In this paper, we look at federal conflicts that emerge in the context of fiscal consolidation in federal states. In these states, fiscal consolidation is a collective action problem since it directly affects the discretion of governments to provide treats to their electorate. We argue that ‘coordination regimes’ – the combination of federal safeguards and fiscal regimes – determine the way in which these conflicts are managed. Federations are successful in managing federal conflicts if problem-solving (the consolidation of budgets) does not lead to spillovers in what we call the ‘power stream’, that is the arena where the interests of federal actors are confronted and balanced. Looking at fiscal consolidation in four federal states (Canada, Germany, Spain, and Switzerland), we distinguish three ‘coordination regimes’: ‘market discipline’, ‘negotiation’ and ‘majority decisions’. These coordination regimes differ in their ability to maintain the ‘institutional equilibrium’ of federal systems.
INTRODUCTION

Since the 1990s, the consolidation of government budgets has become a main concern in advanced industrial states (Wagschal and Wenzelburger 2008, 5; Streeck 2014). The vast increases in spending and the continuous expansion of the public budget, which characterized the development of the welfare state after the Second World War, became substituted by a policy of balanced budgets, spending efficiency and the trimming down of government expenditures. The Keynesian view on macroeconomic stabilization characterized by a voluntary increase of deficits and increased public spending in times of economic hardship was replaced by supply-side economics and monetarism (White 2012), while “neo-liberal thoughts” started to guide the thinking about state-society relations. Public Choice Theory became an important source of fiscal policy advice for dealing with unsustainable expansions of public budgets (Buchanan and Wagner 1977). The focus of attention was now directed to the behavior of policy-makers and electoral incentives as important causes of such expansion. A policy of balanced budgets through the introduction of fiscal rules was more and more seen as a remedy to avoid the spending thrift of politicians and as a mechanism of self-constraint (White 2012; Schaechter et al. 2012; Kopits and Symansky 1998).

When it comes to fiscal consolidation, federal states - the country population we are interested in - face a collective action problem since any successful policy of consolidation depends on the collaboration of federal and subnational governments. This is because fiscal policy is distributed between two – and often even three – levels of government. In contrast to unitary states, subnational governments enjoy fiscal autonomy. They usually can make deficits and accumulate debt. In federations, successful consolidation, therefore, depends on the coordination of efforts leading to the compliance of all actors to general fiscal rules. But, such coordination is in no way guaranteed since governments face incentives to shirk. Subnational governments benefit from deficit-making as long as costs (high interest rate payments) are not internalized, which is often the case in so-called ‘fiscal transfer regimes’
where large parts of subnational incomes are financed by collective resources (joint taxes, federal government transfers, and equalization payments).

The obligation to respect “fiscal rules” as the major consolidation instrument can meet resistance because it directly touches upon the discretion of subnational governments to choose government policies of their liking in order to find support among a majority of voters. The introduction of fiscal rules may, therefore, be difficult and generate conflicts between the federal government as the guarantor of macroeconomic stability and subnational governments. They may, moreover, be difficult to sustain, if the contract is ambiguous and enforcement mechanisms weak. And, finally, fiscal rules are likely to intensify other federal conflicts once fiscal rules have been adopted. Spillovers on federal solidarity, namely the equalization system, in the implementation phase of fiscal rules are particularly likely.

The aim of this article is to analyze how federations have managed to introduce fiscal rules and maintain the ‘institutional equilibrium’ in the federation. To put it otherwise, we explain how fiscal rules can be adopted and implemented in a way that eliminates or reduces opportunistic behavior, that is in a way that does not result in federal conflicts. We use an analytical model which draws on Bednar’s (2009) rational choice and systemic approach on federal robustness on the one hand and ‘actor-centred institutionalism’ (Scharpf 1997) on the other. The answer we provide is that different ‘coordination regimes’, i.e. the way federal actors interact in order to solve policy problems, determine whether also federal conflicts can be dealt with. The functioning of coordination regimes themselves is determined by federal safeguards on the one hand and fiscal regimes on the other.

Analyzing consolidation policies in Canada, Germany, Spain and Switzerland, we find that market discipline explains the adoption of fiscal rules in ‘loosely coupled fiscal regimes’. These systems tend to produce sustainable solutions when federal safeguards are strong. But when safeguards are weak, there is a probability that spillovers that disturb the ‘institutional equilibrium’ cannot be prevented. ‘Tightly coupled fiscal regimes’ tend to produce negotiated solutions that maintain the ‘institutional equilibrium’ in the short run if safeguards are strong. However, these solutions are not sustainable since the ‘institutional
equilibrium’ can only be maintained as long as mechanisms fostering agreement support the power balance. If safeguards are weak in ‘tightly coupled fiscal regimes’, the federal government creates majorities to impose fiscal rules. These fiscal rules severely limit the discretion of subnational governments.

**OPPORTUNISM AND FISCAL RULES**

As the ‘second generation’ literature on fiscal federalism contends, interdependent types of fiscal federalism provide incentives for governments to engage in opportunistic behavior and cause negative externalities for fellow union members (J. A. Rodden 2006; J. A. Rodden, Eskeland, and Litvack 2003; Treisman 2007; Weingast 2009). In fiscal policy, governments behave opportunistically if they continue to make debt and have deficits in anticipation of federal bailouts or other mechanisms of federal solidarity (burden shifting). It is mostly subnational governments who resort to this kind of behavior whereas the federal government often is the main responsible actor during crises and the guarantor of macroeconomic stability. But, since it has to ensure that subnational governments play along, it faces incentives to impose restrictions on constituent units (federal encroachment). However, subnational governments might decide not to comply with fiscal rules since they have immediate negative effects on the discretionary powers of subnational governments to decide on spending matters and limit their capacity to provide treats to their voters in the short run. Our assumption is that the process to introduce fiscal rules and make them sustainable is subject to substantial federal conflicts, which are played out in what we call the ‘power stream’, the arena where the interests of federal actors are confronted and balanced.
We assume that problem solutions may lead to federal conflicts if these solutions affect either the ‘authority’ of federal actors or their ‘discretion’ or both. Authority refers to the constitutionally or legally guaranteed rights to decide in a certain policy area or matter. The contestation of such rights by one side of federal actors and their transfer to another level of government is called ‘authority migration’ (Gerber and Kollman 2004). Authority rights in fiscal policies concern the right to levy different taxes, to borrow, and to spend in certain areas. Discretion in fiscal policies means to have the right to decide freely what to do and how to spend, tax or borrow. Discretion of subnational governments is restricted when, for example, they have the authority to collect direct taxes and decide on levies, but only within a certain range that depends on the tax rates defined by the federal government. Authority migration would take place if the federal government decided to claim direct taxes for itself. Conditional grants are further instances of limits of subnational discretion since the federal government expects that subnational governments spend this money according to priorities of the federal government, as are regulations limiting subnational borrowing on domestic markets. Fiscal rules similarly limit the discretion of governments. This is because governments can still spend money in the respective policy areas over which they have authority, but they need to balance their budgets. Governments, thus, maintain their authority rights, but they cannot spend as much money as they want in order to please their electorate.

In order to consolidate their budget, federations, therefore, have to deal both with opportunism in borrowing and possible resistance of subnational governments against the loss of their discretion by fiscal rules. We argue that this game is decided in so-called ‘coordination regimes’, i.e. by the way federal actors try to solve problems and maintain the ‘institutional equilibrium’. Coordination regimes differ between federal countries and depend on fiscal incentives (what we call ‘fiscal regimes’), on ‘federal safeguards’, and finally, on mechanisms that directly influence the distribution of costs and benefits of opportunism in the federal game.
**Fiscal regimes** are defined by incentive structures in fiscal policy-making in federal countries. Two types of fiscal regimes can be distinguished (see for this also Rodden and Eskeland 2003): on the one hand a ‘loosely coupled fiscal regime’ (LCFR) in which subnational governments have substantial taxing rights which allow for tax competition, lower transfer rates from collective resources, and usually a credible non-bail out commitment of the federal government. ‘Tightly coupled fiscal regimes’ (TCFR, or ‘fiscal transfer regimes’) by contrast have lower incomes from own revenues, high transfer rates, and the federal government cannot credibly commit not to bail out constituent units. These different incentive structures lead, according to the literature (J. A. Rodden, Eskeland, and Litvack 2003; Treisman 2007; J. A. Rodden and Wibbels 2002), to different behavior when it comes to opportunism in borrowing: the first group usually has a strong self-interest in dealing with excessive borrowing by own means, while the second group is prone to temptations for shirking by burdening other members with the costs involved in continuing borrowing.

Fiscal regimes alone, i.e. the incentive structure as such, do not yet explain fully the different outcomes in dealing with federal conflicts related to fiscal consolidation. Even in LCFR, federal conflicts may emerge if the subnational governments fail to deal with borrowing problems and cause collateral damages by increasing interest rates, or if spillovers into areas outside the fiscal regime where powers overlap lead to federal conflicts. In TCFR, it needs still to be seen how the endogenous propensity for shirking can be prevented to become translated into federal conflicts.

But, in order to understand the different coordination regimes, we need a second structural variable, i.e. ‘federal safeguards’. (Bednar 2009) Federal safeguards are institutional incentive mechanisms that protect the ‘institutional equilibrium’ of federations. A constitutional court, for example, can annul federal or subnational laws that violate the constitutional distribution of power. Whether federal safeguards are weak or strong, balanced or unbalanced, that is whether they are able to protect both levels of governments from transgressions of the other affects coordination regimes.

Finally, different ‘mechanisms’ are at play that affect directly the costs and benefits of opportunistic behavior of federal actors in the coordination process. The existence of an
‘external enforcer’ (such as the European Union or the International Monetary Fund) does not determine the interaction mode nor does it affect the compensation of standard interests, but it increases the pressure on members of a federal union to find a solution. The ‘external enforcer’ rarely determines the whole process in fiscal rule setting such as the distributive bargain that takes place, but it makes non-agreement extremely expensive. ‘Moral suasion’ does not increase costs of non-agreement but this mechanism consists of the use of arguments to convince actors to accept fiscal rules. Rationalizing institutions such as fiscal councils or fiscal bodies fulfill this function (IMF 2013). They exclude political considerations (electoral incentives) from the process and focus the attention of actors on problem solving by providing advice and recommendations. ‘Financial compensations’ (or side-payments) are resources that equilibrate standard interests by adding resources so that losses of authority or discretion are compensated through benefits in capacity. Compensation payments are an important resource in fiscal consolidation since the main problem of consolidation is the loss of capacity to act. What these mechanisms have in common is that they alter the incentive structure in a way that benefits of agreement outweigh its costs.

Coordination regimes determine how fiscal rules are adopted, namely whether cooperation is compulsory or whether governments act independently from each other. In accordance with Scharpf (1997), we distinguish three different coordination regimes: ‘non-coordination’, ‘majoritarian decisions’ and ‘negotiation’. Coordination regimes, based on fiscal regimes and federal safeguards and influenced by the mechanisms listed above, determine the stability of federal relations and the possibility to avoid borrowing opportunism. They also affect federal conflicts that arise in the aftermath of consolidation, when fiscal rules lead to spillovers on other arenas such as fiscal equalization. What is more, coordination regimes in the aftermath might differ from coordination modes of adoption of fiscal rules. By combining fiscal regimes and federal safeguards, we can formulate several expectations with regard to the outcome of coordination processes in consolidation policies.

- Strong safeguards coupled with a loosely coupled fiscal regime lead to non-coordination. In this case, market discipline is the main reason why governments
adopt fiscal rules (independently from each other). Market coordination is the coordination mode with the highest effectiveness in the maintenance of the institutional equilibrium since spillovers from problem solution, i.e. fiscal rules, to federal relations should be avoided as long as self-control of subnational governments is effective.

- If safeguards are weak in loosely coupled fiscal regimes, the coordination regime does not change, but spillovers into other arenas such as fiscal equalization are likely to disturb the institutional equilibrium in the aftermath of consolidation since safeguards are not able to prevent spillovers on the power stream.

- If safeguards are strong in systems with a tightly coupled fiscal regime, we expect negotiation among equal partners to be the prevalent mode of interaction since the federal government has to bargain with the subnational governments in order to make them accept fiscal rules. Similar to market discipline, this interaction mode should be quite effective in maintaining the institutional equilibrium. The main mechanism to reduce the losses of discretion of subnational governments consists of side-payments that compensate losses of discretion by reducing the overall amount of consolidation needed.

- Majoritarian decisions are the main interaction mode in tightly coupled fiscal regimes with weak safeguards since the federal government has the power to impose constraints on subnational budgets. This interaction mode is also in principle based on bargaining, but the federal government can be able to create majorities that enable it to impose solutions in consolidation policy. It is clear that in this case – if no side-payments are taking place – the interests of subnational governments are violated and may lead to resistance and opposition, i.e. unstable federal relations. In this setting of a tightly coupled fiscal regime and weak safeguards, governments might, however, accept imposed losses of discretion due to the existence of an ‘external enforcer’ or ‘moral suasion’, but such an institutional equilibrium would always remain fragile.
In the following, we want to verify our argument by analyzing the consolidation policies of three federal countries – Germany, Spain, and Switzerland – which represent different coordination regimes.

RESULTS

GERMANY

Germany has a ‘tightly coupled fiscal regime’ since major taxes (VAT, corporate and personal income taxes) are shared. Of total Länder revenues, only 7 percent are own taxes, and 52.2 percent are federal transfers (Cottarelli and Guerguil 2015). Given the high level of fiscal interdependence (Bolleyer and Thorlakson 2012), fiscal policy requires coordination and cooperation. The Bundesrat, consisting of members of Länder governments, is the main institution of joint-decision making since it has to approve any federal legislation that affects the Länder (Hueglin and Fenna 2015). In fiscal policy, this basically means that the federal government cannot alter taxes without the consent of governments of the Länder. Given its veto power, the Bundesrat is a strong federal safeguard. As a matter of fact, Germany has a balanced system of strong federal safeguards that protect both levels of government (in addition to the Bundesrat: an integrated party system with a high level of partisan discipline (Benz 2009; Feld and von Hagen 2007), a Constitutional Court that arbitrates in the case of federal conflict (Hrbek 2005), and a quite well-developed system of vertical and horizontal intergovernmental councils). Germany’s only weakness in terms of federal safeguards is its electorate’s strong orientation towards national solutions and reluctance towards competition (Wintermann and Petersen 2008). In the past, the German federation had experienced opportunism in fiscal policy since a number of Länder have been borrowing until they found themselves in serious budget crises and had to ask for federal bailouts. But, whereas Bremen and Saarland have received such bailouts in the 1992 (J. A. Rodden 2003), the Constitutional Court ruled in 2006 that Berlin did not qualify for a federal bailout. Moreover, the Constitutional Court requested that the federal government and the Länder establish a mechanism that monitors budgets in order to prevent further budget crises (Heinz 2016). The combination of a ‘tightly coupled fiscal regime’ and strong federal safeguards gives Germany a balanced system of strong federal safeguards that protect both levels of government.
safeguards implies that federal and subnational governments negotiate solutions in fiscal policy in order to prevent that fiscal consolidation affects the ‘institutional equilibrium’. Indeed, ‘negotiation’ has been the main mode of interaction leading to the entrenchment of a “debt brake” into the federal constitution in 2009. In 2007, a federalism reform commission (Föderalismuskommission II) consisting of an equal share of federal and Länder representatives started to negotiate another round of federalism reform after a first reform in 2006 disentangled a number of responsibilities. Whereas the federalism reform commission started with a broader mandate to reform a number of elements of fiscal federalism (Föderalismuskommission II 2010), the reform was eventually watered down to the entrenchment of a balanced-budget rule in the federal constitution and the establishment of a “Stability Council” to monitor federal and Länder budgets. One reason was that the Constitutional Court, in its 2006 ruling on Berlin’s demand for another federal bailout, requested that German governments establish a joint mechanism for monitoring of budgets aiming at anticipating and preventing budget crises (Heinz 2016). Furthermore, the federal government was committed to consolidating its budgets after it had to enact fiscal stimulus programs during the Global Financial Crisis to foster economic growth (Heinz 2016). In order to prevent that distributive struggles hinder problem solving of consolidation, fiscal equalization and other contentious issues such as pre-existing debt have been subsequently excluded from the reform (Föderalismuskommission II 2010). What is more, a compromise turned out to be possible only because of pressure from the ‘external enforcer’ – Germany’s need to comply with the Stability and Growth Pact – and side-payments provided by the federal government. These side-payments consisted of so-called consolidation assistance payments (“Konsolidierungshilfen”) to the five Länder that claimed they would otherwise be unable to consolidate their budgets and comply with the debt brake (Föderalismuskommission II 2010). Since the debt brake commits both levels of government to balanced budgets, negotiation has led to equal losses of discretion for the federal government and the Länder. What is more, governments maintain their authority to decide how to balance their budgets. Federal safeguards such as the Constitutional Court, coalition governments, and the Bundesrat have prevented that conflicts related to consolidation disturb the ‘institutional equilibrium’. But, in order to maintain the ‘institutional
equilibrium’, once the fiscal rule was adopted and fiscal equalization returned to the political agenda, side-payments were once again needed in order to make compromise possible. This time, the federal government had to make sure that no Land loses from fiscal equalization, and to solve this distributional struggle by providing compensations once again. However, neither the debt brake nor the establishment of the Stability Council has solved a more fundamental conflict of the German federation. Since the adoption of the debt brake, German governments have benefitted from a good economic performance and low interest rates (Heinz 2016). Less favorable economic conditions could certainly lead to more structural conflicts. This conflict is related to the very limited room for maneuver Länder governments have on the revenue side of their budgets, given the system of tax sharing, but also on the expenditure side given that they have to implement and administer federal laws. Therefore, it is likely that Länder governments continue to claim federal compensations. If the federal government is unable to provide these treats at some point, spillovers into the power stream can be expected.

**SPAIN**

Like Germany, Spain has a ‘tightly coupled fiscal regime’ that is based on tax sharing. Subnational governments, the Autonomous Communities, receive roughly 40 percent of total revenues (however, not as own taxes), and they are responsible for approximately 40 percent of general government expenditures. This share of general government revenues is relatively high, and the result of an ongoing fiscal decentralization process in the last decades. Nevertheless, transfer dependency of the Autonomous Communities is also comparatively high (49.7 percent in 2005) (Cottarelli and Guerguil 2015). Federal safeguards in Spain are weak and unbalanced. The Senate does not represent subnational governments (in contrast to the German Bundesrat) and it cannot veto federal laws — making it practically superfluous. Further, the party system is integrated by centralized: both main parties are nationally oriented and the national branch is very strong (Barragán Manjón 2012). Furthermore, other structural safeguards are missing since residual powers are assigned to the federal government. Therefore, there are hardly any veto points for
subgovernments at the federal level. Coordination in financial matters happens between both layers in the ‘Consejo de Política Fiscal y Financiera’ (CPFF). It is composed of the 17 subnational finance ministers and the national finance minister. Formally, the decisions are taken by majority vote. But since the federal government holds 50 percent of the votes it needs only one subnational government to win the vote.\textsuperscript{viii} Similarly, to the weakness of structural safeguard, the function of the CPFF gives the federal government an important level of leverage in fiscal policy. The judicial system includes a constitutional court that can and is often called upon by subnational governments and parties in case of transgressions by as well the federal government as also the subnational governments. The constitutional court, however, has not prevented the centralization that happened after 2010. Like Germany, Spain has experienced borrowing opportunism of subnational governments during the 1990s and since the Global Financial Crisis. Particularly around 2010, the Spanish subnational governments received bailout funds from the federal government. The combination of a ‘tightly coupled fiscal regime’ and weak federal safeguards leads to the coordination regime of ‘majoritarian decisions’. In this coordination regime, the federal government can create majorities to impose solutions – this is best exemplified with the CPFF described above, in which the federal government has practically the majority of votes and can thus impose decisions on fiscal policy. This is what happened when the federal government created majorities to enact a General Law on Budget Stability in 2001 and entrenched a constitutional debt brake committing both levels of government in 2011. Similar to Germany, the ‘external enforcer’ and ‘side-payments’ (federal bailouts in 2010) played an important role. Given that federal safeguards were unable to constrain the federal government, fiscal consolidation has affected the ‘institutional equilibrium’ in a way that has not only shifted power towards the federal government but that has also led to desolidarization. The example of Spain points, hence, to an ambiguous role of the ‘external enforcer’. Whereas European regulations and rules have increased the pressure to find a solution, the solution that was found has led to spillovers into the power stream. Even in the aftermath, the ‘institutional equilibrium’ could not be regained since centralization and desolidarization are persisting.
In contrast to Germany and Spain, Switzerland has a ‘loosely coupled fiscal regime’ in which large shares of revenues (40.6 percent) and expenditures (41.6 percent) are assigned to the cantons. Furthermore, tax competition is quite strong. The most important taxes, namely progressive personal and corporate income taxes, are cantonal taxes and the federal government can only levy a small piggy-back tax (Kirchgassner 2007). Therefore, transfer dependency of the cantons is comparatively low (14.9 percent in 2005) (Cottarelli and Guerguil 2015). Switzerland has a well-developed and balanced system of strong federal safeguards based on coordination and consultation. Coalition governments, enumerated powers of the federal government and strong bicameralism provide for numerous veto points on the federal level (Watts 2008). Switzerland lacks a constitutional court that arbitrates in the case of federal conflict and has a regionalized party system (Ladner 2014) that weakens the political safeguard, but the popular safeguard (direct democracy) and mechanisms of intergovernmental coordination compensate for this weakness (Bolleyer 2006). Given the combination of a ‘loosely coupled fiscal regime’ and strong federal safeguards, non-coordination prevents that consolidation disturbs the institutional equilibrium since each government adopts fiscal rules on its own in order to consolidate its budget. Consequently, authority or discretion of other governments was not in question. Indeed, all Swiss cantons but Appenzell-Innerrhoden (Yerly 2013) have adopted and amended fiscal rules independently from the federal government and quite independently of each other. Therefore, cantonal fiscal rules vary in their design and strictness (Yerly 2013). The federal government has adopted a first fiscal rule in 1998 (‘Budget Objective 2001’) as a test-run before entrenching a debt brake in the federal constitution in 2001. This debt brake entered into force in 2003 (Der Schweizerische Bundesrat 2003; Schaechter et al. 2012). Given that non-coordination has been the interaction regime in which fiscal rules are adopted, the federal debt brake limits discretion of the federal government only and does not affect the cantonal authority of discretion. The interaction regimes changed somewhat in what we call the aftermath of fiscal consolidation – that is once fiscal rules have been adopted or amended. After the Global Financial Crisis, when both levels of government were consolidating their budgets, the ‘external enforcer’ (EU, OECD) obliged Switzerland to reform.
its corporate tax system in order to comply with international regulations on tax competition.\textsuperscript{xii} Given that both levels of government levy corporate taxes and since the federal government benefits from special tax regimes with which cantons attract corporations,\textsuperscript{xiii} this game took place in an arena where non-coordination is not possible. Moreover, the federal government represents Switzerland at the international level, but cantons have to implement the tax reform. Therefore, the federal government and the cantons engaged in negotiations and set up an intergovernmental working group (\textit{Projektorganisation Unternehmenssteuerreform III}). At more or less the same time, a scheduled review of fiscal equalization had to be undertaken by the federal government and the cantons, and the federal parliament had to adopt a law that renews fiscal equalization. Fiscal equalization being another arena where non-coordination is not possible, reviewing and renewing fiscal equalization requires negotiation. Strong federal safeguards, the intergovernmental safeguard and bicameralism in particular, prevented that problem solving leading to the Corporate Tax Reform III and the renewal of fiscal equalization disturbed the institutional equilibrium. Horizontal intergovernmental councils and the establishment of the \textit{Projektorganisation} have ensured that cantonal preferences were heard throughout the elaboration and decision phase. And the Council of States has proven to be very sensitive to cantonal interests.\textsuperscript{xiv} In the case of the Corporate Tax Reform III, federal compensations ensured that losses emanating from the reform were equally distributed.\textsuperscript{xv} The solution found for the new period of fiscal equalization similarly distributes losses of discretion equally among the federal government, equalization beneficiaries, and net payers: equalization payments are cut less than contributors to equalization claimed but more than beneficiaries wanted.\textsuperscript{xvi}

\textit{CANADA}

Similar to Switzerland, Canada has a ‘loosely coupled fiscal regime’. Provinces collect around 60 percent of own revenues (Courchene 2004) and are responsible for 45,1 percent of general government expenditures (compared to a federal share of 37,5 percent) (Boadway 2007). Consequently, transfer dependency of the provinces is comparatively low
(Wagschal and Wenzelburger 2008; OECD 2000). However, the federal spending power enables the federal government to spend in areas of provincial jurisdiction. Provinces have no formal obligation to accept federal grants, but de facto, they often do not have a choice since the Canadian electorate has been used to a higher level of public services, and provinces are responsible for the bulk of welfare policies (Courchene 2006). This implies a certain degree of de facto transfer dependency of the provinces in areas such as healthcare, education and social services (Wagschal and Wenzelburger 2008). In contrast to Switzerland, Canada has weak and unbalanced federal safeguards that favor the federal government. The Supreme Court, Canada’s constitutional court, is the only strong federal safeguard, having frequently ruled in favor of the provinces even though the federal government appoints the judges (Cameron 2014). But, weak bicameralism, single-party governments and the assignment of residual powers to the federal government (Watts 2008) indicate that the other safeguards are weak and that they fail to protect the provinces from federal transgressions. Further examples of weak safeguards are intergovernmental councils that tend to work on an ad hoc basis, lack institutionalization (Bolleyer 2009), and are dominated by the federal government (in the case of vertical councils). The party system is regionalized but has shown that it can be a last resort mechanism of coordination in certain cases (Esselment 2012). Similarly, the electorate can be a safeguard or not, since it is quite sensitive to the issue of federalism but willing to accept federal intervention in provincial responsibilities for the purpose of receiving more welfare services. Given the combination of a ‘loosely coupled fiscal regime’ and weak safeguards, governments have adopted fiscal rules independently from each other (Tapp 2010), and market discipline has been the main reason why governments adopted fiscal rules. But, consolidation has led to spillovers on the power stream. The so-called ‘landmark budget’ of 1995, in which the government committed to a number of consolidation policies, severely cut transfers to the provinces by merging two independent transfers (Established Programs Financing (EPF) and the Canada Assistance Plan (CAP)) into a single block transfer and by cutting the total amount of transfers. Even though the federal government claimed that the transformation of earmarked transfers into a block grant would increase discretion of the provinces, the opposite was the case since provinces lost an important amount of revenues. Given that the
federal government engaged in new spending initiatives based on its spending power once it had successfully consolidated its budget, bypassing the provinces in many instances and ignoring their statements on preferences (Courchene 2004), consolidation somewhat shifted the power balance towards the federal government. Thus, consolidation and its aftermath affected the institutional equilibrium, and provinces are still complaining today that the federal government had been shifting burden in 1995 and keeps encroaching in provincial jurisdictions. But consolidation has also triggered horizontal conflicts. One instance is Ontario’s complaint that even though it had become an equalization beneficiary after the Global Financial Crisis, it had to fund social services in other parts of the federation since its taxpayers contributed 39 percent of federal tax revenues but received only 34 percent of federal spending in return.

CONCLUSION

In federal systems, governments face a collective action problem when it comes to fiscal consolidation because consolidation can only be successful if all governments comply with fiscal rules. However, in federal systems, where power is distributed between several levels of government, governments face incentives to shirk when costs such as high interest rate payments are not internalized. In this paper, we investigated how federal states have adopted fiscal rules, arguing that the adoption of fiscal rules is likely to lead to federal conflicts since they directly affect the discretion of governments to provide treats to their electorate (type-1 policies). The answer we find is that the combination of fiscal regimes and federal safeguards determine the ‘coordination regime’ of consolidation, that is the way in which fiscal rules are adopted. Coordination regimes, on their turn, determine whether fiscal consolidation maintains or disturbs the ‘institutional equilibrium’ of a given federation.

Our findings underline that the adoption of fiscal rules is likely to affect the ‘institutional equilibrium’ in both ‘tightly coupled fiscal regimes’ and ‘loosely coupled fiscal regimes’ even though governments introduce fiscal rules independently from each other in ‘loosely coupled fiscal regimes’. In both cases, conflicts can emerge both when fiscal rules
are adopted and as a collateral effect. If federal safeguards are weak, these conflicts are likely to affect the ‘institutional equilibrium’ because they are unable to prevent spillovers into the power stream. When it comes to ‘loosely coupled fiscal regimes’, the likelihood of spillovers increases when policy areas of interdependence are affected by fiscal consolidation, as the Canadian example illustrates. Whereas the federal government and Canadian provinces adopted fiscal rules independently from each other, the federal government shifted burden to the provinces in order to consolidate its budget. It could do so because it had created interdependencies in welfare-related areas through the use of its federal spending power. Federal safeguards had been unable to constrain the federal spending power and were unable to prevent federal burden shifting since the federal government could decide unilaterally on how it would consolidate its budget. Therefore, provinces severely lost discretion. In the other decentralized system, Switzerland, in contrast, federal safeguards prevented that fiscal consolidation affected the ‘institutional equilibrium’. Like in Canada, market discipline led to the adoption of fiscal rules by all but one governments. In the aftermath, federal safeguards such as the second chamber and intergovernmental councils ensured that the reform of corporate taxes and the renewal of fiscal equalization distributed losses equally among levels of government and between cantons. In ‘tightly coupled fiscal regimes’, safeguards determine whether ‘majority decisions’ or ‘negotiation’ becomes the main ‘coordination regime’. The German example shows that strong federal safeguards (such as the Bundesrat), ensured that the federal government and the Länder adopted the German fiscal rule (the debt brake) as equal partners. The existence of an ‘external enforcer’ fostered agreement. That the Länder had to agree in order for the federal government to entrench a fiscal rule in the federal constitution had two consequences. First, distribution issues had to be excluded from the agenda. Second, the federal government had to provide ‘side-payments’ to a number of Länder. That ‘side-payments’ had to be provided again and to all Länder in the aftermath, when fiscal equalization was renewed, indicates that consensus is only possible when the federal government provides treats, even more so when distributional issues are at stake. Therefore, it is likely that the ‘institutional equilibrium’ can only be maintained as long as the federal government is able to provide these treats. The combination of a ‘tightly coupled
fiscal regime’ with weak federal safeguards in the Spanish federation, supported by the existence of an ‘external enforcer’ and ‘side-payments’ provided to the Autonomous Communities, has enabled the federal government to create majorities in order to impose fiscal rules. Autonomous Communities have lost an important degree of discretion. Therefore, the ‘institutional equilibrium’ has shifted towards the federal government because federal safeguards were not able to protect subnational governments.

Comparing both types of regimes, we find that solutions are more sustainable in ‘loosely coupled fiscal regimes’, in particular when safeguards are strong. In these systems, limits on discretion are self-imposed since each government adopts fiscal rules individually. If safeguards are strong, they prevent that spillovers into areas of interdependence disturb the ‘institutional equilibrium’. Even if safeguards are strong in ‘tightly coupled fiscal regimes’, solutions found through ‘negotiation’ or ‘majority decisions’ tend to be successful in the short run only, namely merely as long as the federal government can provide treats or has enough power to create majorities. Therefore, we can conclude that federal safeguards are important gatekeepers that prevent spillovers from fiscal consolidation into the power stream. But in ‘tightly coupled fiscal regimes’, even strong safeguards are effective only if mechanisms that foster agreement such as an ‘external enforcer’, ‘side-payments’ or ‘rationalizing institutions’ complement them.
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A fiscal rule is a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates (Budina et al. 2012: 5): It is defined “as a permanent constraint on fiscal policy through simple numerical limits on budgetary aggregates” (Kopits und Symansky 1998)

This kind of policies, which serve the purpose of getting reelected, are policies of first preference (type-1 policies). The introduction of fiscal rules engender consolidation policies that can been described as type 2-policies, namely policy actions that aim at pleasing first of all the creditors in order to maintain access to money on the capital market.

The ‘institutional equilibrium’ refers to the interaction of the institutionalized division of powers and concrete actor interests. It is maintained when the institutionalized division of powers corresponds to actor interests, i.e. when actors do not contest the distribution of power (Filippov, Ordeshook, and Shvetsova 2004). If this is the case, a federation is stable.


Note that a final decision is still pending. This section refers to the current state of negotiations (March 2016).

See Art. 167 and Art. 168 of the constitution.

Except for the five Autonomous Communities enjoying a special status and asymmetric powers (Watts 2008).

See Reglamento del Consejo de Política Fiscal y Financiera (last modification: January 2004).
The authority of the federal government to raise direct taxes as a piggy-back tax to
cantonal taxes is, moreover, limited in time and has to be renewed by popular vote and the
Council of States every ten years (Linder 1999).

It is important to notice that the consolidation pressure was comparatively low due
to a culture of prudent fiscal policy.

A handbook of budgeting issued by the Conference of Cantonal Directors of Finance
(Finanzdirektorenkonferenz, FDK) in 1981 and horizontal learning have led to some kind of
coordination among cantons, but this has not had any impact or discretion or authority of
the cantons.

“Unternehmenssteuerreform III: Widmer-Schlumpf startet grosse Steuerreform”,
NZZ Online 01.09.2012.

“Wir backen künftig kleinere Brötchen”, NZZ 04.04.2015.

“Unternehmenssteuerreform III: Ernüchternd mutloser Ständerat”, NZZ Online
15.12.2015.

At the moment of writing of this paper, the corporate tax reform has not yet been
finally approved by both chambers of parliament. Therefore, this conclusion is mere a
preliminary one.


The federal constitution legitimates the federal spending power since it authorizes
the federal government to spend in any policy area even in areas of provincial responsibility
(see Watts 1999).

“Other provinces have no cause to gloat over Ontario’s economic woes”, The