of 2004. Equalisation grants were general grants and distributed according to formulae developed by the Commonwealth Grants Commission (CGC), an independent body of economists nominated both by the federal government and the States.

The system goes so far as to also include categorical grants by the federal government in the calculation of equalisation rights of member states. This can be considered as a considerable disincentive for the federal government to abuse its financing powers and for member states to engage in rent-seeking by applying for individual special purposes grants.\(^8\) Despite of such incentives, categorical grants play an important part of the resources of member states (see below).\(^9\)

The equalisation system was set up in 1933 with the creation of the CGC after serious conflicts and a profound discontent of some States with existing financial arrangements that were completely at the discretion of the federal government (Craig 1997: 184). The solution was, however, not as in Germany, cooperative federalism and shared arrangements but delegation to an independent body. The CGC has no statutory powers whatsoever but no government would dare to not listen to the recommendations of the CGC in matters of equalisation.

The delegation to an independent body is indeed as the recent literature on independent regulatory agencies reveals a way for governments to demonstrate their willingness accept certain arrangements in the long term. Delegation reduces the discretion of the federal government and is therefore a self-enforcing mechanism to avoid predatory behaviour (Braun 2005)\(^10\) and establish an equal order that is considered legitimate.\(^11\) Though there are

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\(^8\) Craig 1997: 185: The methods used by the CGC “have the effect of clawing back any advantage or disadvantage conferred by specific purpose payments”.

\(^9\) McLean gives a number of reasons why these grants remain attractive (McLean 2002: 31).

\(^10\) McLean 1999: 34: “The CGC is a non-partisan agency immune from political manipulation”.

\(^11\) “While the political question – the extent of equalization – needs to be determined by governments, it is generally accepted in Australia that an independent body is more likely to achieve an equitable distribution of grants than is a process of political bargaining by governments of different political complexions and different fiscal strengths” (Spahn and Sha 1995: 65)
occasional complaints by richer states, the legitimacy of this order is not questioned.

This does not mean that policy-makers did refrain all the time from intermingling with equalisation policies of the CGC. From times to times there were attempts to make categorical grants more attractive and useful by appealing to the CGC to not include some of these grants into the calculation of equalisation rights. But such opportunistic behaviour is seldom. The CGC itself is well protected because it needs unanimous consent among all states, the Territories and the federal government to abolish it.

The guideline adopted by the CGC in determining the “relative needs” of each state is: each state should be able to give the same services and standards to its citizens if it has made the same average effort to raise revenues and if it acts at an average level of efficiency (McLean 2002: 23). This indicates the richness and complexity of procedures that are needed to determine these three components. Australia seems to be unique in that it equalises for expenditure needs and in taking into account of efficiency (McLean, 26). All three components are standardised to have a national average that serves as the base for the distribution of money. The actual tax policies are not taken into account. The states receive such an amount that is needed to engage in the average delivery of services independent of if the states will use this money in such a way. This is at their discretion.

Spahn and Shah praise these the formulae applied by the CGC (1995: 64) “Of all federal countries, Australia is best noted for its balanced emphasis on expenditure need and revenue means factors in determining state relativities for the distribution of unconditional equalization transfers”.

With the GST replacing existing financial assistance grants, the possibilities of the federal government to engage in discretionary behaviour are diminished even further. While it still could decide in an unilateral way about the amounts of money it wanted to inject into the equalisation procedure (Galligan 1995), the GST does not allow this anymore as the whole tax income is distributed among the states. The CGC distributes the money according to the established criteria. In addition, it was agree upon that no State would be worse off as a result of the introduction of the GST. Currently, total GST revenue is still less than the federal grants distributed before. Consequently, the Commonwealth funds the shortfall of member states through Budget Balancing Assistance.

The equalisation system seems therefore to be well protected from the discretionary influence of the federal government and rent-seeking behaviour of states seem to reduced.
Not all reports on the system are, however, favourable. The famous Garnaut/FitzGerald report (Garnaut and FitzGerald 2002) for example warns that there may be disincentive effects diminishing productive activities of richer States (p. 31) and that rent-seeking remains a problem in the system. Equity might nevertheless come with a negative effect on efficiency after all. This opinion, however, is also contradicted by other actors (Federal-State 1998). It seems to me that one can always raise quarrels about such kind of inefficiencies in equalisation systems. The overall impression is that though some kind of rent-seeking behaviour and disincentive might occur, this is not a structural and predominant feature of the system.

On the contrary, the features presented – the CGC as an independent body; the introduction of the GST – point to the willingness of the federal government to avoid predatory behaviour though property rights remain in the hands of the federal government and in more strenuous periods this might lead to a reversal this attitude. In this sense, existing regulations are not self-enforcing. However, even if this would happen, the federal government could only manipulate the overall sum of money but not distribution criteria as long as the CGC remains the distributive authority. The applied formulae are complex and comprehensive. They seem to be a fair base for distributing equalisation money. In addition, they respect the autonomy of member states in calculating a standardised average of service delivery.

Finally, psychologically this system seems to have advantages compared to the German one, because it seems more acceptable to not be attributed money from the federal government than to lose money that was created by economic activities in the region. In both cases we have a zero-sum-game but giving away money one owns seems to raise more conflict than money one is entitled to but has never received.

(3) Switzerland has revised equalisation procedures and its fiscal constitution in a profound way in 2004, after a ten-year process of negotiation. The reasons were profound deficiencies in the efficient functioning of this order: disparities were not reduced; the categorical grant system led to fiscal illusion, waste and rent-seeking. The system seemed too complex and not transparent enough to understand the effects it produced and member states complained about too much power for the federal government. Like in Germany, the federal government had become an active part in a large number of cooperative areas it co-financed, which gave it sufficient power to use the “golden leash” and encroach upon cantonal (Freiburghaus 2001: 12).
The reform was inspired by the economic theory of federalism and is therefore particular interesting for our purposes.

As a precondition for efficient fiscal federalism, 29 of 50 cooperative areas were decoupled. The cantons received 21 areas and the federal government 8. The remaining cooperative areas were organised along the lines of new public management ideas by attributing steering tasks to the federal government and operational tasks to the cantons. Contracts are set up to define relationships, output and monitoring. The money spent by the federal government is now general and not categorical and only big programs are financed. This has given cantons more autonomy than before.

Two clear general guidelines were applied in order to inform deliberations on the fiscal constitution (Freiburghaus 2001: 18): fiscal federalism should be based on subsidiarity and the financial capacity of cantons had to be improved by giving more own resources. Both rules served to reduce predatory behaviour of the federal government.

There are four parts of the new equalisation agreement (NFA; “Neuer Finanzausgleich”):

(a) Resource equalisation (“Ressourcenausgleich”): Switzerland changed its system by introducing a horizontal equalisation component like in Germany which had not existed before where all equalisation was financed with federal government money. Solidarity between cantons was supposed to be improved. The base for calculation is a new “resource index”, which takes only the tax potential of cantons into account, i.e. the tax income on the base of supposed equal taxation. The most important tax resources of cantons are included in the formula. The former system had also included elements of expenditure needs (“Lastenelemente”). The advantage of the new calculation base is supposed to be in the fact that tax potential cannot be manipulated by cantons by own tax strategies nor by expenditure behaviour (Feld forthcoming: p. 188). Manipulation had been a problem in the former system. Switzerland has never been a federation that envisaged equality among cantons. Differences are accepted (Braun 2003). This explains that the underlying criterion for equalisation is not equality but equity. At the moment, an equalisation rate of 85% of the average tax potential is valid. The federal government pays 1.8 billion and the 8 rich cantons 70% of this sum. The minimum that cantons have to distribute is fixed in the constitution and set to two-third of federal government money. The contributions by both cantons and the federal government demonstrate moreover that resource equalisation is a combination of horizontal and vertical equalisation. It is important to note that the equalisation rate is fixed politically, that means that the federal parliament (which has a Chamber of the States) can decide to change the rate
of 85%.

(b) Switzerland has introduced a guaranteed minimum of financial resources for cantons: if horizontal equalisation does not suffice, i.e. if cantons still do not have 85% of the average tax potential, the federal government adds money up to this standard.

(c) Costs equalisation (“Lastenausgleich”): In addition, Switzerland has introduced a cost equalisation procedure for those cantons that have particular structural disabilities like having large mountain areas or being an agglomeration with particular socio-demographic problems.

(d) Cohesion fund (“Härteausgleich”): Finally, it was decided like in Australia that no canton should suffer losses from these changes in procedures: for a limited period there will be compensatory payments that give each canton the sum of money it has obtained before. After eight years a digression clause sets in that reduces this sum for 5% each year. Both the federal government (two-third) and the cantons (one-third) are participating in the financing of the cohesion fund.

Both this guarantee of not losing money as well as a guarantee that no canton should pay more after the revision has made it possible that the reform was accepted.

Evaluating these arrangements, one can confirm that the main ideas, subsidiarity and own resources of cantons, has been respected. The decoupling of areas has been substantial giving cantons much more independent competence areas than before. And it is generally considered that after the reform, which will be in effect next year, even the weaker cantons will have more money at their disposal. The discretion of the federal government to distribute resources by categorical grants has been radically curtailed. Categorical grants as such do not exist anymore. They are replaced by general grants and contract mechanisms that give cantons more “voice”.

Other advantages improving the degree of efficiency of arrangements are that the new resource index is supposed to work against manipulation and therefore rent-seeking by cantons. In addition, it is a transparent and parsimonious formula. This makes an interesting contrast to the complex and sophisticated formula, the CGC is using in Australia. The CGC did not want to exclude standardised expenditure needs. In addition, it has an efficiency component in it. Standardisation might help against manipulation, but it is certain that information and monitoring costs are considerably higher in the Australian case than in Switzerland. Time will tell, if “tax potential” as the sole calculation base will indeed reduce opportunistic behaviour by cantons.
All equalisation payments may have an effect of diminishing own efforts for economic and social improvement by member states. However, in the Swiss case the low degree of equalisation (85%) reduces this risk considerably as it makes it worthwhile for cantons to make further efforts in order to at least attain the national average of services. The incentive component of the Swiss equalisation system is therefore much higher than in Australia or Germany, while keeping equity as the base of action.

The introduction of the cohesion fund has been necessary to find a consensus on reforms. On the other hand, it is set up in such a way that it is not an open-ended, but a closed financing. Cantons must therefore learn to improve their financial capacity in order to make for eventual losses from the revision in the long run.

In this way, Switzerland has at least intended to follow a number of categorical and application rules: reduce rent-seeking by cantons; avoid predatory behaviour; reduce fiscal illusion and maintaining equity with acceptable effects for efficiency. Rights and resources of cantons were strengthened and encroaching activities of the federal government were reduced. The connectivity principle is respected.

There are more doubts about the respect for the principle of avoiding disincentives for productive behaviour. Though marginal tax rates are limited they may still be too high for productive behaviour of cantons (Feld forthcoming: p. 190).

The decision to fix the equalisation rate by parliamentary debate and decisions is questionable. The advantage is without any doubt that it allows to account for circumstances and changes in the economic and cultural environment. On the other hand, the agreed formula is not self-enforcing and will be under constant political struggle and subject to political hazard. This is no credible solution and may lead to future conflict.

5 VERTICAL TRANSFERS BY THE FEDERAL GOVERNMENT

One could not discuss equalisation systems or borrowing without mentioning grants by the federal government. But in both cases such grants were usually not categorical but general. In the Swiss case we found a mix of categorical grants and equalisation intentions in the older system. Usually, categorical grants do not carry such a rationale with them. In the context of equalisation and borrowing, the danger of predatory behaviour was, therefore, limited when the federal government distributed money. This is different with categorical grants that are
designed to realise political objectives of the federal government at the level of member states thereby encroaching upon own objectives of member states. It is these grants that we will deal with in this chapter. They can be considered as the last of the four revenue sources available to member states.

There are several problems with categorical grants one could mention with regard to opportunism:

- By using the “power of the purse”, the federal government can impose its will upon regions putting into question the autonomy of decision-making of member state governments; This is indeed what one calls the “golden leash” syndrome;

- Categorical grants may cause waste and overspending if the amount of money given to the member states exceeds the amount that would be spent according to public demand in such regions (Spahn and Shah 1995: 60).

- As categorical grants are usually negotiated between individual member states and the federal government this can lead to rent-seeking by member states and predatory behaviour by the federal government. So-called "robbers coalitions” emerge above all between financially weak states that need additional money and the federal government.

- These problems are more visible in federal states with a high VFI as in Australia as the federal government disposes of most resources and can abuse these powers. Our discussion of Australia has also demonstrated that this is not a necessary development.

Categorical grants are not only a danger but have also advantages as Gandhi states (1995: 46) because they can “encourage local tax effort and discourage wasteful spending”. It is only important that a number of principles are obeyed: First, such grants “must make a measurable contribution to a clearly defined goal. Second, they must be inversely related to the grantee government’s “fiscal capacity” and directly related to its “fiscal needs”. And they must be measured with a clear, quantifiable, and transparent formula”. One should therefore not condemn categorical grants as such but rather find self-enforcing mechanisms that respect categorical and application rules.

(1) Germany changed its system, as already mentioned, in 1969 from one in which vertical transfers with conditions attached were very prominent to one in which the cooperative and sharing aspect predominated and in which the “golden leash” was reduced (Adelberger 2001).
Today, one part of vertical transfers of the federal government is bound into the equalisation procedure as mentioned above (“Bundesergänzungszuweisungen”). These payments cannot be considered being a “golden leash” the federal government could use to impose certain rules and regulations on the Länder. The “special purpose payments” that are part of these transfers (see above) have in addition been restricted, above all in order to reduce rent-seeking and not to prevent predatory behaviour by the federal government: the sum of money given to smaller Länder with high administrative costs is reduced; the payments for the special burdens of eastern Länder have become digressive and closed-ended and budgetary emergency payments to the western states will not be renewed (Jeffery 2003).

In other so-called “mixed financing areas”, which gave the federal government the opportunity not to impose but to considerably influence policies on the member state level, a “prohibition to cooperate” was introduced for those areas that, after the first federal reform, have been put under the sole authority of the Länder. This new constitutional article was designed explicitly to limit the influence of the federal government and give more autonomy to the member states. One of those areas is for example the financing of kindergarden and of universities. This prohibition does, however, not yet work as a self-enforcing device as recent discussions on the financial help of the federal government for kindergarden demonstrate. The remaining problem here is that, though for example, the Länder have received 70% of the money the federal government had spend in the university area for their own use in this domain, most financial questions are not settled yet but wait for discussion in the framework of the second federal reform directed to fiscal federalism. In the meantime, the Länder are often lacking the necessary resources in order to take advantage of the new freedom in several transferred policy domains.

In other mixed areas where the federal government is still contributing (for example the improvement of agricultural structure or regional promotion) the rules have been revised. Payments are now closed-ending and digressive which is intended to break the spiral of the federal government encroaching upon areas of the member states and member states attempting to seek rents.

This is no complete overview of changes taking place but one can see that Germany is busy to improve the efficiency of its transfer system, first, by introducing measures that serve to fight against fiscal illusion of member states and, second, by reducing the number of areas the federal government can intervene. In both cases, measures are not radical but they may diminish some of the inefficiencies that have been produced until now.
Australia uses special purpose payments (SPPs) as categorical grants, which made up for about 50% of total grants the federal government paid before the GST was introduced. SPPs remain an important source for the States (one fifth of total revenues) but as already has been explained in the context of equalisation payments, an important disincentive for both the federal government to abuse its financial power and for member states to seek rents on this base is that SPPs are part of the equalisation calculation base which diminishes opportunism on both sides. Nevertheless, there are some advantages for the Länder to use them and with this, the usual problems linked to the use of this instrument can arrive.

A part of the SPPs are addressed to institutions or individuals and are only passed through the States, which serve at this moment as administrative agents of the federal government. This means that there is no attempt to directly influence the policy decisions of the States and reduce their autonomy but to offer extra services the federal government consider as important in the various regions. Such services can, of course, conflict with offers delivered by the states and they can also conflict with basic policy intentions of States. For example, the decision of the federal government to subsidise private schools and not public schools may be in conflict with the philosophy of a State government that fosters above all public schools. The States could refuse to pass through such payments but usually they do not fearing a negative backlash during elections for not having transferred extra money to the region.

Other SPPs are directly addressed to the States. The bulk of the money is spent in education and health. The rest is shared between social welfare, housing, transport, communication and other policies (Craig 1997: 182).

Four different kind of requirements exist (Craig, 181f):

- General program requirements, such as the requirement that states provide free public hospital treatment to Medicare patients in return for grants made for hospitals
- Requirements that the payment be spent for a specific purpose, or be passed on to other entities, like universities
- Agreements covering service provision and program delivery mechanisms
- Detailed conditions on the operation of joint expenditure programs.

There is a mix in the degree of conditions the federal government applies. Some of the largest SPPs have a limited set of conditions and provide States with a relatively high degree of
flexibility to provide services. In other cases we find strong requirements.

But overall, given the importance that these grants still have for member states, one cannot deny that the federal government has possibilities to influence member states behaviour on the base of these grants. But it is probably even less this aspect which matters but more the degree of discretion the federal government has in curtailing, cutting or extending SPPs to its own liking. The member states usually do not have an influence on these decisions. The States could refuse to accept such programmes but often they do not, because of the additionally money that allows to fund projects they were reluctant to carry on on their own. On the other side, this creates also the danger that overspending and waste may be part of transfer procedures.

(3) Coming to Switzerland I can be rather brief as most features of the vertical grant system have already been described in the context of equalisation. Switzerland has considerably reduced the number of categorical grants by the new reforms. If they exist they are bound into a contract mechanism and only addressed to larger programs. Emphasis is laid on non-categorical grants and a system that strongly fosters sufficient rights and resources of member states. This objective has reduced considerably the need for supplementary transfers by the federal government. With the introduction of the new system, categorical grants will have lost their importance.

6 CONCLUSIONS

A number of preliminary conclusions can be drawn:

(1) There have been reforms in all three countries that envisage improving the efficiency (not equity) along the lines of some of the categorical and application rules that were stipulated in the beginning. They were the most far-going in Switzerland, while Germany has started with a number of incremental improvements above all designed to cope with rent-seeking, fiscal illusion and disincentives for productive behaviour. Australia has probably changed its system the least, partly because the initial conditions of Australia were more conducive to develop a favourable balance, above all because of regional differences that were less important than the ones in Germany or Switzerland. This reduces the financial pressure on the system and the search for rents.

(2) If one looks more in particular on the starting conditions of the three federal states, this impression is confirmed: Germany and Switzerland had or have to go a long way in order to
achieve a self-enforcing fiscal order while Australia already had a more favourable balance when discussions about reforms came up in the 1990s.

Before Germany started to seriously discuss reforms in 1999, one can describe the fiscal federal system as a system built primarily on waste and inefficiency, while it maintained well equity. The tax-sharing system, borrowing conditions and the equalisation system all contributed to a violation of categorical rule 1 (rent-seeking), 3 (fiscal illusion), and 4 (disincentive for productive behaviour). The reasons for this are found in soft budget constraints, a collective bail out system, insufficient autonomous rights and resources for member states and a lack of connectivity between revenue and expenditures of member states. Germany has recognised its flaws and began – after soft pressure of the Federal Court - to introduce a number of measures that pointed in the right direction and that aimed to improve the incentives for richer states to invest by reducing marginal tax rates and to create stronger incentives for the Länder to avoid fiscal illusion, overspending and rent-seeking, most notably by accepting more divergences in fiscal capacities between the member states. In all cases, these measures were modest and one cannot expect a major turnaround in the right direction. This is why all federal actors still feel that a more fundamental reform is needed.

Switzerland had a similar bad record before it achieved to adopt the new fiscal constitution. There is one notable difference with Germany, though, and that is the difference in the distribution of property rights on taxes: Switzerland has a strong degree of tax autonomy of member states which can almost be regarded as a necessary condition for a self-enforcing fiscal order. Only with tax autonomy one can for example introduce hard budget constraints by the market or reduce encroaching activities by the federal government. Only with tax autonomy an interest in creating own well-being can arise. Tax autonomy as such is not yet the guarantee for a self-enforcing order but a very important precondition. While Switzerland has therefore had a favourable base to start with that also had its beneficial effects for the borrowing of member states, the results on other points was less favourable. Switzerland had problems to overcome structural deficiencies among cantons, had favoured a strong influence of the federal government on cantonal policies and gave incentives for rent-seeking and fiscal illusion. The enacted reforms have rigorously dealt with such questions and, though one cannot expect an ideal self-enforcing fiscal system from now on the measures taken are well conceived to respect the categorical and application rules: predatory behaviour is almost excluded on the base of the decoupling that has taken place and on the base of the new public management strategies applied in the remaining cooperative policy areas; rights and resources
of member states have been strengthened; marginal tax rates for richer states have been limited though it might still be an insufficient incentive for productive behaviour; rent-seeking and fiscal illusion was reduced by the resource index, while equity has been improved though it remains still at a level that productive behaviour of recipient states may not be hampered.

Australia seems to have had above all two problems with the fiscal constitution: hard budget constraints and encroaching activities by the federal government. Rent-seeking and fiscal illusion as well as disincentives for productive behaviour do occur without any doubt in such a system of almost complete equality between regions. But they are seldom considered as being a major flaw of the system. Experiences in borrowing are particularly instructive as Australia did not for a long time achieve to control the borrowing by member states with different systems, a top-down and collectively controlled system, as well as with a system of coordinated control. Only when market mechanisms were strengthened, incentives to cheat seem to have been taken away from the system. In order to introduce such a system, it was explained, Australian states needed some autonomy in tax resources. This autonomy does exist though it is less strong than in Switzerland. Without this degree of autonomy, however, the “market turn” could not have been introduced. This simple fact limits the options in Germany as long as a tax separation system has not been introduced. Though this is discussed, the chances to do so are not too good and Germany must probably look for other solutions to introduce hard budget constraints. Predatory behaviour has been reduced in Australia first of all by the introduction of an independent agency, the CGC, that is the authoritative agency for designing and organising the equalisation process, and second by introducing the GST that limited the discretion of the federal government to manipulate the amount of money injected into the equalisation system. SSPs remain a problem though and can still be used for predatory behaviour. The overall outlook for Australia is therefore mixed but favourable.

Finally, with regard to self-enforcing mechanisms, one can probably mention a number of interesting features on the base of this comparison:

- The choice of the equalisation formula is an important decision. The inclusion of actual fiscal capacity and expenditure behaviour or the pure calculation on the base of inhabitants seem to be deficient formula. A standardisation of all criteria seems necessary to avoid manipulation by member states. The Swiss choice of a simple “tax potential formula” seems attractive but must still prove its value. The more complex formula of the Australian CGC has proven its worth and has led to a very reasonable equalisation process. But it is costly in terms of information and monitoring.
- The introduction of an independent and neutral body for the organisation of the equalisation process is apt to reduce political conflicts and create a high consensus about equalisation payments; the choice in Switzerland to let parliament determine the level of distribution seems to contradict this and may be a wrong choice.

- Rules and regulations are seldom enough as budget constraints. Market discipline works better though it may not suffice. Institutional constraints like financial referendums may help to improve both a system based on rules and a system based on market discipline. The lack of bail out is also conducive to hard budget constraints.

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