

Economic and financial crises can change the dynamics of federal relationships

By Democratic Audit UK

*Economic recession and soaring deficits in the wake of the recent fiscal and economic crisis do not only ask for intelligent fiscal policies but need also coordinated efforts in federal states in order to forego contradictory and inefficient fiscal reactions to the crisis. **Dietmar Braun** and **Philipp Trein** have investigated eleven federations to discover what extent the crisis has contributed to such confrontation and changes in federal relations.*



Federation square in Melbourne (Credit: Rob Deutscher, CC BY 2.0)

During crises, federal states face particular challenges in coordinating their response, as authority over revenue and spending is usually shared across different jurisdictions. Such coordination problems are often linked to selfish behaviour by federal actors neglecting the “federal costs” of such behaviour.

Examples are opposition policies to the federal government because of party struggle in the country; cost-shifting to the other levels of the federation or, among member states, to other sub-governments; or continuing over-spending despite a serious distortion of the budget balance.

Especially consolidation policies may lead to serious confrontation among federal actors because they involve diminished revenues and expenditures and, hence, increasing difficulties to maintain electoral support on either the national or sub-government level.

As the crisis exerts considerable pressures on many federations, such “opportunistic behaviour” may challenge solidaristic attitudes in federations and lead to institutional reforms about competence and discretion rights. Shifts in the equilibrium of territorial powers in fiscal policy-making are imminent.

In an empirical analysis of the recent global economic and financial crisis and its effects on federal fiscal policy-making in eleven federal countries (Argentina, Austria, Australia, Belgium, Canada, Germany, India, South Africa, Spain, Switzerland, US) we show that three different kinds of coordination problems occurred during the crisis in these federations.

Sub-government disobedience

Firstly, during the first phase of the crisis, characterised by a strong fall of the economic growth in 2008 and 2009, one notices that sub-governments in several federations did not abide to the expansionary and demand-stimulating fiscal policies of the federal government, simply by not using the transferred federal grants as envisaged by the federal government but rather for own purposes not in line with the combat of the economic recession. This was for example the case in Australia and the USA where sub-governments feared that such grants would put them too much under conditions dictated by the federal government and would reduce their discretion in fiscal policy-making.

Actual disrespect with regard to the use of federal grants were only signalled Australia and South Africa. In other federations, however, grants were a welcome (and often necessary) support for helping to reduce the economic slump in the regions. However, also in those countries where disrespect became obvious, this did not lead to legal change in federal relations though public debates about the “efficiency” of the federal order happened.

Rent-seeking

The second type of coordination problem that occurred in the context of the crisis was cost-shifting and avoidance of implementation of adequate action by sub-governments (“rent seeking”). Here, sub-governments demanded for example additional transfers, for instance extra tax shares from the national government, from equalisation payments, or from federal grants, in order to compensate for their income losses.

Receivers of funds of equalisation payments were on several occasions accused of seeking rents for example in Spain, Australia, Germany, Belgium, Canada and the USA. However, in the latter case these criticisms focused on the grants by the federal government rather than payments from the fiscal equalization system. In Canada, some provincial governments accused others of not pursuing enough consolidation policies and thereby burdening other sub-governments with unnecessary costs.

In other countries, richer sub-governments criticised the existing formulas for fiscal equalisation for being too generous and demanded less payments in order to compensate for their own losses in income. Consequently, this led to re-evaluations and discussions concerning fiscal equalisation, as for instance in Australia and Canada. In Germany, the richer Länder appealed before the courts to challenge the existing formula, whereas in the USA disputes remained at the rhetoric level. In Belgium and Spain, these conflicts are part of a larger territorial conflict between sub-governments.

Borrowing and spending

The third coordination problem that occurred in the context of the crisis was related to the borrowing and spending behaviour of subnational governments. It was in connection with this problem that the potential for conflict in the relations between the national government and subnational government became obvious and that the “ghost” of (re-)centralisation entered the political agenda. However, contrary to the economic crisis of the 1930s, or to a case like Brazil in the 1990s, there were no shifts in taxation and spending rights in favour of the federal government or, in other words, “authority migration” was not observed.

By contrast, and this in particular in the Euro-zone, most affected by the financial crisis, one observed an increasingly tighter stance with regard to the use of fiscal rules for budget policies and, at least on the paper, to a substantial loss of fiscal discretion for sub-governments but also for the federal government which felt under the same fiscal regime of the Euro-zone. Federal governments were, however, delegated with implementation and oversight of the agreed upon rules in the Euro-zone. This could lead, as in the case of crisis-ridden Spain, to emergency measures granting the federal government substantial powers to effectuate the fiscal contract *vis-à-vis* sub-governments.

In other cases, sub-governments were still able to negotiate conditions of implementation and above all the distribution of costs linked to austerity policies and possible sanctions for disrespect of the Euro-zone rules. In the decentralised federations Canada, Switzerland, and the USA, sub-national governments had already introduced fiscal rules on the sub-government level before the crisis which had precautionary effects in Switzerland, being almost unaffected by the crisis, drastic and rapid re-adjustments in the American case, but a much slower reaction in Canada, where all federal levels had spent substantially during the economic recession. Here, the crisis

sparked vivid debates about a reform of the borrowing system.

In India, Brazil, and Argentina, the crisis did provoke a lesser reaction, not only because often the economic slump was less dramatic than, for example, in the Euro-zone but also because financial crisis had already been an issue in the 1990s and had led to institutional reforms of the borrowing system, mostly in the form of fiscal pacts and extensive compensation payments by the federal government for “fiscally disciplined behaviour” of sub-governments. In the crisis, fiscal discipline was weakened but the contracts are still valid in all three cases. In Brazil one can speak of a “re-centralisation” with regard to these reforms, while the pacts in the other two countries did not change existing federal relations.

In sum, it became obvious that the recent economic and financial crisis itself did not lead to a re-centralisation of fiscal authority rights but, above all in the Euro-zone, sub-governments are subject to harder budget constraints and, hence, a loss of discretion in their fiscal rights while the federal governments has the difficult task to guarantee the fulfilment of the contract with the “external enforcer”, the European Union. How this is done differs but usually, sub-governments have important “voice” and even “veto-powers” in the setting up of enforcement mechanisms and in the distribution of costs linked to consolidation policies.

Loss of fiscal discretion is also the normal case in the other federations, in India, Brazil, and Argentina already in effect before the crisis and in decentralised federations on the base of self-imposed fiscal rules. Overall, one can perhaps say that federal relations in fiscal policy-making are changing but not because of authority migration to the national level.

Instead, one sees diminishing powers of fiscal policy-making due to harder budget constraints, which, though they are valid for both levels of the federation, reduce the capacity to act of sub-governments much more than for the federal government, which is usually equipped with more financial resources and instruments to act.

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