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Fiscal Federalism

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A. Definition and Meaning

1 The term 'fiscal federalism' does not appear in any constitutional document. However, the concept is a keystone of federal studies (→ *federalism*) because it addresses the perceptions, negotiations, compromises, and give-and-take that make it possible for any federal system to function (Palermo and Kössler 3; Sharma 177). According to the *Oxford Dictionary of Economics* (2016), fiscal federalism is concerned with 'the division of revenue collection and expenditure responsibilities among different levels of government [which] are connected by overlapping responsibilities and the transfer payments made between them' (at 157). According to the *Dictionary of the Social Sciences* (2002), it 'refers to the question of the efficient governmental location of taxation and expenditure decisions [and] seeks to determine which dimensions of fiscal programs are best located at the state or local level and which are better handled nationally' (at 166). It explores the roles of the different levels of government both in normative and positive terms, 'with a particular focus on the raising, borrowing, and spending of revenues' (Anderson 3) and on 'the ways in which (the different levels) interact with one another through such instruments as intergovernmental grants' (Oates 1120). In simple terms, fiscal federalism deals with 'the division of policy responsibilities among different levels of government and with the fiscal interactions among these governments' (Wildasin 405).

2 From the definitions discussed above, it is clear that fiscal federalism goes beyond the mere allocation of fiscal powers (→ *distribution of powers in federal systems*) and takes into consideration how the system functions by means of 'intergovernmental relations' (Anderson 221). In fact, in post-Second World War political science literature, questions were raised regarding 'the formulation and implementation of public policy, the actors involved in the policy process, and the levels across which policies were made and delivered' (Loughlin 468; → *ordre public (public policy)*). In Anglo-American political science, KC Wheare's formal-legal approach gave way to an understanding of federalism as a 'bargain' (Riker 11–14), an ongoing 'process' (Friedrich 7), and 'a covenant among equal partners' (Elazar xii). In European political science, federalism came to be viewed as a multilevel concept—'a system of continuous negotiations among nested governments at several territorial tiers' (Marks 392)—with a commitment to social solidarity.

3 In this context, Cheryl Saunders highlights the advantages of an inclusive approach, since 'the effects of federalism may be obtained in the absence of fully federal constitutional arrangements' (Saunders 62). This is even more true of fiscal federalism, the principles of which may be applied to all multi-level democracies, irrespective of their formal constitutions. In fact, many unitary countries, particularly the Nordic ones, have developed their own models of fiscal federalism, which are characterized by well-developed fiscal and financial local autonomy. Furthermore, for fiscal federalism scholars, assessing the impact on intergovernmental fiscal relations of fiscal rules designed to curb fiscal deficits, limit public debt, and establish fiscal discipline of governments at various levels, has emerged as a new area of concern since the 1990s.

4 Against this composite background, the notion of a financial constitution could be taken as a common point of reference (see Valdesalici 20ff). The term is the literal translation of *Finanzverfassung*, used by Austrian and German scholars to refer to constitutional provisions governing → *public finance*. In particular, it entails the determination, distribution, and use of financial resources by different levels of government (Hellermann 1099ff; Pernthaler 21ff; BVerfGE 55, 274, 300). A financial constitution includes both a monetary constitution (see the essays in Yeager) and a fiscal constitution (see Dam). The former constrains government's monetary behaviour (Brennan and Buchanan 151), while the latter constrains government's power to tax (→ *taxes*) and spend (Brennan and Buchanan 181). In other words, the term 'financial constitution' encompasses monetary and fiscal rules related to public → *spending power* and revenue raising (including taxation and borrowing) at the different levels of government. Moreover, from a constitutional law perspective, a financial constitution includes not only rules 'formally incorporated in some legally binding and explicitly constitutional document', but also unwritten rules like 'customary, traditional, and widely accepted precepts' (Buchanan and Wagner 24). As such, fiscal federalism takes into consideration all sources of law that affect the subject, even though they do not have formal constitutional status.

B. Evolution of the Concept

5 Before the expression 'fiscal federalism' was coined, the term in vogue was 'federal finance'. Alexander Hamilton is credited with designing the first explicitly 'federal financial system' for the United States ('US') in 1789, which ended the central government's dependency on financial contributions from the states (Selko 54) and gave Congress the authority to levy taxes and to borrow, to issue money, and to regulate its value (Cain 335). 'Federal finance' finds mention also in the official documents prepared in the run-up to the formation of the Commonwealth of Australia (Australasian Federal Convention 1897). The key concern was to work out how to ensure that the states had adequate revenue for their responsibilities. Distribution of the surplus and/or transfer of the debts of the several colonies to the Commonwealth were two options (Johnston 1). But only the first happened. The Indian economists Bhalchandra P Adarkar and RN Bhargava made first attempts to develop theoretical foundations for federal finance, by revising the existing theory of public finance related to unitary states (→ *unitary state*), so as to extend it to federal states.

6 The term 'fiscal federalism' was coined by Richard Musgrave, the father of modern public finance. The theoretical foundations can be found in his 1958 book *The Theory of Public Finance*. In particular, the expression was used to refer to the fiscal operations among and within different layers of government in both 'pure federations', where regional units possess full autonomy, and 'other multi-level states', where national government is in charge of horizontal equity with regard to the total tax bill and minimum level of public services (Musgrave 179–83; → *public service*).

7 Musgrave (180–81) proposed a three-fold classification of public functions: stabilization, eg maintaining price stability, balance-of-payment equilibrium and full production capacity; redistribution, ie to adjust the distribution of income and wealth; allocation, ie making adjustments in the production and provision of public goods and services. While the first two are essentially 'national' functions, the only role for state and local governments lies in the third branch (→ *local government*). 'The heart of fiscal federalism' stated Musgrave (at 181), 'lies in the proposition that the policies of the Allocation Branch should be permitted to differ between states, depending on the preferences of their citizens.' Musgrave's contemporaries, namely, Mancur Olson, Albert Breton and Wallace Oates further extended the theory by addressing the central problem of economic (fiscal) federalism, that is to define the optimal structure of public sector organization.

8 The ultimate goal of economic theories of federalism is not political participation (→ *principle of participation*) or the protection of → *individual rights*, but rather economic efficiency (Inman and Rubinfeld 45). The latter can be achieved by a combination of the 'recommended institutions of competitive decentralized local governments and a strong central government to provide pure public goods and control intercommunity externalities' (Inman and Rubinfeld 47). Indeed, economic federalism, whose most authoritative description has been provided by Oates's classic *Fiscal Federalism* (1972), makes a case for decentralized provision of public goods and services (→ *decentralization*). At the same time, it articulates the need to enable central governments to deploy a system of intergovernmental grants and/or a set of (Pigouvian) taxes and subsidies to internalize externalities. This creates conditions for a strong central government and consequent fiscal centralization marked by transfer dependency and centralist intervention in subnational affairs. However, the traditional models of fiscal federalism do not explicitly recognize the potential failings of central government policy-making (Inman and Rubinfeld 48). This is because these models assume that a benevolent federal planner—entitled to determine the final outcome(s)—will make the most efficient use of the available policy instruments such as tax-assignment and/or the design of intergovernmental transfers, in its pursuit of maximizing the utilities of citizens.

9 It was for Brennan and Buchanan, other contemporaries of Musgrave, to highlight that in the economic approach to fiscal federalism, political constraints were ignored in the design of tax policy. Mounting a challenge to the prevailing wisdom, the authors criticized transfers as collusive devices and advocated tax separation to discourage welfare-deterioration (Brennan and Buchanan 216; → *general welfare*). They supported federalization of the political structure as a means to constrain the potential fiscal exploitation of Leviathan (Brennan and Buchanan 203), on the belief that a strong central government could become a monolithic agent (Leviathan) inflicting deleterious effects on markets in pursuit of majoritarian politics (→ *majoritarianism*). This public choice view of fiscal federalism has been at the forefront of the 'market-preserving federalism' ('MPF') research agenda. The MPF literature assumes that institutional mechanisms designed to grant independent revenue-raising authority to subnational governments ('SNGs')—in the context of a common market and of hard budget constraints for SNGs (Qian and Weingast; Rodden, Eskeland and Litvack)—will preserve market forces by creating horizontal as well as vertical competition among self-serving Leviathans, who will end up restraining each other's expansionary tendencies.

10 The whole range of alternative approaches—which add to the understanding of the problems of multilevel finance and the puzzle of differentiated economic performance of federal systems—has been clubbed as the 'second-generation fiscal federalism' ('SGFF'). The common thread among all the second-generation scholars is their scepticism about the ability of a central government alone to achieve economically efficient outcomes. Particularly, the SGFF studies 'emphasize the extension of normative fiscal federalism to take systematic account of public official incentives' (Weingast 280). They examine the workings of different political and fiscal institutions and the incentives embodied therein, with the aim of estimating the impact on the behaviours and policy choices of all levels of government (Oates 356).

11 Over time the theory of fiscal federalism has evolved considerably. The goal of modern fiscal federalism is not just to ensure the efficient allocation of resources (Musgrave; Oates), but also to protect liberty and restrain the power of government (Brennan and Buchanan; Buchanan and Tullock), to share legislative and fiscal competencies (Marks, Hooghe and Blank), to foster political participation (Inman and Rubinfeld) and preserve markets (Qian and Weingast).

12 As such, fiscal federalism is no longer in the exclusive domain of economists and public finance experts. Since it can help achieve a number of governance objectives, disciplines genealogically unrelated to public economics such as public law, public administration, and political science are now examining this phenomenon and benefiting from this extended perspective. Enriched by contributions from political scientists and legal scholars, the latest wave of scholarship on fiscal federalism takes more seriously human actors and the institutional settings in which they interact.

13 The multidisciplinary perspectives on fiscal federalism are not mutually exclusive, as the overlaps are significant. However, it is useful to highlight the dominant concern of each discipline. As a subfield of public economics, fiscal federalism addresses optimal centralization and decentralization of the public finance functions of the state (allocation, redistribution, and stabilization functions) that will maximize social welfare—irrespective of the political structure of the state (Musgrave; Oates). From a public law perspective, fiscal federalism examines how different levels of government make use of the constitutionally assigned legislative and executive powers they are responsible for. It studies interactions of fiscal sovereignty and tax assignment, as well as legislative, administrative, and judicial decisions in fiscal- and financial-related matters (Avi-Yonah and Lang). Public Administration scholars focus on the question of intergovernmental management, local administrative capacity, implementation processes, and accountability in a multi-level setting where powers and responsibilities of federal and SNGs overlap (Asenio). From a political science perspective, fiscal federalism embraces decision-making as a distinct dimension of state activity (Beer). Political scientists focus on fiscal coordination between different levels of government, adopting a principle-agent framework, in case the central governments dominate, or a game theory framework, where SNGs have status as equal partners with the central government.

C. Analysed Constitutions and Rationale for Selection

14 Intergovernmental financial dynamics in all federal systems (→ *types of federalism*) reflect the functioning of intergovernmental relations within a constitutional framework that is subject to formal and informal changes. This dynamic is also shaped by several exogenous and endogenous variables of historical, political, economic, and socio-cultural nature. Thus, fiscal-federalism systems differ in terms of historical origins and cultural context, the nature of constitutional arrangements, the political and economic systems they operate in, and interactions among various determinants of intergovernmental financial relations, such as: fiscal autonomy, fiscal competition, fiscal equalization, fiscal discipline, and tax- and financial-harmonization. A few examples could be illustrative in this respect.

15 Taking the historical evolution as an example, the US began, under the Articles of Confederation (1781–89) as a system with strong state governments and a central government entirely dependent on contributions from the states (→ *component federal units*). This changed with the 'federal' Constitution of 1789, which granted the centre significant powers over fiscal resources. Later on, the Sixteenth Amendment in 1913 further removed the condition that hindered the federal power to tax income. Similarly, Australia (1901) began with concurrent taxation but gradually drifted towards a centralized system. A uniform income tax legislation was implemented during the Second World War, making the Commonwealth (federal) government the sole authority levying income tax. The introduction of the Goods and Services Tax ('GST') in 2000 was another step towards fiscal centralization. States and territories agreed to abolish a number of taxes in exchange for the new GST sharing arrangement because it provided them access to a substantial buoyant, or growth, tax. In contrast, Canada (1867) began with a high degree of federal oversight over the provinces and a centralized tax system but gradually drifted towards a decentralized model, with the → *Supreme Court of Canada (Cour suprême du Canada)* playing a key role in this respect.

16 Apart from history, cultural factors also account as an important determinant of the degree of fiscal centralization or decentralization in a federal system. For instance, German federalism, which centralizes legislative but decentralizes executive authority is a product of its culturally rooted reluctance to allocate 'law-making authority' to the *Länder*. Regional leaders in Germany are unwilling to demand more fiscal autonomy, that is, independent taxation powers (Van Houten 3). In the US, states vary in their capacity to raise tax revenue. Despite such disparities, there is negligible support for equalizing programmes across states (Shah 362). In Canada, on the other hand, there is a broad national consensus in favour of equalization (Lecours and Béland 574). Similarly, in Australia, although the three net-donor states complain regarding the size of redistribution, there has been no demand to review the underlying principles of horizontal fiscal equalization ('HFE'). In fact, all the major political parties view full and comprehensive equalization as reflective of an established 'political consensus' (Morris 64), though disputes exist on the ever rising standard of equalization. In Brazil there is a broader political consensus on the existing vertical fiscal asymmetry ('VFA') and almost no disputes regarding assignment of revenue raising powers. Even the quest to find definitive solutions to regional inequality (such as fiscal equalization schemes) has never been on the political agenda (Souza 43). However, there is a demand by most municipalities and states for more federal transfers.

17 Thus, it is the prevailing discursive conditions (which are subject to change) that allow a system to expand or restrict financial autonomy of SNGs during a specific period. If a change in these factors gets channelled in political debates, it might impact the functioning of a system and eventually also generate demand for reforms. In the US, for instance, the need to stimulate the economy and create jobs after the 1929 Great Depression led to an era of centralization at the expense of the rights of the states. However, since the mid-1990s there has been an urge to make the US federal system more balanced. This reflects in the approval of the Unfunded Mandates Reform Act (1995) intended to limit the number of unfunded federal mandates imposed by the federal government. Since then a series of verdicts of the US Supreme Court have attempted to prevent federal invasion into matters lying under states' jurisdiction (eg *US v Lopez* (1995) (US); *Printz v US* (1997) (US); *Alden v Maine* (1999) (US) *and US v Morrison* (2000)).

18 With this in mind, the financial constitutions of six federal systems are identified and examined, as displaying significant variations along the aforementioned dimensions. These include three classical 'dual' federations namely the US, Canada, and Australia, which sought to establish clearly demarcated areas of competence, and three 'cooperative' federal systems, namely, Germany, India, and Brazil, which have institutionalized the notion of common or shared competencies (Steytler 272; → *exclusive and shared competences in federal systems*). Of these, Germany is considered as a mature federation like the US, Canada, and Australia, while Brazil and India are transitional federations (Watts 1).

19 Differences among the case-studies are also related to the degree of de/centralization. All in all, Canada is the most decentralized, followed by the US. Germany lies in the middle, and Australia is the most centralized. Of the two developing/transitional countries considered in this study, Brazil (since the enactment of the 1988 Constitution) lies towards the decentralized side of the centralization-decentralization continuum, while India is located more towards the centralization pole. However, owing to the flexibility of the Indian constitution, the actual position during a particular period remains subject to the nature of government formation and the ideological configuration of the national ruling party.

20 The US model with limited exclusively federal and concurrent jurisdictions and a large residual authority to the state governments has been followed by Australia. Nevertheless, Australia, a parliamentary federal system (→ *parliamentary systems*) has pioneered a thorough equalization system which is absent in the US and at the same time federal dominance on state governments is stronger than in the US. Brazil follows the presidential congressional model of the US with → *separation of powers* and → *checks and balances* (→ *presidential systems*). However, when it comes to the allocation of powers, it upholds the German approach, providing for extensive lists of federal and concurrent powers, which shrink the residual powers of the states. Like the German federation, it also combines centralized legislative authority with a decentralized execution of public policies

(→ *representation of component federal units in federal systems*). However, Brazil is far from the German model of joint-decision or integrated (interlocking) federalism. Furthermore, unlike Germany, Brazil's 1988 Constitution provides for a high degree of subnational control over revenue sources thereby limiting federal influence to an extent that Celina Souza has identified Brazil as a case of 'centre-constraining federalism' (Souza 28). Curiously, Canada, where residuary powers lie with the federal government, is one of the most decentralized federal systems in the world. However, India which follows a similar 'three-list' scheme with residual powers to the central (or 'union') government, oscillates between extreme centralization and weak decentralization depending on political party dynamics, particularly, party constellation at the centre (Sharma and Swenden 57).

D. Comparative Description

1. The Constitutional Assignment of Tax Powers

(a) America

21 The 'federal' Constitution of 1789 (Constitution of the United States of America: September 17, 1787 (in effect March 4, 1789) (as Amended to May 7, 1992) (US)) granted the central government significant power over fiscal resources but required federal direct taxes to be apportioned equally across the states (Art. 1 s 9). However, this condition was removed by the ratification of the Sixteenth Amendment in 1913, which authorizes Congress to tax income without apportioning it among the states. Federal and state governments both collect (individual and corporate) income tax, but both have full control over their tax bases and rates. Payroll tax is collected by the federal government and sales tax is collected by the state governments. There is no harmonization of tax bases and rates either between the national and state governments, or across state governments. Each state has its own tax administration. Some states allow the tax bases and rates to vary even across their local governments. This flexibility varies across the states.

22 The US Constitution imposes certain limitations to governments' power to tax. First, under Article 1 section 9 the federal government cannot impose taxes on states' exports, and under section 10 states cannot levy taxes on imports and exports. Second, the federal Constitution and federal laws take precedence over state laws and constitutions. The impact of the federal supremacy clause on subnational autonomy was established by cases such as the *National Labor Relations Board v Jones and Laughlin Steel* (1937) (US); *Steward Machine Company v Davis* (1937) (US); *Wickard v Filbum* (1942) (US); and *Cooper v Aaron* (1958) (US)). Third, states cannot regulate property or operations of the federal government. In *McCulloch v Maryland* (1819) (US), the Supreme Court established the doctrine of intergovernmental tax immunity that barred state governments from applying taxes to a federal entity. The doctrine also prevents the federal level to tax state government, if it challenges its existence or if the national measure is discriminating (*New York v US* (1946) (US)). Finally, the 'dormant commerce clause doctrine' prohibits states from discriminating against interstate commerce and engaging in the race to the bottom (*City of Philadelphia v New Jersey* (1978) (US)).

(b) Australia

23 The Australian Constitution (Commonwealth of Australia Constitution Act: July 9, 1900 (as Amended to October 31, 1986) (Austl)) provides for a system of concurrent federal-state taxation (s 51). There is neither any tax piggybacking, nor any provision for tax revenue sharing across the tiers of government. Nevertheless, in its functioning it gradually drifted towards a highly centralized system. As a result of Federation in 1901, customs and excise duties—on which the former colonies had relied as their predominant source of revenue—were made exclusive to the Commonwealth under section 90. In order to address the vertical fiscal imbalance ('VFI') thus created, provisions were made to transfer a proportion of revenue from customs and excise duties to states under section 87. A separate provision to return the surplus to the states was made under section 94. A major step to encroach on areas of taxation lying in the sole domain of the states was taken during the Second World War, when the federal government adopted the uniform income tax act (1942) to meet war-related expenditures. Although the legislation was supposed to be temporary, it remained in force after the end of the war and the federal government became the sole authority levying income tax. This was possible thanks to the combination of the Commonwealth's defence power in time of war, the federal power to tax and the federal power to grant financial assistance to states pursuant to section 96 Constitution Acts. The states lost over 45 per cent of their tax-revenues.

24 The third wave of centralization came in 2000 with the introduction of the GST under the Inter-governmental Agreement on Reform of Commonwealth–State Financial Relations. States and territories agreed to abolish a number of taxes in exchange for the new GST sharing arrangement: this was based on equalization formula and offered them access to a substantial buoyant or 'growth tax'. At present, the federal government raises public-sector revenue from income tax, company tax, excise duties and levies, international trade, and GST. Whereas states and territories raise revenue from payroll and land taxes; mining royalties; and taxes on gambling, insurance, and motor vehicles. Finally, local governments raise revenue through municipal taxes and user charges.

(c) Brazil

25 The Brazilian federal Constitution of 1988 (Constitution of the Federative Republic of Brazil: October 5, 1988 (as Amended to December 14, 2017) (Braz)) allocates the power to tax among the three levels—federal, state, and local (Arts 153–56). The federal government is exclusively responsible for taxing both corporate and personal income, foreign trade, payroll, wealth, banking, finance and insurance, hydroelectricity, mineral products, and rural property. The federal government also raises an array of 'social contributions' intended to finance social services. The tax bases used for collection of social contributions include salaries and wages, income, profit, asset gain, goods, and services. The federal and state tax bases of 'social contributions' on transactions of goods and services (Imposto sobre Circulaçao de Mercadorias e Serviços ('ICMS')) overlap.

26 The states derive 70 per cent of their revenues from three sources: the subnational value-added tax ('VAT') on goods and services (ICMS), inheritance and gifts, and motor vehicles registrations. The federal government also allows states to levy supplementary rates up to five per cent on the federal income tax base. Municipalities levy taxes on general services (Imposto sobre Serviços ('ISS')) and urban properties, which together account for about 60 per cent of total municipal tax revenue. Municipalities also apply user charges and collect taxes on retail sales of fuels (except diesel), on property transfers (intervolves), and special assessments (frontage). Both states and municipalities are then allowed to collect social contributions from their own employees to help finance their respective pension systems.

(d) Canada

27 The federal and provincial governments both have access to broad-based tax sources: personal income tax, sales tax, and payroll tax. The authority of the federal government is defined in very broad terms in section 91.3 of the Canadian Constitution (Constitution of Canada: The Constitution Acts 1867 to 1982 (Unofficial consolidation)(as amended to December 16, 2011) (Can)). The provincial jurisdiction is specifically enumerated in section 92. Indirect taxes fall within the exclusive federal jurisdiction, although provinces can impose license fees that could to a certain extent be considered as a form of indirect taxation. The Supreme Court states that if a Province imposes an indirect tax, the act is unconstitutional as ultra vires. Nevertheless, to verify if a tax is indirect or direct the legal form and not of the economic substance is considered (*Bank of Toronto v Lambe* (1887) (Can)).

28 Regarding personal and corporate income tax, provinces can determine their own tax structure and rates (with certain limits). However, under a set of tax-collection agreements, most provincial taxes are collected by the Canada Revenue Agency ('CRA') and then transferred to the participating province. Agreeing provinces must use the federal definition of 'taxable income' but may provide both non-refundable tax credits and refundable tax credits to taxpayers for certain expenses. They may also apply surtaxes and offer low-income tax reductions. All provinces, whether or not they have signed a tax agreement, apply an agreed common allocation formula. Provinces are free to join or opt out of tax-collection agreements, but all (except Québec) have entered into the agreement in respect to personal income taxation and all but Québec and Alberta have similar agreements with respect to corporate income taxes.

29 Unlike income taxes, the sales tax structure varies much more widely. There are three different types of taxes: the GST is a federal tax levied by the federal government across the country at a uniform rate of five per cent. It is collected by the CRA. In addition to GST, some provinces and territories levy a Retail Sales Tax on top of the GST, generally called Provincial Sales Tax ('PST') or Québec Sales Tax in Québec. Five provinces (Ontario, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland and Labrador) combine GST and PST into one and enact a Harmonized Sales Tax, which is collected by the CRA and the revenues thereof are allocated in proportion to taxable consumption.

(e) Germany

30 In Germany the power to tax is basically reserved for the federal level. Article 105 Basic Law (Basic Law of the Federal Republic of Germany: May 23, 1949 (as Amended to July 11, 2012) (Ger)) stipulates in detail the distribution of the legislative authority to tax between the federal government (*Bund*) and the *Länder* in order to avoid overlapping. Accordingly, the *Bund* has the exclusive right to legislate with respect to customs duties and fiscal monopolies. The *Länder* on their side can legislate on local taxes on consumption and expenditures so long and insofar as such taxes are not substantially similar to taxes regulated by federal law' (ie taxes on beverages and on packaging). In addition, they can determine the rate of the tax on acquisition of real estate (Art. 105.2a).

31 However, the most important taxes representing about 70 per cent of all taxes (eg, personal and corporate income tax, VAT) fall within the concurrent legislative competence (Art. 105.2). In practice this concurrent power has been interpreted and used so extensively by the federal government, that the margin of autonomy of the *Länder* in this field is de facto nullified (*Badische Weinabgabe* (1958) (Ger)). On the other hand, the tax autonomy of both levels of governments is restricted. In fact, when the *Bund* legislates on taxes, the revenue from which accrues wholly or in part to the *Länder* or to municipalities (associations of municipalities), the consent of both the *Bundestag* and the *Bundesrat* is required. No change can thus be made to the tax base or rate, or to the tax-revenue sharing arrangement without the consent of the other side. As a result, there is total tax harmonization in Germany.

(f) India

32 The framing fathers of the Indian Constitution (Constitution of the Republic of India: January 26, 1950 (as Amended to September 16, 2016) (India)) embraced the principle of the separation of tax powers, which means the exclusive assignment of tax categories either to the centre or to the states (Part XI, Chapter I, Art. 246 to be read with Schedule VII). This system remained in force until the implementation of the GST from 1 July 2017. The Constitution of India assigns most broad-based taxes to the centre, including taxes on income and wealth from non-agricultural sources, corporation tax (→ *corporations*), taxes on production (excluding those on alcoholic liquors), and customs duty. A long list of taxes has been assigned to the states. These include, inter alia, tax on agricultural income, professional tax, state excise duty, land revenue, stamp duty, and tax on the sale and purchase of goods. The local bodies collect property tax and taxes on services like drainage and water supply. In addition, all residual powers for taxation under Article 248(2) of the Constitution and Entry 97 of the Union List are assigned to the centre. On 1 April 2005, a state-level VAT system was implemented in place of the complex and fragmented sales tax system. India moved towards the levy of a comprehensive GST in 2017.

33 The demarcation of the tax handles of the central and state governments, as enshrined in the Seventh Schedule to the Constitution of India, did not permit the centre to levy sales tax, nor did it allow the states to charge excise duty or service taxes. The provision related to the tax on services was inserted in the Constitution by the 88th Constitutional Amendment Act, 2003, formally placing it under the Union List. Prior to this, Parliament invoked residual powers to levy the service tax. With the 101st Amendment Act, 2016, which led to the implementation of the GST, India embraced the principle of concurrency. According to Article 246A, inserted through section 2 of the Amendment Act, both the union and the state legislatures have concurrent powers to levy and collect their shares of GST on a common base of economic activity. However, Article 269A grants the Parliament of India exclusive power to make laws with respect to the interstate supply of goods and services (Integrated Goods and Services Tax), the tax proceeds from which are to be shared between the centre and the states.

2. Tax-Revenue Sharing and Intergovernmental Grants

(a) America

34 Prior to the Great Depression of 1929, the federal government was small and its role in the economy was limited. As the New Deal was introduced in 1933 by President Roosevelt in an attempt to stimulate the economy and create jobs, an era of centralization at the expense of the rights of the states began. On 14 August 1935, the US Social Security system was set up as one of the largest government programmes in the world (→ *social security*).

35 President Lyndon B Johnson took centralization a step ahead in 1964 by launching the Great Society programmes. Congress went on to enact legislations on a wide range of matters—such as solid-waste disposal, water and air pollution, consumer safety, and home insulation. The federal government assumed the power to provide financial aid to the states to support (and influence) them in areas such as education and criminal justice that fall under subnational authority. Conditional grants, and the conditions attached to them, have expanded over time.

36 The federal government attempts to influence the states through federal financing of programmes such as the jointly-funded Medicaid (a social welfare programme for low-income individuals), the federally-funded Medicare (a social insurance programme for the aged), and the Social Security pension programme. Temporary Assistance for Needy Families is another federally funded programme implemented by states, but states have broad flexibility to carry out their programmes. Although an equalizing element is built into these intergovernmental grants, there is no formal HFE system. Also, there is no tax revenue-sharing scheme in the US. The Nixon Administration implemented a revenue-sharing programme in 1972, which was ended by the Reagan Administration in 1986.

(b) Australia

37 Prior to 1933, the Commonwealth Parliament provided financial assistance to the states in an ad hoc manner. The Commonwealth Grants Commission ('CGC'), an independent body, was established by the CGC Act 1933, to provide advice to the Australian Government on the level of grants to be paid to the states to achieve HFE. The CGC make recommendations in response to terms of reference decided by the Commonwealth in consultation with the states. The Premiers' Conference of April 1977 decided to replace financial assistance grants by income tax sharing arrangements thereby widening the scope of the CGC to encompass all states, not just the claimant states. Revenue under this arrangement was to be distributed on the basis of relativities based on equalization principles. Since 1981, the CGC has recommended relativities based on full equalization. According to the CGC, the HFE aims to equalize fiscal capacity (on both the revenue and expenditure side of state budgets), in order to ensure services and → *infrastructure* at the same standard in each SNG, providing that each one makes the same revenue effort and operates at the same level of efficiency. However, under the Treasury Laws Amendment Act 2018 (Making Sure Every State and Territory Gets Their Fair Share of GST), which amends the CGC Act 1973 and the Federal Financial Relations Act 2009, the Commonwealth has initiated a gradual transition from full to reasonable equalization. This change in benchmark should ensure that the SNG fiscal capacity is equalized to provide services and infrastructures at a reasonable (rather than the same) standard.

38 The equalization pool is financed through (a) the GST revenues—of which the entire amount is allocated to states and territories as untied grants, and (b) the health care grants financed by a Medicare levy. The federal government also provides specific purpose payments ('SPPs')—tied to specific objectives—to influence local spending decisions in accordance with central preferences. The CGC includes SPPs in the scope of the commission's assessments, so that SNGs receiving a higher share of SPPs obtain a lower share of untied grants.

(c) Brazil

39 In Brazil, the federal government shares income and manufacturing tax-revenues with the states (via the State Participation Fund) and the municipalities (via the Municipality Participation Fund) at the rate of 21.5 per cent and 22.5 per cent respectively. The federal government collects taxes on financial operations in gold and then transfers the entire amount to states and municipalities. The federal government also collects rural property tax and gives half of the proceeds to local governments. Similarly, the states share with local governments 25 per cent of their VAT collections and 50 per cent of motor vehicle tax receipts.

40 In Brazil, the ownership of → *natural resources* lies with the federal government. However, under Article 20.1 of the Brazilian Constitution (the Constitution of the Federative Republic of Brazil: 5 October 1988 (as Amended to 2017) (Braz), royalties and financial compensation for the use of natural resources like mining and extraction of oil are assigned to SNGs. The rules for compensation are established by federal legislation. While revenue sharing is unconditional, there are two major categories of specific purpose transfers. The first relates to education funding (called Fundo de Manutenção e Desenvolvimento da Educação Básica e de Valorização de Profissionais de Educação ('FUNDEB')) and the second to the health care system. Unconditional transfers are not subject to any explicit equalization formula whereas conditional transfers are equalized, though in a limited sense that follows no consistent pattern.

(d) Canada

41 In Canada there is no tax-revenue sharing and federal transfers are mostly used for equalization purposes. According to section 36.2 of the Constitution of Canada (Constitution Act 1982 (Canadian Constitution Acts, 1867 to 1982): 1 January 1982 (as Amended to 2011) (Can), 'the principle of making equalization payments' is vested with the parliament and the government of Canada and it shall ensure that 'provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation'. The federal government makes use of two types of intergovernmental transfers: unconditional equalization transfers and the much larger per capita bloc-transfers (population based), supposedly to encourage provinces to meet nationwide standards in the provision of health, education, and other social programmes. These transfers are largely unconditional, insofar as recipient provinces and territories are not required to report to the federal government on the use of the transferred funds. Equalization transfers are unequivocally unconditional and go to the provinces whose revenue-raising capacity is below a norm determined by a five-province standard.

42 There are two additional types of transfers: the Canada Health Transfer ('CHT') and the Canada Social Transfer ('CST'). For CHT, the conditions are mentioned in the Canada Health Act, the compliance of which is monitored by the Canada Health Act division. This is not the case for CST, however, which is only notionally tied to the condition of meeting a national standard in spending areas. Provinces have the option of rejecting the federal requirements and declining the transfer payments, though none has ever refused them. The only instance is of Québec opting out of conditional federal transfers in 1960.

(e) Germany

43 As the *Länder* have practically no autonomous power to tax, revenue sharing mechanisms are essential to subnational financing. The Basic Law for the Federal Republic of Germany: 23 May 1949 (as Amended to 13 July 2017), Article 106 (Ger) provides for the vertical apportionment of tax-revenue. Paragraphs 1 and 2 enumerate the taxes whose revenues accrue fully to the federal (eg the road freight tax, the motor vehicle tax, and other taxes on transactions related to motorized vehicles) or to the *Länder* level (eg the inheritance tax, the tax on gambling establishments). Pursuant to Article 105.3 Basic Law, revenues from individual and corporate income taxes are shared equally between the federation and the *Länder* (the 15 per cent goes to municipalities). Vertical sharing of VAT revenue is also established by the Basic Law (Art. 105), though in accordance with a federal law requiring the consent of the *Bundesrat* (*Finanzausgleichsgesetz* of 2001, as modified in 2018). As of 2020, a share of 45.2 per cent of the tax yield will be transferred to the *Länder*.

44 While revenue from income tax is distributed based on the place of origin (derivation principle), and so is not equalizing, the distribution of VAT revenue results in equalization. As of 2020 the distribution thereof continues to be based on population, though corrected on the basis of the *Länder* financial capacity: entities with a below-average financial capacity will receive a supplement, whereas resources from VAT will be accordingly reduced for the ones with an above-average capacity. This lifts the financial capacity of all below-average *Länder* closer to the national average. Finally, the poorer *Länder* whose fiscal capacity remain below average even after VAT redistribution receive additional vertical transfers in the form of general supplementary federal grants and supplementary grants for special needs. Together with the highly centralized power to tax, this system yields a strongly egalitarian pattern of fiscal equalization.

(f) India

45 Originally, the Constitution of India: 26 November 1949 (as Amended to 16 September 2016) Article 270 (India) provided for the compulsory sharing of the personal income tax and the optional sharing of the union excise duties (Art. 272) with states. The corporate income tax and custom duties were not shareable. However, the 80th constitutional amendment (2000) abolished Article 272 and revised Article 270 to provide the states with a share—at a rate prescribed by the parliament on the recommendations of the Finance Commission ('FC')—of the net proceeds of all central taxes and duties referred to in the Union List except those in Articles 268 and 269 (which the centre is constitutionally mandated to assign to the states), surcharges referred to in Article 271, and any cesses levied for specific purposes. This amendment was based on the 'alternative scheme of devolution' recommended by the Tenth FC (→ *devolution*). The Eleventh FC—the first to take this change into account—recommended an overall share of states in net central taxes at 29.5 per cent. Later, the share has been gradually increased to 42 per cent.

46 The criteria for horizontal distribution of the aggregate share among all states is also developed and reviewed by successive FCs, constituted quinquennially. The FC also works out revenue-deficit grants for states under Article 275. In addition, central government ministries provide grants to their political counterparts in the states. These are provided for specific projects either wholly funded by the centre (central sector projects) or requiring states to share a proportion of the cost (centrally sponsored schemes). These grants are not based on any formula but are completely discretionary. Finally, there are various forms of ad-hoc assistance provided for by the centre to the states in the form of grants and loans.

3. The Involvement of Subnational Entities in Fiscal/Financial Decision-Making

(a) America

47 In the US no specific institution exists to involve the states in fiscal decision-making at the federal level, probably because the Constitution envisaged the two levels to be autonomous and coordinate. However, the Senate, where all states have equal representation (two senators per state), has → *veto* power on all legislation. As such it is considered the strongest federal second chamber in the world (→ *bicameralism*). Nevertheless, over the years, the federal government has adopted laws that oblige SNGs to perform certain actions and to promote national goals in areas traditionally reserved to them. Many of these so-called federal mandates are unfunded and thus impose heavy costs on the part of the states. However, in 1995 the Unfunded Mandates Reform Act was adopted to limit this practice and strengthen the partnership between levels of government. In *Alden v Maine* (1999) (US), the Supreme Court expanded state immunity from lawsuits in which private parties sought to enforce federal mandates. In 2000 the Supreme Court, in *US v Morrison*, held that the provision of the Violence against Women Act of 1994 allowing women the right to sue their attackers in federal Courts invaded the powers of police that were reserved for the states.

48 Although there is neither any tax harmonization nor any fiscal equalization programme, states have devised compensatory mechanisms such as interstate tax compacts. For instance, states signed the Multistate Tax Compact in 1967 to share information on tax compliance. This voluntary tax compact was not sanctioned by the Congress as a formal compact and is not to be considered as an 'agreement or compact' under the Compact Clause of the US Constitution (Article I, Section 10, Clause 3 of the Constitution of the United States of America: 17 September 1787 (as Amended to 1992) (US). The Multistate Tax Commission, an outcome of the tax compact, is a US intergovernmental state tax agency, of which 47 states are members, that attempts to promote uniformity in the structure of the corporate income tax. In 1978, the Supreme Court in *US Steel Corp. et al. v*

Multistate Tax Commission, upheld the constitutionality of the Multistate Tax Compact despite the lack of Congressional approval. Similarly, in 1999, the National Governor's Association and the National Conference of State Legislatures created the Streamlined Sales and Use Tax Project to simplify the sales tax by structuring it on a destination basis, enabling states to collect sales taxes on remote transactions. 24 states have entered into the Streamlined Sales and Use Tax Agreement ('SSUTA') and passed the conforming legislation to simplify sales tax collection procedures. The US Supreme Court in *South Dakota v Wayfair, Inc., et al* (2018), overruled the physical presence rule that had been preventing states from taxing remote sales. The Court noted that SSUTA standardizes taxes to prevent discrimination between sellers and reduce administrative and compliance costs. Overall, by securing voluntary interstate cooperation, the tax compacts and agreements seek to seize the middle ground between non-uniformity and federal mandates. In other words, such voluntary compacts resolve the trade off between the uniformity of state tax systems and preservation of state sovereignty over tax policy and tax administration.

(b) Australia

49 The high centralization of the tax power is only partially counterbalanced by the strong powers vested in the Australian Senate which include authority to approve all bills. In order to manage issues that need coordinated action by all Australian governments, the Council of Australian Governments ('COAG') was set up in 1992. It grew out of the Australian Premiers' Conference as the principal forum for intergovernmental collaboration in Australia. This vertical cooperation forum of Australian leaders at all levels (federal, state, and local) is the only mechanism to facilitate cooperation between the Commonwealth and state and territory governments on issues of national importance, however it has no constitutional or statutory basis. The COAG meetings discuss priority issues and facilitate national partnership agreements between the Commonwealth of Australia and the states and territories in order to make funding available to the latter as an incentive to implement the agreed national reforms. In addition, Ministerial Forums focus on the COAG Reform Agenda. On 29 November 2008, the Intergovernmental Agreement on Federal Financial Relations was developed in a COAG meeting. The agreement provided an overarching framework that aims at improving the quality and effectiveness of public service delivery in Australia (see OECD 'Australia: The Intergovernmental Agreement on Federal Financial Relations', in Reforming Fiscal Federalism and Local Government: Beyond the Zero-Sum Game (2012)). Prior to this the Special Premiers' Conference on 13 November 1998 had developed the Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations. The GST law rests on this agreement.

50 The Council for the Australian Federation ('CAF') was established in 2006 as a mechanism for horizontal cooperation. The CAF serves as a counterweight to Commonwealth dominance of intergovernmental affairs.

(c) Brazil

51 In Brazil, there is a lack of effective institutional mechanisms for intergovernmental cooperation and coordination as such. The influence of horizontal cooperation forums such as the Fiscal Forum of the Brazilian States on policy-making at the federal and subnational level remains uncertain. The Council of Ministers of Finance of the States ('CONFAZ'), presided over by the federal Minister of Finance, was established in 1975 in accordance with the requirements of Complementary Law No. 24. Along the same lines as institutional devices such as the Canadian First Ministers' Conference (turned into the 'Council of Federation' in 2003) and the Australian Premiers' Conference (turned into the COAG in 1992), the CONFAZ was supposed to prevent non-cooperative behaviour among SNGs and to promote the coordination of interstate fiscal policy. However, its focus remains limited to achieving national coordination of the state taxes on goods and services only.

(d) Canada

52 Although there are frequent discussions between federal and provincial officials, the mechanisms for promoting intergovernmental cooperation are weakly institutionalized. However, interprovincial meetings were formalized with the establishment in 2003 of the Council of the Federation ('COF'). This institution grew out of the Annual Premiers' Conference, but it has no constitutional foundation. Like the CAF and National Governors Association of the US, the COF aims at forging a united front towards the federal government and has, at times, provided a useful forum for intergovernmental interactions.

(e) Germany

53 The German federation is known for joint decision-making and interlocking relationships between the federal and the *Länder* governments. German *Länder* undertake several actions to coordinate their position in the Federal Council (*Bundesrat*), as the latter can veto any federal law affecting subnational interests, and above all financial affairs. Since tax-revenue sharing and intergovernmental transfers constitute the predominant segment of subnational revenues, vertical coordination and cooperation become crucial. For this purpose, the Stability Council (*Stabilitätsrat*) was established in 2010 and consists of both *Bund* and *Länder* representatives. It plays a significant role as it is in charge of the supervision of the budgets and results in an early-warning system to prevent and remedy future budgetary crises. There are also intergovernmental councils to achieve horizontal cooperation, such as the Conference of Ministers of Education, the Finance Ministers Conference, and the Conference of the Head of the *Länder* executives. These horizontal intergovernmental councils aim at countering centralization and federal encroachment and result in genuine policy coordination among the *Länder*.

(f) India

54 In India, the Inter-State Council ('ISC') was established under Article 263 in 1990, as a consultative body, under the Union Home Ministry. The ISC is responsible for strengthening inter-state and centre-state coordination and cooperation. However, its meetings are not convened regularly, and its potential remains untapped.

55 In 2016, the GST Council was established under Article 279(A) inserted by the 101st Constitutional Amendment Act, 2016. The institution is responsible for intergovernmental collaboration, bargaining, and conflict resolution on policy matters related to GST. Intense centre-state consultations in the GST Council meetings led to implementation of the concurrent dual GST and a multi-layered tax rate structure as a grand bargain between the centre and the states. As such the Council has emerged as an illustrative example of a collaborative approach to managing contentious intergovernmental issues.

E. Comparative Assessment

1. Tax Assignment at Work: Implications for Fiscal Autonomy and Competition

56 Tax assignment in federal systems is a key concern. Comparatively observing the selected cases, it emerges that as a rule it follows one or a mix of the three principles: tax separation (base and rate autonomy); concurrent taxation (co-occupancy of tax bases along with the autonomy to set tax rates); and tax-revenue sharing (both base and rate are under national control, but a fixed proportion of revenue is shared with states). While tax separation can lead to horizontal tax competition, concurrent taxation might lead to vertical tax competition. Tax sharing takes care of these disadvantages, but to the detriment of fiscal autonomy.

57 In the US, the tax structure varies across states. In fact, there is fiscal autonomy in terms of the ability of states to control their budget composition, expenditure levels, and tax structure (bases and rates). However, this independence has not generally led to a race to the bottom to attract business (Chirinko and Wilson 149). This happens because in the US the concurrent multi-tiered income tax system discourages horizontal tax competition. Vertical competition as a consequence of concurrent taxation is prevented by allowing taxpayers to deduct either the income or the sales taxes already paid to state and local governments while computing their federal tax liability. Instead, the countervailing forces of vertical and horizontal competition working to offset the overall distortionary effects of intergovernmental competition are evident in Switzerland (Blöchliger and Campos 24).

58 Two other tools reduce the impetus for tax competition: these are tax harmonization and equalization mechanisms (which reduce payments to a tax-lowering region seeking to improve its own revenue by attracting the mobile tax base at the cost of neighbouring regions). In Australia, a system of full and comprehensive HFE is in place and it creates disincentives for tax competition; in Germany and Canada both tax harmonization and horizontal equalization play a role in this respect. Conversely, India had originally embraced the principle of separation of tax powers in its Constitution but adopted the principle of concurrency for indirect taxation after 2016 (101st Amendment Act). Tax-base sharing has eliminated tax disharmony and strengthened the shared-rule dimension of fiscal federalism. Coupled with the 14th FC's recommendations, which enhanced the states' share of the central tax receipts (the divisible pool) from 32 to 42 per cent, the GST reform has reduced the tendency of states to indulge in the sales tax rate war. As the competition to offer lower tax rates loses its significance, the states are competing to offer a better business environment and an attractive local entrepreneurial spirit.

59 On the other hand, in the Federal Republic of Brazil, which broadly follows the principle of tax separation, the lack of tax harmonization and the absence of a formal equalization mechanism has led to the inter-state fiscal war to attract industries and foreign direct investment to their jurisdictions. Although some perceive fiscal wars as a substitute for the absence of a federal policy to cope with regional disparities, there is a growing awareness of the futility of these fiscal conflicts.

2. Revenue Sharing and Intergovernmental Grants at Work: Implications for Fiscal Gaps and Imbalances

60 VFA is a common characteristic of all multi-level fiscal systems. This is a situation where the central government has access to more revenue resources than it needs to finance own-purpose expenditures (not including equalization commitments), while the SNGs are assigned more expenditure responsibilities relative to their revenue raising authority (Sharma 102). Federations all over the world, with the exception of the US, use the surplus revenue so earned to resolve horizontal fiscal imbalances/disparities and equalize the fiscal capacities across SNGs. However, if a federal government has undesirably large revenue surplus, beyond its legitimate needs (including equalization commitments), obtained either by pre-empting SNGs' revenue sources or offloading expenditure responsibilities, a VFI emerges. A VFI remains in place until addressed by the reassignment of responsibilities. On the other hand, if the revenue-raising powers of the federal government are perceived as legitimate and desirable, but the size of transfers falls well short of the surplus of the federal government accruing to it from the existing assignment of taxes, a vertical fiscal gap ('VFG') emerges. A VFG remains in place until addressed by a combination of lump sum grants—designed for state specific and/or purpose specific targeting—and revenue sharing—designed to correct the equity distortions (eg need-capacity based sharing) and/or to correct efficiency distortions (eg origin-based sharing). The fiscal instruments enacted by federal systems to resolve fiscal gaps and imbalances, vertical as well as horizontal, differ from case to case influencing the balance between autonomy and solidarity concerns. Thus, theoretically, a state can be reached where there is no imbalance and no gap. Since the literature lacks a systematic way to refer to this state, the term 'vertical fiscal difference' was proposed by Sharma (2012, 112).

61 There is an intense debate in Canada on the existing VFA: whether it should be corrected by turning over more tax room to the provinces—if there is a structural imbalance which must be addressed by reallocation of fiscal instruments or by increasing transfers to the provinces—if inadequate transfers, not inappropriate allocation are issues under debate (Sharma 2012, 106). Typically, provinces with higher revenue capacity or autonomy aspirations lean towards being in favour of the former option, while economically weaker provinces seek the latter solution.

62 A similar debate on the size of equalization transfers exists in Australia. Typically, the larger states demand reduction of subsidies to the smaller states, while the beneficiary states opine that redistribution is mostly fair and reasonable in nature. The equalization grants do not accommodate 'extra' spending. These grants are directed towards ensuring that each state and territory will have equal financial capacity to deliver services of a comparable standard. However, to ensure that no regions suffers from fiscal imbalances resulting from disabilities beyond the control of the SNGs, the equalization grants are subject to periodic review to respond to changes in the relativities such as an increase in costs of delivering services or the ability to raise revenue.

63 In Brazil, there is no debate regarding reassignment of responsibilities but rather a demand by most municipalities and states for more federal transfers (indicating a VFG). Thus, the government attempts to fill the gap by using revenue sharing mechanisms and vertical fiscal transfers. However, a substantial portion of funding is distributed based on political rather than economic considerations, particularly to favour political allies. Furthermore, the absence of a formal fiscal equalization transfer programme in Brazil—already characterized by large regional disparities— creates a high degree of horizontal fiscal imbalance.

64 In Germany, a majority of the *Länder* favour the existing system of fiscal equalization because it helps them meet their legal obligations and spending needs. This system also provides risk sharing, insures state budgets against revenue shocks and significantly soothes income shocks. However, the three financially strong (donor) *Länder* (Bavaria, Baden-Württemberg, and Hesse) that support the rest of the *Länder* are not satisfied with the system. In March 2013, Hesse and Bavaria filed a lawsuit arguing that the equalization schemes overburden their economies and hamper competition. Overall, the equalization system is extremely popular among *Länder* officials and there is no demand for higher tax autonomy for the *Länder*.

65 India has a comprehensive system of intergovernmental transfers to address VFG and horizontal fiscal imbalance. The states' aggregate share in the central pool of taxes is subject to revision every five years, based on the recommendation of the FC. Similarly, the criteria for horizontal distribution is also reviewed by successive commissions. However, substantial grants are also provided by central government ministries to their counterparts in the states. Recent empirical evidence suggests that these grants are channelled to particular constituencies based on political considerations, at the expense of broader public interests—an instance of pork barrel politics (Sharma 14). These grants are so regressive that they offset whatever fiscal equalization is achieved by the FC transfers. Thus, fiscal disparities persist despite fiscal equalization.

3. The Challenge Ahead: Fiscal Discipline in Federal Systems

66 In Germany, there is little incentive for fiscal discipline at the subnational level. This is because the *Länder* lack tax autonomy and transfers via the equalization system create 'soft budget constraints' (Rodden 161). Due to the possibility of bailouts there is little incentive for prudent fiscal management. In 2017, the average level of German *Länder* direct debt was as high as 176.6 per cent of total revenue (Barisone 7). Although the federal government is bound by the European Union Stability and Growth Pact to stay within the limits on government deficits (three per cent of gross domestic product ('GDP')) and debt (60 per cent of GDP), it imposed no restrictions on subnational borrowing until 2020. Thus, many *Länder* get caught in a borrowing and debt cycle and seek bailouts from the federal government. So far three states (Saarland, Bremen, and Berlin) have sued the federal government for a bailout. Indeed, in an earlier judgment the Court ruled in favour of Saarland and Bremen (*Finanzausgleich II* (1992) at 260–61 (Ger)), further softening the budget constraints. Although, in a subsequent decision (*Berliner Haushalt* (2006) (Ger)) the Court applied a stricter scrutiny and rejected the claim. The situation should somehow improve, as the *Länder* are supposed to have balanced budgets starting from 2020.

67 In Canada, intergovernmental transfers do not lead to demand for bailouts because provinces enjoy a high degree of fiscal autonomy which makes them deeply accountable and responsive to their electorates. Furthermore, the magnitude of the transfers is not a function of the financial needs of the recipient governments, so there is no way the recipient provinces can increase transfers by indulging in fiscal laxity or profligacy. Overall, the Canadian system controls bailout expectations of SNGs as effectively as the US (Boadway and Shah 161). Similarly, in Australia, equalization transfers do not lead to perverse incentives to indulge in inefficient and wasteful spending. However, there are no restrictions on SNGs borrowing to finance expenditures. Australian Loan Council arrangements emphasize transparency of public sector borrowing rather than adherence to strict borrowing limits.

68 Many countries such as Brazil, Russia, South Africa, and India rely on fiscal rules to improve fiscal discipline. Brazil adopted the Fiscal Responsibility Law in 2000, which sets incentives to discourage fiscal misconduct. In India, the Fiscal Responsibility and Budget Management Act was implemented by the central government in 2003 and by state governments between 2002 and 2006. This legislation laid down targets to eliminate current deficits and keep fiscal deficit below 3 per cent of state GDP. The 12th FC recommended that the central government should not provide loans to the states but rather allow them to access the market directly. The 15th FC, set up in November 2017, has been given the mandate to prepare a fiscal consolidation roadmap for sound management of government finances. Germany introduced balanced budget provisions and a 'debt brake rule' with the *Föderalismusreform II* (2009), nonetheless the new rules entered into force in 2016 only for the *Bund*. They apply to the *Länder* as of 2020.

69 However, imposing fiscal rules is not the only way to ensure fiscal discipline. There are other mechanisms too. Federal governments in the US, Australia, Canada, and Switzerland, do not impose fiscal constraints on SNGs. In the US, the federal government follows a credible no-bailout policy (since 1840), meaning that states are supposed to cope with the effects of cyclical macroeconomic slowdowns through own revenues. Consequently, 49 states have constitutional/statutory provisions for balanced budget, which limit their ability to indulge in excessive spending and borrowing. In Australia, while the Commonwealth has built a fiscal discipline framework for itself through the pursuit of the Charter of Budget Honesty (1998), SNGs rely on financial market scrutiny of proposed public sector borrowing. Similarly, in Canada, many provinces self-impose restrictions on deficit financing, while capital market rules end up imposing fiscal discipline on all levels of governments.

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