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Beyond Gaps and Imbalances: Re-Structuring the Debate on Intergovernmental Fiscal Relations

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BEYOND GAPS AND IMBALANCES: RE-STRUCTURING THE DEBATE ON INTERGOVERNMENTAL FISCAL RELATIONS

Abstract:

How do we know whether a country suffers from vertical fiscal imbalance (VFI)? What should be done about it? Academic appreciation of these issues in general, and the nature of political behaviour in particular, both have major implications for the way federations are fiscally structured. While the latter clearly is a problem of political negotiations, our focus is on the former, i.e., conceptual clarity, which precedes meaningful negotiations. Thus, the paper aims to clarify the multiple usages of the symbolically loaded terms VFI and VFG (Vertical Fiscal Gap) by critically engaging the fundamental assumptions and premises underlying these ostensibly similar notions. It proposes an alternative conceptual framework and introduces the concepts of Vertical Fiscal Asymmetry (VFA) and Vertical Fiscal Difference (VFD) that have the potential to better structure public debate on issues of vertical fiscal relations and stimulate a sensible appreciation of the problem and possible remedies.

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"The paper is both a nice synthesis and an important new way of looking at fiscal gap/imbalance issues."

–Professor Robin Boadway

*Sir Edward Peacock Professor of Economic Theory
David Chadwick Smith Chair in Economics
at Queen's University, Canada.*

"This is a valuable exercise in conceptual clarification on a troubled and important public policy topic. I regard the article as highly successful and found its discussion of the literature most helpful. Given its ambitions, the length of the paper is justifiable."

--Anonymous Reviewer (*Public Administration*)

"The paper is an impressive analysis and clarification of the important notions of fiscal imbalance and fiscal gap, and will be of interest to scholars and practitioners of fiscal federalism."

--Anonymous Reviewer (*Public Administration*)

This paper is essentially a treatise. The problem is a significant one, an innovative approach is taken to addressing the problem, and the issues are of international concern. I think the paper makes a useful contribution in terms of framing the debate and inviting further refinements."

--Anonymous Reviewer (*Public Administration*)

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1. INTRODUCTION

2. DEFINING THE PROBLEM

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4. VFI IN THE CONVENTIONAL FRAMEWORK: WHAT'S WRONG WITH THE OBSERVABLES?

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INTRODUCTION

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This article examines the concept of vertical fiscal imbalance (VFI), which remains under debate because there is neither a universally accepted definition of VFI in the fiscal federalism literature (table 1) nor a commonly accepted approach to measuring it (see table 2). Estimates of VFI are derived, much like accounting or deficit measurements, by comparing the revenues and expenditures of two levels of government. VFI is, however, too nuanced an issue to be described by this kind of national accounting procedure.

The problem we address is substantive, but also has an important terminological dimension. Terms such as VFI and VFG (vertical fiscal gap) are often used to structure political debate in federations, but different authors use them with different meanings and thus cause ambiguity in the policy solutions to the assumed problems. The imprecise usage of VFI (table 1) and VFG (table 3) for different ideas in different contexts not only makes it difficult to combine the results of papers, which might employ the same concept for different ideas or different concepts for the same idea; it can also cause the fiscal policy debate to deteriorate into a tug-of-war between federal and regional interests (for example, the Canadian example in the section that follows). Thus, this paper attempts to resolve the terminological ambiguity that obscures these substantive issues in policy.

One of the substantive issues in the debate on vertical fiscal relations is the question of the existence or absence of fiscal gaps and imbalances. Another issue is the rhetorical emphasis on either of two remedies, that is, federal transfers and subnational tax autonomy. This paper presents a conceptual framework that goes beyond the 'rhetoric' on either side of intergovernmental debates about vertical fiscal relations and promotes a more nuanced understanding of the problems of fiscal gaps and imbalances and their potential solutions.

In the section that follows, we begin by defining the problem and subsequently place it in an international context. To establish the need to re-evaluate VFI, we then critically examine the conventional approach to VFI and show why it is not useful for evaluating fiscal policies in the public sector. This is followed by a review of scholarly attempts to 'refine' the conventional definition of VFI by placing it in a dynamic framework. The penultimate section proposes an alternative conceptual framework to evaluate VFI and VFG more precisely. This section introduces a new concept of vertical fiscal difference (VFD) that is rooted in a coherent and logically sustainable conceptual framework. The final section applies the proposed conceptual framework to the problem of VFI and its resolution.

BEYOND GAPS AND IMBALANCES: A CONCEPTUAL PERSPECTIVE ON VERTICAL FISCAL DIFFERENCE (VFD)

In this section, we propose an alternative conceptual framework to evaluate vertical fiscal relations. This alternative framework clearly distinguishes between VFI and VFG and defines them in terms of their respective conceptual premises. Thus, it harnesses the ability of these concepts to evaluate and guide fiscal policies in the public sector. Whilst we recognize that the conceptual perspectives behind VFI and VFG raise important points for consideration, the proposed conceptual framework offers an impartial solution that avoids taking a side with either perspective.

Integrating VFI and VFG in a unified framework

As discussed above, there are two contrasting ways to evaluate and guide fiscal policy in multi-tiered systems. The drawback of the VFG perspective is that it views even a large vertical fiscal asymmetry (VFA) – termed VFG – as optimal. This approach can rationalize the intrusive actions by the federal government that lead to coercive fiscal relations characterized by federal pre-emption of state and local authority (see Kincaid 1990). However, the VFI perspective is equally flawed in that it goes to the other extreme and argues that transfers are weak policy instruments that sever the connection between spending and taxing authority.

In fact, the revenue-expenditure asymmetry between the two levels of a government does not always clearly indicate the extent to which the revenue-raising powers should be matched to spending responsibilities and the extent to which a restructuring of intergovernmental transfers is required. Thus, instead of claiming that this state is either VFI or VFG, we should call it VFA.

It should be noted that VFA has two components: VFI – the undesirable part (to be addressed by reallocation of fiscal instruments), and VFG – the desirable part (to be addressed by transfers). The concept of VFG, as originally conceived, states that the federal transfers must bridge the vertical fiscal gap, implying that, unless

addressed, a fiscal gap will remain. When transfers are adequate, there is no gap.¹ Thus, a state can be reached where there is *no imbalance and no gap*. We propose the term ‘vertical fiscal difference’ (VFD) for this state. The literature lacks a systematic way to refer to this state.

From the above it is clear that VFI and VFG both represent the situations that need correction, albeit by applying different fiscal instruments. Interestingly, when Seguin Commission (2002) argued for a radical rebalancing of the federation to virtually close all but a small amount of the fiscal gap, they clearly understood the two distinct problems of fiscal arrangements in a federation (that is, inappropriate allocation and inadequate transfers) and even attempted to empirically estimate their value. On one hand, the Commission argued that the federal government had undesirably large revenue-raising powers, often used for federal-provincial transfers, beyond the legitimate need to fulfil equalization commitments. It argued that the transfers should not be used as conditional grants in areas of provincial jurisdiction. Thus, it recommended that the social component of existing transfers should be replaced with a substantial reallocation of revenue-raising authority from the federal government to the provinces.

At the same time, the Commission also held unilateral reduction in federal transfers as a factor responsible for shifting the federal deficit problem to the provinces during the deficit reduction years of the Paul Martin Finance Ministry. The Commission observed that federal reductions in federal cash grants were much larger in percentage terms as compared to the reductions in conditional grants for federal spending programmes in areas of provincial jurisdiction.

Thus, VFI and VFG in the perspective proposed in this study may be understood as illustrated in table 5 and figure 1. VFI is a result of inappropriate assignments. Thus, it is a *structural* problem. If there is excessive revenue centralization then a positive VFI will emerge. If there is excessive revenue decentralization then a negative VFI will emerge. In extreme cases of negative VFI, the SNGs finance national government expenditures. For example, under the first American Constitution (1781–89) the general government was entirely dependent on contributions from the states as it did not have any power to raise revenues. This negative fiscal imbalance was rectified in the new ‘federal’ Constitution of 1789, which granted the central government significant power over fiscal resources (Studenski and Krooss 1963). Similarly, the fiscal arrangements implemented by the Government of India Act 1919 resulted in a huge surplus for the provinces. The centre, in turn, was financed with the contributions from the provinces. This negative fiscal imbalance was corrected by the Government of India Act of 1935, which granted more revenue powers to the centre with a concomitant system of devolution. This is summarized as:

VFI = Actual Vertical Fiscal Asymmetry – Desired or Optimal Vertical Fiscal Asymmetry

VFI = +ve when Actual Asymmetry > Desired Asymmetry

VFI = –ve when Actual Asymmetry < Desired Asymmetry

VFI = 0 when actual asymmetry is optimal.

The proposed conceptual framework is based on the understanding that some revenue-expenditure asymmetry is inevitable and desirable. In this perspective, the absence of asymmetry should not be defined as the *standard*, relative to which the state of VFI exists, because restoring balance by eliminating asymmetry is not a realistic possibility. We say this for the reasons detailed in the section, ‘What is VFD? Why it is Needed’.

¹ The originators of the term ‘fiscal gap’ (Boadway and Flatters 1982, p. 6) clearly stated that from an economic perspective the ideal form of government – that is, the one that is most conducive to efficiency and equity – is the single-tier system of government. In their view, in a multi-tier system, a ‘fiscal gap’ is desired to enable the central government ‘to replicate the efficiency and equity outcomes of a unitary state, through the application of intergovernmental transfers’ (p. 6). Thus, transfers, in this view, are determined not by the asymmetry between revenue and expenditure, but by the federal government’s need to achieve a second-best unitary outcome in a decentralized setting. The term VFG is used, in this perspective, to avoid using the word imbalance; in other words, VFA should not be called VFI because is a desirable state of affairs (see, for example, Winer and Maslove 1996, p. 52; Breton 1998, pp. 197–8). It should instead be called VFG, which implies that there is not an imbalance to be resolved with reassignments, but only a gap to be filled by transfers (Boadway 2004a, p. 2; Dahlby 2005, p. 3; Lee 2006, p. 14).

Despite the original intention to replace VFI with VFG, an attempt has recently been to redefine VFI in a sharp contrast to its conventional meaning. For instance, Boadway and Tremblay (2006), re-define VFI as a situation where the federal government does not provide the proper level of grants to bridge the *vertical gap* between revenue sources and expenditure responsibilities at the provincial and federal levels, which arises due to the greater revenue-raising ability of the federal government. Using the term VFI for this state is not only inconsistent with the very concept of VFI and its usage, but also goes against the original definition of the VFG concept. It would be more appropriate to say that there is no VFG (i.e. VFG is addressed) when the gap is bridged, and that VFG remains (unaddressed) otherwise

The standard of reference for estimating VFI is 'optimal asymmetry'. The issue of determining optimality is discussed in the final section.

VFG implies that there is no problem with assignments as such. The only remaining issue is of closing the gap. If the federal government focuses too much on federal transfers, the gap will be over-filled and a negative VFG will emerge. It will create the soft budget constraint problem (SBC). With a SBC, subnational governments have perverse incentives to indulge in inefficient project spending (see Wildasin 1997). However, if – at the extreme end of the spectrum – the emphasis is placed on eliminating federal transfers, VFG will not be bridged. Thus, a positive VFG will emerge. It will create an inefficiently inflexible hard budget constraint (HBC) that can discourage investments that are socially efficient (see Besfamille and Lockwood 2008). This is summarized as:

VFG = Desirable Asymmetry – Federal Transfers
VFG = +ve when Federal Transfers < Desirable Asymmetry
VFG = -ve when Federal Transfers > Desirable Asymmetry
VFG = 0 when Federal Transfers = Desirable Asymmetry
(that is, when transfers are optimal)

The above discussion leads to a clear choice of remedies. To the extent that the actual revenue-expenditure asymmetry deviates from the optimal, that is, when there is VFI, the system will require rebalancing by reassignments (for example, by devolving more revenue-raising powers to SNGs). To the extent that there is VFG, the 'gap' should be 'filled' by using the transfer scheme (see figure 1, above). Thus, both policy instruments have separate and complementary functions. Although both can supplement subnational funds, neither can compensate for the lack of the other. Thus, neither is superior to the other. This perspective eliminates the possibility of favouring one policy over the other for rhetorical reasons.

Federal transfers refer to:

- Formula based grants, basically lump sum (unconditional) but also conditional for specific programmes of national significance;
- Need-capacity based revenue-sharing (under special circumstances). This system works like block grants with the limitation that it cannot be targeted to specific SNGs;
- We exclude loans because they are not transfers in the strict sense of the term. Loans only become transfers when they have interest subsidies or are written off.

Subnational own-source revenues refer to:

- Tax and non-tax revenue from own sources. These include (a) tax revenue from the tax bases either exclusively assigned to SNGs or jointly occupied with the national government; and (b) non tax revenues from user charges;
- Origin-based revenue sharing (under special circumstances). This system works as a substitute for devolution of tax powers when subnational capacity to administer taxes is severely lacking;
- We exclude subnational borrowing because it is not an alternative to taxation and tax revenues must subsequently repay it.

Our approach does not overemphasize the case for own-source revenues and it does not allow transfers to cause dependency because they are used to fill optimal VFA, rather than actual VFA. The latter approach (filling actual VFA at subnational level) has been used in the past with unwelcome results in China, India, Malaysia, Pakistan, South Africa, and Sri Lanka (Shah 2007, p. 19). In our approach, transfers do not lead to accountability problems because SNGs control their own revenues at the margin, for example, by choosing tax rates (Bird 2000).

This method not only prevents the use of transfers to accommodate 'extra' spending but also restricts SNGs from borrowing to finance current expenditures. Together, these conditions require SNGs to raise taxes to finance their marginal expenditures (that is, above what is covered by the federal transfer), and leaves them accountable to voters for their tax and spending decisions. These restrictions preserve accountability without recourse to strict separation of tax-raising powers.

FIGURE 1 A schematic view of the alternative conceptual perspective

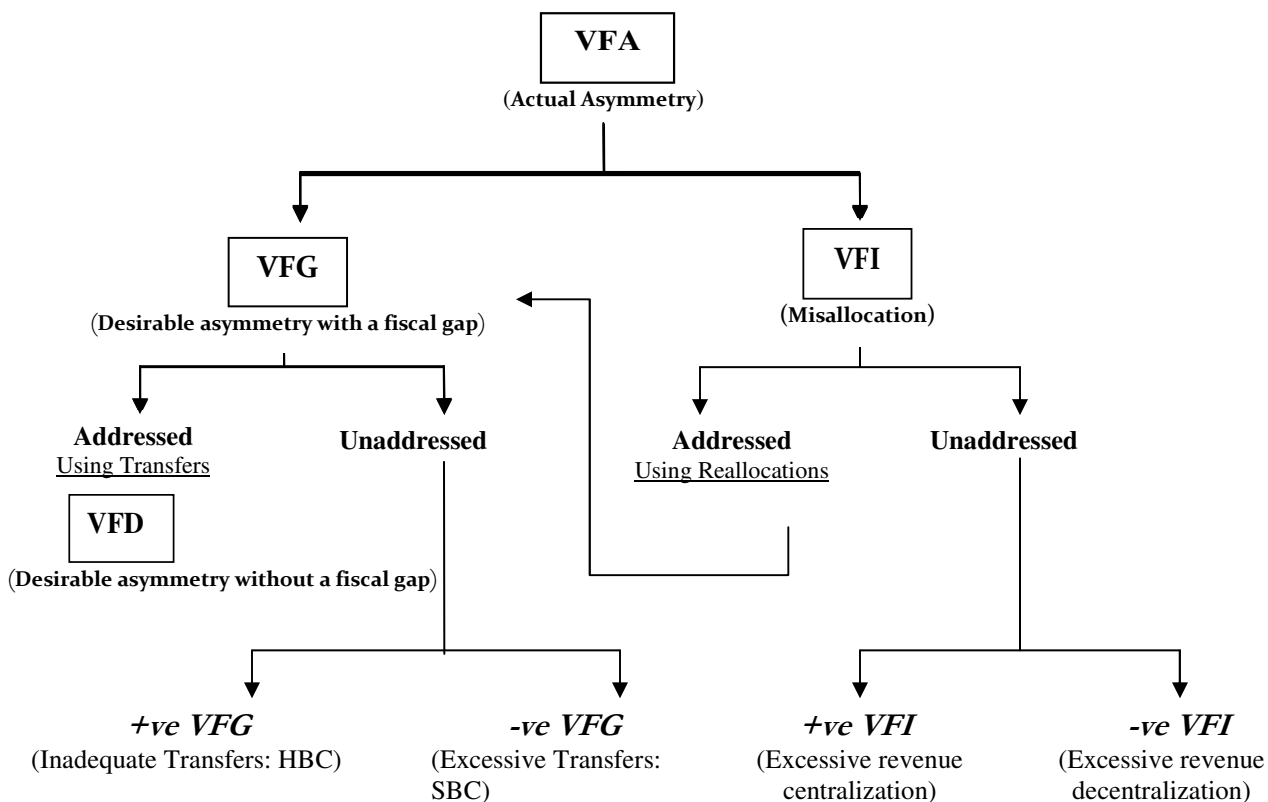


TABLE 5		Towards Resolution of Terminological Confusion		
State of fiscal arrangement	Terms in vogue	Terminology proposed		
A given revenue-expenditure asymmetry	VFI (Vertical Fiscal Imbalance), VFG (Vertical Fiscal Gap)	VFA (Vertical Fiscal Asymmetry)		
Inappropriate allocation of revenue powers and spending responsibilities	VFI, VFG	VFI		Remedial Measure
		<i>Positive VFI</i>	<i>Negative VFI</i>	Reassignment of revenue raising powers
		Extreme centralization of revenue powers	Extreme decentralization of revenue powers	
Desirable revenue-expenditure asymmetry with a fiscal gap to be closed	Optimal VFG, VFI	VFG		Remedial Measure
		<i>Positive VFG</i>	<i>Negative VFG</i>	Recalibration of federal transfers
		Inadequate federal transfers relative to the desired asymmetry	Excess federal transfers relative to the desired asymmetry	
Desirable revenue-expenditure asymmetry without a fiscal gap (i.e. gap is closed)	-----	Vertical Fiscal Difference (VFD)*		

* In this paper we use the term VFD to refer to the optimal or desirable VFA because the term VFG is symbolically 'loaded' and implies that there is a 'fiscal gap' to be closed.

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