

Principles and the Practice of Fiscal Equalization Transfers with special emphasis on Solidarity or Robin Hood Programs

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Outline

- Fiscal Equalization Transfers, Why?
- Fiscal Equalization Transfers By Whom?
- Fiscal Equalization Transfers For Whom?
- Fiscal Equalization How?
- National or Provincial Fiscal Equalization (so-called Vertical) Programs
 - Switzerland, Canada, Australia, India, Brazil, Russia
- Fiscal Equalization Through Solidarity or by Robin-Hood (Horizontal Programs)
 - Germany, Sweden, Denmark, Norway, Finland, Switzerland
- Lessons from International Practices

Fiscal Equalization Transfers: *Why and Why Not?*

- **Why?**

- **Political:** Overcoming threat of secession and creating a sense of political unity
- **Fiscal Efficiency and Fiscal Equity:** Advances social justice (fiscal equity) and efficiency in market resource allocation (fiscal efficiency) (Boadway, 1982,2007).
- **Securing a Common Economic Union:** Integration of fiscally disadvantaged regions in the national economy.

- **Why not?**

- **Capitalization** of taxes and expenditures, higher prices for public services but lower prices for private goods and services in poorer jurisdictions. Factor mobility more important.
- **Disincentive for local economic development.**
- **Weakens Fiscal Discipline:** Weakens hard budget constraint.
- **Endangers long term growth prospect:**
- **For paternal (vertical) programs - constrains fiscal space for the national government.** May limit national action due to inflexibility of expenditures.

Basic considerations in the design of fiscal equalization grants

- **Societal consensus on an affordable equalization standard and how to finance it. Clarity** in objectives, **consistency** of design with objectives and **singular focus**
- **Simplicity, objectivity and transparency** of allocation criteria
- **Restraining soft budget constraints and strategic gaming.**
- **Autonomy with citizen-based accountability for results:**
Independence in designing programs and flexibility in use of resources
- **Revenue Adequacy** and responsiveness
- **Predictability**
- **Fairness:** entitlements vary inversely with fiscal capacity and directly with fiscal needs; one size does not fit all – urban vs. rural, large vs. small
- **Affordability**
- **Review:** Sunset clauses to ensure periodic review and assessment

Equalization by Whom? International practices in transfers to reduce regional/local fiscal disparities

- ◆ **Design:** General non-matching fiscal capacity and fiscal need equalization transfers as a residual program
- ◆ **Selected practices:** Fiscal equalization programs (*sources : CGC (2014), Morris (2005), Finance Canada (2014), Dafflon and Mischler (2008), Lotz (2012), Shah (2007,2011), Spahn & Werner (2007), Borge (2010), Dahlberg (2010), Moisiso et al (2010), Mau (2009), Switzerland (2012), Swianiewicz, (2014).*)
 - ◆ **Paternal (Vertical, By higher order government):** Australia (fiscal capacity plus fiscal needs) and Canada (fiscal capacity only)
 - ◆ **Solidarity, Fraternal (voluntary, horizontal) – An Ideal System:**
 - ◆ **Fiscal capacity:** Germany (?), Finland
 - ◆ **Expenditure Need:** Denmark, Norway, Sweden
 - ◆ **Robin Hood (Involuntary, horizontal):**
 - ◆ **Fiscal capacity:** Sweden, Denmark, Norway, Switzerland, Poland (10% of Robin Hood fees to PCGDP<75%)
 - ◆ **Expenditure Need:** Poland (through distribution of Robin Hood contributions)
 - ◆ **Mixed:** Germany, Switzerland, Sweden, Denmark, Norway, Finland
- ◆ **Institutional Arrangements for grant determination:** Intergovernmental Forums versus Independent agency

Pros and Cons of Alternate Equalization Programs

Program	PROS	CONS
Paternal (Vertical)	<ul style="list-style-type: none"> • Easier to finance and administer • Supports national objectives in creating a common economic and social union • Glue for holding the country together 	<ul style="list-style-type: none"> • Undermines local accountability to residents; • Strategic behavior by recipients; complexity; • Incentives for lobbying, inefficiencies and disincentive for improving tax base and amalgamation; • Non-transparent; • Central discretion; and • Lack of explicit national compact on equalization
Solidarity/ Fraternal (Horizontal)	<ul style="list-style-type: none"> • Ideal system. Simple and transparent • Pool subject to discipline of an explicit compact and potential for right balance in equalization 	<ul style="list-style-type: none"> • Political bargain possible only in relatively homogeneous societies • Compact problematic for cost/need equalization
Robin Hood (Horizontal)	<ul style="list-style-type: none"> • Transparent • But forced compact 	<ul style="list-style-type: none"> • Excessive marginal tax rates; false prices for public goods • Disincentive for local economic development

Safeguards for equalization payments programs

- Introduce a formal legal framework e.g. fiscal arrangements act by the national parliament Specify institutional arrangements for grant determination and conflict resolution mechanisms.
- Introduce a well defined sunset clause with requirements for mid term and final review and renewal.
- Total pool determination: Too much or too little equalization – need a national consensus on the equalization standard as in Canada. For fraternal programs needs a formal solidarity pact as done in Germany.
- Limiting uncertainty for the donor(s) and recipients: Introduce a cap (and a floor in the event of recession) on the rate of growth (decline) of the payments possibly tied to the rate of growth (decline) of donor revenues or GDP e.g. 3-year moving average of GDP growth in Canada
- Predictability of funds over a defined period for recipients: introduce floors in yearly change for individual allocations
- Special provisions for dealing with volatile sources of revenues
- Hold harmless provisions

Equalization for Whom?

- Guiding Principle. One size does not fit all. Equalization among jurisdictions that have similar responsibilities and characteristics. **“Uniform treatment of different entities causes injustice.”** The Constitutional Court of Indonesia – South Sulawesi Case.
- Requires separate local government grouping by size (population and area) , class , urban/rural etc.
- Denmark: Metropolitan govts, Counties, Smaller local governments.
- Canada: provinces, territories, cities by population size class, rural municipalities and improvement districts
- Germany: Landers (provinces), Boroughs, Municipalities and Administrative Districts
- Finland: Metropolitan, Counties, Smaller LGs

Equalization Objectives and Implied Standards in Selected Countries

- **Australia:** “capacity to provide services at the same standard with same revenue effort and same operational efficiency”.
- **Canada:** “reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces”
- **Germany:** “to equalize the differences in financial capacity of states”
- **Switzerland:** “to provide minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than others”.

The Choice of Equalization Standard

Standard of equalization	None (general revenue sharing systems)	National Average or Fraction	Complex statistical criteria
Determines Pool only			
Determines Allocation only	Most developing countries e.g. Brazil, India, Thailand, UK	Australia, China, Russia, Switzerland	Indonesia (Williamson's Index)
Determines both Pool and Allocation		Canada, Germany, Finland, Denmark, Sweden	

Denmark: Equalization models and standards - 2006

Equalization Type	Counties	Metropolitan Areas	LGs
Fiscal capacity	85% Robin Hood	90% Robin Hood	50% central grant
Fiscal Needs	85% Solidarity	60% Solidarity	35% Solidarity

Fiscal Equalization – Fiscal capacity equalization component: *How?*

- **Fiscal (Revenue) Capacity Equalization - Alternatives**
 - Macroeconomic Indicators: India, Brazil
 - Actual Revenues: Germany, Nordic countries
 - Representative Tax System (equalize per capita potential revenue capacity using national average tax rate): Australia , Canada, Japan, Finland
- **Fiscal Capacity Equalization : Choices of revenue bases**
 - **Defining tax bases, treatment of local tax incentives and exemptions**
 - **Inclusion of all tax bases vs major tax bases only**
 - **Treatment of Natural Resource Revenues and other volatile revenue sources,**
 - **Treatment of user fees, lottery revenues**
 - **Treatment of conditional transfers and external assistance**

Conceptual basis for expenditure need equalization and practical challenges

- Strong theoretical support for a comprehensive fiscal capacity and expenditure need equalization program.
- But expenditure need equalization through a comprehensive program a daunting task
- Need to equalize inherent needs and disabilities (demographics, terrain etc.) but not policy based cost differences.
- Even for inherent cost differences such as urban/rural/mountainous/remote –efficiency and equity tradeoffs. No justification for similar level of service in all incomparable type of areas. Equalize only within comparable strata.
- Best done by fraternal programs.
- What are then the options? How various countries have risen to this challenge?
Are there some lessons from these experiences?

- **Expenditure Need Equalization Alternatives**
 - **Theoretically Ideal Representative Expenditure System** : Not practiced anywhere
 - **Ad hoc determination**: Most countries. Germany: population size and density, China- number of public employees, India: backwardness, Switzerland: demographics, area, unemployment, large cities, social assistance, foreigners.
 - **Representative Expenditure System (RES)** using direct imputation methods or regression analysis to determine differential costs/needs: Australia, China, Indonesia, Norway, Netherlands . Choice of expenditure categories, treatment of tax expenditures
 - **Sectoral needs based on service population (school age population, kms of roads etc) grants with no conditions on spending**: Canada, Brazil, Chile

Need Factors Used in Expenditure Need Compensation: International Practices

- **Macro variables** : Indonesia, India, Brazil
- **Demographic variables:**
 - Australia: Demographic, socio-economic, ethnics
 - Canada: Population only
 - Denmark, Norway, Netherlands: population by age groups
 - Italy: population weighted by age groups
- **Service specific variables**
 - Canada provinces, Italy and Germany : mostly service population and service area
 - Switzerland: population, population density, population size class, people 80 years +, social welfare recipients, foreign adults, large cities, area
 - Denmark: commuting time, unemployment, families in poor dwelling, rented dwellings, singles, psychiatric patients, children of poorly educated parents
 - Norway: divorced, unemployed, travel time and distance, mortality, mentally handicapped, senior citizen singles, immigrants
 - Netherlands: dwelling, high density, low income households, households on social welfare, students, physical features
 - Australia: scale factors, population, pop dispersion, aboriginal population, urbanization, age structure, physical and economic environment

Representative expenditure system using direct imputation or regression methods

- Classify expenditures by function
- Identify relative need/cost factors for each function
- Assign relative weights using direct imputation or regression analysis
- Allocate total expenditures of all jurisdictions on each function on the basis of their relative costs and needs for each function to obtain standardized expenditures for each jurisdiction.
- Compare standardized expenditure per capita for each jurisdiction with the standard national per capita expenditure for each function to determine grant entitlements.
- Used by Australia, China, Indonesia, and Netherlands

Expenditure need equalization in Australia: A Puzzle to Solve: Category Disability Lower than all individual factors in richer states and vice versa in poorer states – why?

Disability Factors	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Dispersion	0.9973	0.9921	1.0093	1.0106	0.9972	0.9952	0.9885	1.0710
Grade Cost	1.0014	1.0028	0.9966	0.9950	0.9992	0.9998	1.0016	0.9979
Input Costs	1.0120	0.9950	0.9860	1.0030	0.9910	0.9900	1.0080	1.0340
Relevant Population	0.9749	0.8874	1.0983	1.1639	0.9679	1.1422	0.9750	1.2226
Administrative Scale	0.9946	0.9946	0.9946	1.0065	1.0105	1.0304	1.0463	1.1139
Service Delivery Scale	0.9922	0.9906	1.0031	1.0153	1.0166	1.0380	0.9714	1.1141
Vandalism & Security	1.0023	1.0023	0.9973	0.9973	0.9973	0.9923	0.9923	0.9923
Cross-border	0.9965	1.0001	1.0001	1.0001	1.0001	1.0001	1.0660	1.0001
Category Disability	0.9692	0.8658	1.0815	1.1941	0.9772	1.1917	1.0440	1.6605



The Practice of Expenditure Need Equalization Through Sectoral Expenditure Need Based Block Grants (with no conditions on spending)

Canada Healthcare transfer to provinces – equal per capita transfers with no condition on spending but conditionality on access.

Conditions: (1) Universality(2) Portability(3) Public insurance but public/private provision(4) Opting in and out (5) No extra billing

Penalties for non-compliance: Threat of discontinuation for breach of the conditions (1)- (4) above.

Dollar for dollar reduction for breach of the condition (5).Sunset clause: Parliamentary review every 5 years.

Canada Social Services Transfer to provinces –equal per capita transfers for post secondary education and welfare: Conditions: All Canadians treated alike for post secondary education and welfare programs.

Brazil: Unified Health System transfers to states and local governments – Per capita. *School transfer:* Based upon school age population to municipalites and based upon school enrollments to all providers.

Canada – Provincial Transfers to local governments: Road grant based upon Kms of roads, police grant based upon no. of households, school grant based upon enrollments.

Expenditure Need Equalization: Some Conclusions

- Expenditure need equalization through representative expenditure system equalization programs leads to super complexity, acrimony and controversy and may even lead to inequity. Better to keep it simple. According to the Commonwealth Grant Commission of Australia, **“Given the number of conceptual and empirical difficulties.. and numerous judgments.. different relativities (and grant outcomes) could be just as valid as those presented (here)”**. (CGC 2000/07, Oct. 2000)
- Sectoral block grants based upon service population but no conditions on spending offer a simpler yet rough justice alternative to compensate for expenditure needs. Such transfers preserve simplicity and local autonomy. With minor tweaking, they can also be used to introduce incentives for competitive provision and enhanced local government accountability for service delivery performance to own residents. Thus such transfers can also bring a cultural shift from input controls to accountability for results.

THE PRACTICE OF REGIONAL FISCAL EQUALIZATION

Fiscal Equalization Program	Australia	Canada	Germany	Switzerland
Legal Status	Federal Law	Constitution	Constitution	Constitution
Paternal or Solidarity	Paternal (vertical)	Paternal (vertical)	Solidarity (horizontal)	Mixed
Total Pool determination	Ad hoc	Formula	Formula	Ad hoc
Allocation	Formula	Formula	Formula	Formula
Fiscal capacity equalization	Yes, RTS	Yes, RTS	Yes, Actual Revenues	Yes, major macro tax bases

Fiscal Equalization Program	Australia	Canada	Germany	Switzerland
Expenditure Need Equalization	Yes	No	No (only pop size and density)	some
Program Complexity	High	Low	Low	Medium
Political Consensus	No?	Yes (?)	Yes (?)	Yes
Who recommends	Independent agency	Intergov. Committees	Solidarity pact II	Federal Government
Sunset clause	no	Yes (5 years)	no	no
Dispute resolution	Supreme court	Supreme Court	Constitutional court	Supreme court

THE PRACTICE OF LOCAL FISCAL EQUALIZATION

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Local Fiscal Equalization in Nordic Countries: A Summary View

	Fiscal capacity equalization	Expenditure need equalization
Denmark	Mixed central plus Robin Hood program with 85% tax rate if PCFC > 115%. Subsidy rates (SR): 85% if PCFC < 90% otherwise 45%	Solidarity Program
Finland	Solidarity RTS program with 37% tax rate for above national average per capita fiscal capacity (PCFC); SR 100% if PCFC < 92%	Central program of cost equalization for health, welfare and education and rural/urban cost differences above 65% of national average.
Norway	Robin Hood Program covering major taxes except PT with 60% tax rate for above average PCFC. SR 95% for PCFC < 90% otherwise 60%	Solidarity Program plus special central grants to smaller LGs, northern counties and fast growing LGs
Sweden	Same as in Denmark but SR 95% if PCFC < 115%	Solidarity program of cost equalization for 9 services

Relevance of the Nordic Experience with fiscal equalization grants

- Well performing and empowered local governments. Homogenous societies with high degree of altruism reflected in grant design. High Robin Hood (RH) fees have not hurt development as altruism combined with political commitment for growing local economy trumps concerns for local revenues.
- Desirable features: Separate equalization programs and standards for various local governments. Total pool and allocation determined by formula. Solidarity programs for cost equalization (Norway, Denmark, Sweden) and revenue equalization (Finland only). Finland ignoring cost variations up to 65% above average. Finnish RH tax rate.
- Less desirable features: Regression based standardized cost approaches. High RH marginal tax rates on richer LGs in Denmark and Sweden. Lack of grant incentives for competition and innovation and results based accountability to citizens. Incentives for X-inefficiencies and against amalgamation, partnerships.

Fiscal Equalization Grants: Some Lessons from International Experiences

- Equalization formula must determine both the pool and allocations.
- Fiscal capacity equalization with an explicit standard is desirable and do-able in most countries.
- Solidarity based systems are more likely to strike the right balance on an equalization standard. Paternal and Robin Hood programs lack internal discipline – could lead to excessive or too little redistribution.
- Expenditure need equalization is much more complex and controversial. Rough justice may be better than precise justice. Sectoral need based block grants (with no conditions on spending) offer a promising, simpler yet rough justice alternative for expenditure need compensation. These with minor tweaking also offer potential for competitive and innovative provision and service delivery performance based accountability.

..... Lessons from International Experiences

- Equalization transfers must not be looked at in isolation of the broader fiscal system especially conditional transfers.
- For local equalization – one size does not fit all.
- Important to have societal consensus on the standard of equalization
- Must have a sunset clause and provision for a review and renewal
- Institutional arrangements for grant determination and periodic revision require serious thoughts as independent grants commission pursue academic rigor and typically recommend more complex and opaque solutions.