

# ロビン・ボードウェイ教授 講演会報告書

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演題 「Fiscal Decentralization and the Role of Equalizing Transfers」

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## **1. Introduction**

Thank you very much for inviting me here. I have to apologize for bringing this hot weather with me; I did not think it was going to be so warm. I am going to talk about the topic of fiscal federalism, which is a very important and controversial topic in my own country. I want to just begin by explaining a little bit about the situation in my own country, because I know it is very different than yours.

### **1-1. Federation System in Canada**

Canada is a federation and Japan is not; nonetheless, I think there are a lot of commonalities that arise whenever you have a country where decision making is split between different levels of government. In Canada, the splitting up of decision making is very explicit. The Constitution sets out in some detail the exclusive responsibilities of the provinces, areas where they alone are allowed to legislate and, in turn, the provinces exercise control over their own municipalities. Responsibilities for spending are explicating divided between the two levels of government. At the same time, the provinces have very wide powers of taxation. They can levy virtually the same taxes as the federal government. Nonetheless, there is a vertical gap between the federal government and the provinces in the sense that the federal government raises more revenues than it needs for its own programs and it makes sizable transfers to the provinces and I want to talk today about why that is the case.

Importantly, our Constitution also sets out some obligations with respect to equalization, very specific wording about what the equalization system must do and it also sets out some obligations on the federal and provincial governments with respect to social priorities and social spending.

The federal government influence over the provinces is not legislative; rather, it is based on the use of what we refer to as “the spending power”, the use of grants to influence the way in which provinces behave. Nonetheless, our transfers tend to be of what we call a “block nature”. They are not specific but they are designed to finance broad areas of expenditure and there are two main kinds of programs. One is an equalization program, which I will talk a bit about, and the other is a system of social transfers with some mild conditions attached to them in support of provincial spending on social programs: health, education, welfare.

Revenue rising is highly decentralized but we have a fairly formal system of tax harmonization for income taxes and to some extent for our value-added tax. As well, we rely on negotiations between the federal government and the provinces to come to agreements in certain areas. There are agreements in areas of pensions, immigration, agricultural policy and so on, but

there are two broad agreements in particular that are quite important. One is called the Agreement on Internal Trade, which you can think of as being a little bit like a customs union or an economic union treaty, similar to say a WTO. And we also have something called the Social Union Framework Agreement, which sets out guidelines about how the two levels of government will interact in social policy.

## **1-2. Big Problems for Canada**

The big problems that we face are the following: we have a large horizontal imbalance because some provinces are much more wealthier than others and this puts pressure on the equalization system. We also have what is referred to as a vertical fiscal imbalance where the provinces argue that the federal government is collecting too high a share of the revenue relative to their expenditure responsibilities and relative to the transfer that they make to the provinces. Normally, when we worry about this kind of thing in a multi-system government, we worry about the opposite—that the federal government would make too much transfers to the provinces in the soft budget constraint manner. We have the opposite problem, it is argued, that federal government doesn't make sufficient transfers. And there is also quite a lot of tension between the federal government and the provinces over the federal government's use of transfers to influence the way provinces behave because provinces argue that federal government shouldn't try and influence the way in which they legislate in their areas of responsibility. Nonetheless, I think similar problems arise in the Canadian federation as arise in unitary states which have devolved responsibilities.

## **2. Fiscal Transfer under Decentralization**

Now, I should just make clear what I mean a little bit by decentralization. When I am talking about decentralization, I am not just talking about budgetary decentralization, the ability of the provinces to raise revenues and make spending. I am also talking about the extent to which lower levels of government have autonomy in their decision making and in the Canadian context we have a lot of decentralization, both on the budgetary side and on the autonomy side.

Okay, so that is my little background of the Canadian system and what I want to do next is to tell you what I hope to accomplish in this talk. I want to talk about principles, what principles should govern the extent of decentralization and the design of fiscal transfers that facilitate it and I think these principles are relatively universal. There are three common defining features of what I will call multi-tiered government systems so that we can think both of federations and of unitary states with devolved responsibilities.

## **2-1. Fiscal Transfer System**

The first one is that many public services of national importance are provided by lower tiers of government with varying degrees of decentralized authority. This is universal. Lower levels of government provide important things like education, health, social services and so on. There is a vertical fiscal gap in virtually all federations and multi-level governments; central government raises more revenue than it needs and then transfers to the lower levels. And, broadly speaking, the transfers that are used to close this vertical gap have two key properties. One is that they are almost always equalizing and the second is that they have varying degrees of conditionality associated with it. Now, I should mention that the sort of universality of equalization programs is not 100 percent; many people will point out that United States does not have an equalization program, which is true. Nonetheless, their system of conditional grants tends to have built into it equalization principles more on a discretionary basis.

Now, I want to make the point that redistributive issues are central to understanding fiscal federalism and I think this is something that tends to be overlooked, certainly in the scholarly literature, the importance of the redistributive function of government for both the assignment of responsibilities and the transfer system. So I want to spend a bit of time just talking about redistribution and decentralization. And I make the point to begin with that much of what governments do is redistributive in nature, if you think about it. Many, many programs, many of the largest spending programs of government are—their objective is some aspect of redistribution, either equalizing incomes or providing equality of opportunities like the educational system or providing some form of social insurance like the health system, pension system and so on. I once did a calculation in Canada that a portion of spending that was redistributive and it came out to be something like 80 percent so we have to remember that when we are talking about federalism. And the instruments that are used to accomplish this redistribution are very broad.

The tax transfer system, of course, is the one that we normally think of, but many public services are redistributive in nature. Education is a good example; health care, in-kind transfers, social insurance programs, are transfers that are targeted to people on the basis of their need or circumstances. There is a distinction between these transfers. Transfers that are delivered by the income tax system are largely self administered and operate centrally; they are operated on a self-reporting basis whereas other redistributive programs are delivered by agencies on the ground and often delivered at the sub-national level. I am going to take the point of view that redistribution is something that is national concern and given that a lot of these expenditure programs are decentralized, there is de facto a shared responsibility for

redistribution between one level of government and the other. One cannot assign the function of responsibility exclusively to one level or the other; both levels participate in it.

## **2-2. Fiscal Inefficiency and Inequity**

So let me give a broad overview of the way I tend to look at just for federalism and it is all on this one page—well, no, I guess it is on two pages. The basic argument is as follows: there are sound economic arguments for decentralizing responsibilities for provided local services, obviously, but also for delivering public services on the ground to household and firms as well as for targeted transfers, very important programs. At the same time, the case for decentralizing taxation responsibilities are much less and differences across countries are substantially greater than with respect to expenditures. The decentralization of provision of important public services is based largely on the argument that it enhances the efficiency of delivering public services. But at the same time, decentralization can have adverse consequences, both for the efficiency of the national economy and for the equity of the national economy. On the efficiency side, decentralization can distort the efficiency of what we refer to as the internal common market or the internal economic union due to spillover effects, fiscal externalities.

Decentralization can also result in what I am going to refer to as fiscal inefficiency because of the fact that decentralization inevitably leads different jurisdictions with different capacities for providing public services. That being the case, people are going to want to prefer to live in jurisdictions that have higher capacities. By the same token, decentralization can have adverse effects on efficiency, partly because the important redistributive policy instruments are decentralized and if this decentralization was done in an uncoordinated fashion, program design would end up being suboptimal, partly because of competition in redistribution and partly because of the fact that there is no coordination. Moreover, the same differences in fiscal capacity that cause inefficiency also cause fiscal inequity; people who happen to be living in a region with low fiscal capacity would have less valuable public services at higher tax rates than people living in other jurisdictions and that is referred to as fiscal inequity.

So, the way I view the issue of fiscal federalism is the following: how do we reconcile national efficiency and equity objectives with the decentralization of fiscal responsibilities to lower level jurisdictions? Given that the exercise of many of those responsibilities by lower level jurisdictions impinges adversely on national efficiency and equity and that is the setting in which I think it is useful to think of federal-state or federal-national—central-local in your case—fiscal arrangements, not just the transfer system but other fiscal arrangements. So, what I will call the fiscal arrangement, the financial arrangement between the central and regional

governments as well as mechanisms for coordinating policies are devices for facilitating the benefits of decentralization without incurring their costs. Okay, that is what I think about.

### **2-3. Value Judgment for Evaluating Fiscal Arrangement**

Now, let me just mention a few, I think, important caveats that arise when we are trying to evaluate the fiscal arrangements, the transfer system. The first is that I have emphasized that redistribution is an important objective of government and therefore it is going to be an important objective of the transfer system but different people put different weights on redistribution. Different people attach a different weight to equity relative to efficiency.

Secondly, different people have different views about the benevolence of government. Well, you, I am sure in this room, have one view about the benevolence of government but if you look at the scholarly literature, people have very different views and decentralization to some people is a way to combat what they view as being a non-benevolent government and so that is one thing to bear in mind. There is also a lot of dispute in the literature about what precisely is the responsiveness of the economy to various kinds of policies; if the economy is not very responsive to fiscal policies, then problems of efficiency do not arise.

Most importantly, I think, when we are evaluating the transfer system, partly because the transfer system inevitably has got a redistributive component to it across regions, an important aspect of that is the extent to which there is what I will refer to as national solidarity, the extent to which people in one region feel responsible for the goodwill of people in all regions. And this differs quite a bit across countries and my guess is that in this country there is a lot of national solidarity that you care about how well people are, the level of public services that people are getting in all regions. But that is not necessarily the case in all federations and I think that is where you really run into important value judgments.

### **3. Gains from Decentralization**

Okay, so now what I am going to do, I am going to go back and go through in slightly more detail the components of those elements that I just laid out. Some of this you probably will find to be fairly obvious, fairly apparently, but I am just trying to put into your mind a holistic way of looking at the problem of fiscal arrangements that I find to be useful. So let me begin by cataloguing what people argue are the gains from decentralization and I think here especially of decentralization in the autonomy sense; that is, giving autonomous authority to sub-national jurisdictions to deliver the public services that you want them to deliver.

### **3-1. Autonomous Authority**

The traditional argument is simply and this goes back to the literature of the 1950s and 60s, originating probably with Musgrave that decentralization simply allows different jurisdictions to be able to cater better to the particular preferences and needs of their constituents and that is a view that has been quite important in the literature. But my own personal view is that that is not as important as the literature makes it out to be because most public services that are decentralized are things that are provided at relatively common levels across sub-national jurisdictions. Think of education or social services or health care.

Perhaps a more important argument is what I refer to as the argument of asymmetric information that lower levels of government are closer to the people so to speak and are likely to be better informed about who needs services, better informed at targeting those services and needs more accurately, better informed at monitoring the use of those services, better able to act as managers to reduce what we refer to as agency problems in delivering public services, identified delivering costs, monitoring the local providers or agencies that provide those services and simply reducing layers of bureaucracy.

### **3-2. Effectiveness in Delivering Public Services**

Another argument that is used quite often in my country, as a matter of fact, is that decentralization contributes to innovation and cost effectiveness in programs. If there are more units that have responsibility for delivering public services, there is more likely to be innovation in the way those services are delivered and one of the things that one really needs in the public sector is innovation because innovation does not occur in the public sector anywhere near rapidly as it occurs in the private sector for whatever reason. Inter-regional competition is said to improve the cost effectiveness of the delivery of public services; all of inter-regional competition also has adverse effects. And there is also something referred to as yardstick competition where you as a resident of one jurisdiction can judge how well your government is doing by comparing the services you get, the quality of services you get with your neighboring jurisdiction. This is quite an important discipline on lower government. And then there is a series of what I will refer to as political economy arguments that decentralization makes government more efficient; the mobility of people across jurisdictions, the so-called exit and voice option, allows people to have influence over the efficiency with which services are delivered. Local governments have less tendency to be excessive in their spending and unaccountable if expenditures are decentralized. Rent-seeking, corruption and lobbying, none of which occur in this country, I am sure, might be reduced by decentralization and decentralization may serve to make the budget constraint for lower government. I am talking about decentralization there on the revenue-raising side. If you make lower

jurisdictions really responsible for raising their revenues, then their budget constraints become harder. But, of course, decentralization is troublesome in some countries because it might contribute to political disintegration. So, those are the gains from decentralization.

#### **4. Adverse Effects from Decentralization**

##### **4-1. Fiscal Inefficiency**

Now, as I said, decentralization also has some adverse effects so I am going to through these fairly rapidly because I want to get to talking about transfers. But decentralization causes inefficiencies, inequities and so on and let me just mention fairly quickly what are the adverse efficiency consequences of decentralization. There have been three major sources of inefficiency from decentralization that have been identified by experts. The first one of these I briefly mentioned before is what I will call “fiscal inefficiency”. And that is that when you decentralize spending and taxing responsibilities and this, by the way, will be no surprise to you because you deal with this kind of thing. When you decentralize spending and rising responsibilities, you inevitably end up with different jurisdictions having different abilities to provide public services. In our Constitution, we have a clause that says the federal government is committed to the principle of making equalization payments so that all provinces can provide comparable levels of public services at comparable levels of taxation and that is what this is referring to, that if you decentralize without any equalization system, different localities have different abilities to provide public services. And what that means is that if you are living in one of these jurisdictions, what you get on balance from your government, the services you get minus the taxes you pay, will differ systemically according to where you live. If you move from one jurisdiction to another, you are going to find that your benefits less your taxes are going to change and that benefit-less-tax concept is referred to as net fiscal benefit; what you get on that from the government and locality where you live. And these net fiscal benefit differentials will arise whenever you decentralize responsibilities. Now, there is a little example there that I will not go through in detail because you are going to have a look at it yourself; it is just an example of one source of net fiscal benefit differentials. And the purpose of an equalization system is to undo these differences in net fiscal differentials that are caused by decentralization.

Now, the main sources of net fiscal benefit differences that cause inefficiency—actually, I did not explain why they cause inefficiency. Net fiscal benefit differentials will cause inefficiency because they give people in firms a fiscal incentive to move from one jurisdiction to the other, purely fiscal incentives. So they are not responding to productivity differences but they are partially responding just to fiscal differences. The main sources of these main net fiscal benefit differentials are differences in per capita income within your jurisdiction, differences

in per capita consumption, differences in source-based tax capacity, i.e., property, business income, resource revenues, and differences in the need for public services. So if you are living in a jurisdiction with a lot of elderly people, they are going to have a bigger need for public services and that is going to cost everybody more within that jurisdiction. If there were a system of benefit taxation, which economists are often talking about, then these differences in net fiscal benefits across jurisdictions would not arise, but we do not have benefit taxation.

Differences in need cause fiscal inefficiency; that is to say differences in the need for public expenditures that arise because of demographic differences across jurisdictions. Differences in cost of providing services across jurisdictions do not cause fiscal inefficiency. It certainly provides people with an incentive to move from one jurisdiction to the other but that is not inefficiency because they are saving resources when they move from one jurisdiction to the other. Nonetheless, differences in cost of providing public services are important from an equity perspective as we will see in a moment. There has been some debate about the empirical significance of these fiscal inefficiencies arising from net fiscal differentials but, fortunately, it does not matter. It does not really matter how empirically significant they are because if they are not significant, there is another argument that applies, that makes net fiscal benefit differentials significant.

#### **4-2. Externalities**

The other categories of inefficiency that arise from decentralization, I will not spend very much time on. You may be familiar with them anyway. One of them is called “horizontal fiscal externalities”, when the fiscal actions of one jurisdiction have an influence on the well being of residents or the budgets of governments in neighboring jurisdictions. These can be both positive and negative. If I reduce my taxes in my own province, that is going to attract businesses from other provinces; that is a negative fiscal externality. There has been a lot of emphasis on these in the literature but it is not at all clear whether the system of fiscal arrangements can avoid horizontal fiscal externalities except by harmonizing tax systems and coming to some intergovernmental agreement or being very careful about which taxes you decentralize to sub-national jurisdictions. Horizontal externalities can arise not just on the taxation side but also on the expenditure side. If one jurisdiction provided generous social services for poor people, it is argued that that is going to attract poor people from other jurisdictions where such good services are not provided. So, there is some need for harmonization of levels of social services across jurisdictions to prevent those incentives. Moreover, these expenditure externalities can arise simply because of the fact that people take their education in one jurisdiction and then they move and work in another jurisdiction. So, they use the services of one jurisdiction and then pay the taxes of another.

There also can be regulation externalities. This may not be such an issue in Japan but it is a big issue in my country because provinces have significant responsibilities for regulation of labor and capital markets. We regulate professions, we regulate trades, we regulate local financial markets and so on. And this gives rise to obvious barriers to movement of labor and capital across jurisdictions. We also have provinces that for social or cultural reasons, regulate such things as language of work, regulate some aspects of the schooling system and this gives rise to some debate about, well, is this done for protective reasons or is it done for social reasons.

Finally, there is another category of inefficiency that arises from decentralization and it is referred to a vertical fiscal externalities and, basically, this is a bit of a technical argument that suggests that lower level jurisdictions, when they raise revenues, are going to have an influence on the budget of the national government and that is going to encourage them to raise revenues more than they otherwise would. The lower level jurisdictions might actually exploit the national jurisdiction by taking actions that induce the national jurisdiction to provide them with higher transfers that are referred to as the Samaritan's dilemma.

I have listed there some other sources of inefficiency that are going to arise in federations and all of these things point to the need to have some kind of coordination to make sure that the decentralization does not disrupt the efficiency of the internal on the market.

## **5. Decentralization and Equity**

### **5-1. Horizontal Equity**

Okay. Just a word or two about equity tax because they are quite parallel. As I said, the decentralization of spending responsibilities is motivated largely by increasing the efficiency of delivering these services but in the process of doing that important equity consequences can arise and how we value these equity consequences depend upon our values to begin with, depend upon the values of the nation. I talked about the concept of social solidarity where people in one region think of people in all regions as being equal citizens and deserving of equal public services and that sometimes the word "social citizenship" is used instead of social solidarity but there is a value judgment involved, in other words, and the extent to which we think that people in all parts of the country should get comparable levels of public services and that is what economists formally refer to as "horizontal equity".

Horizontal equity is violated by decentralization simply because of the fact that decentralization results in different jurisdictions having different fiscal capacities for providing these important public services. And I think the fundamental reason why we have

equalization systems is not really an efficiency argument but the fundamental reason why we have equalization system is an equity argument, that we have a feeling, we have a sense of social solidarity, and we think that people should have basic education, health, social services wherever they reside and that decentralizations should not result in somebody in a poor area being deprived of public services. And it is important to emphasize, I think, that when we are talking about equity in the federalism context, we are talking about equalizing the provision of public services. We are not talking about equalizing incomes, we are not talking about equalizing private incomes. Of course, I want to say that I am making a value judgment but I think that the literature would basically say that equity in a federal context does not refer to vertical equity, does not refer to income redistribution; instead, it refers to the idea that everybody is entitled to have some common level of public services at the common level of taxation and that is another way of simply saying that net fiscal benefits should be equalized across the jurisdictions. So, that is the discussion on fiscal equity.

## **5-2. Vertical Equity**

Now, of course, decentralization and competition among governments can also have adverse consequences for vertical equity because lower level jurisdictions might feel constrained to offer programs that are of more benefit to higher income people than lower income people simply in order to retain them so that they do not try—I am not sure that all countries face the problem that we do of having a high degree of mobility across jurisdictions but if you do, then you worry a little bit about the so called “race to the bottom”. So, I think I will pass on that and go to talk a little bit about what all this means for intergovernmental fiscal relations.

## **6. Intergovernmental Fiscal Relations**

### **6-1. Vertical Fiscal Gap**

Now, I have listed in the handout but I am mainly meant to be talking about equalization, I have actually listed in the handout three different areas of intergovernmental fiscal relations and the first area is simply the vertical fiscal gap. What size should the vertical fiscal gap be? Why do we have a vertical fiscal gap in the first place? The reason we have a vertical fiscal gap, I think, is for two reasons. One is because the case for decentralization of responsibilities is much larger on the expenditure side than it is on the tax side. You do not increase the efficiency of collecting taxes necessarily by decentralizing tax collection but you do increase the efficiency of providing public services by decentralizing them. So that is one reason. The second reason is that it is valuable to have a vertical fiscal gap in order to put into the hands of the central government the ability to equalize, to make equalizing transfers or to make transfers for whatever reason. In other words, the ability to make transfers is in itself an argument for having vertical fiscal gap rather than the other way around. The need

for transfers does not necessarily arise simply because we have a vertical fiscal gap but we have a vertical fiscal gap because we want to make transfers.

Now, there are a lot of people who argue against having the vertical fiscal gap and they typically argue legitimately on grounds of accountability that if lower jurisdictions are spending money that they are not responsible for raising that somehow they are not going to spend them as effectively. I have never been particularly convinced by that argument, especially if they are able to raise marginal revenues on their own. I think that is quite important that whatever transfer system one has, it is an inframarginal transfer system in a sense that the jurisdictions are responsible for determining the size of their budget; they can increase or decrease their budget, taken as given the transfers that they are getting from the central level. There are also arguments about the fact that there may be a soft budget constraint induced by vertical fiscal gap and one has to be certainly aware of that. If your fiscal transfer system has got elements of discretion and if it lends itself to providing incentives for lower jurisdictions to exploit that, then you have to be careful. And, also, if lower jurisdictions are dependent to some high degree on transfers from the center, there is always the danger that the central government will change its transfers unpredictably. Indeed, that has been a big issue in my own country. So, that is the argument for vertical fiscal gap.

## **6-2. Equalization System**

What about positive arguments for transfers? There are three main forms of transfers that I think we can talk about. The first one is equalization and the reason for equalization, in my mind, is simply to be able to enable all of the sub-national jurisdictions to be able to provide comparable levels of essential public services at comparable levels of taxation, which means, in principle, you should equalize both the revenue-raising capacity and also the needs and costs associated with particular jurisdictions. The structure of equalization system will depend upon which functions are decentralized and the nature of the local tax structure and equalization, I have said, calls for unconditional grants based on a formula rather than discretions.

I find it useful to think of a benchmark equalization system, perhaps, rather than going through the example. The benchmark that I have in mind when I sort of sit down and say, "What should an equalization system look like?" is the following. I would say to myself, suppose that you did not have a multi-level government, that there was one single government deciding everything and that government was a benevolent government and it did not face any inefficiencies associated with providing services. What would be the implicit interregional transfer system associated with that unitary state benchmark and in my mind, if you have

national solidarity, what you find is, well, you would apply a common national tax system and you would use those revenues to provide common levels of public services across the country, with exceptions for the fact that if it is much costlier to provide public services in one area than another, you might trade off the higher costs against the equity benefits. So, for example, in most countries the level of public services in urban regions is higher than it is in rural regions because of cost differentials. But, anyway, in the back of your mind you design an equalization system; you say, well, let us try and replicate what we think a unitary state would do if we believe that everybody should get as comparable public services as is feasible. And I think that what I have called benchmark equalization system here is just a way of putting that in a more specific context and I have just given an example of a benchmark federation in which equal per capital public services are provided across jurisdictions, the regions used have access to some source-based taxes, taxes on businesses and some residence-based taxes, taxes on their citizens, and the residence-based taxes are personal. And the regions differ in their average income levels and in their access to these source-based taxes. And in that very simple setting, a full equalization system is one that equalizes completely the ability to raise revenue across lower level jurisdictions.

In the real world, applying an equalization system is much more complicated and it is much more complicated for a number of reasons. One reason that is particularly important in highly decentralized nations is that lower level governments may behave quite differently; they may chose slightly different tax structures, they may—even though they are providing basic public services—they may provide different kinds of education to different kinds of students; their social services may differ slightly—so this heterogeneity makes it difficult to design an equalization system and one in the end is forced to use some kind of a national average benchmark to determine how much redistribution should be done from one region to the other. One has to worry about incentive problems. You want to have an equalization system that does not encourage sub-national jurisdictions from changing their behavior simply in order to get more revenues. There may be measurement problems about how to measure tax bases for the purpose of equalization. How do you equalize, for example, property tax-raising revenues across jurisdictions if they have different ways of defining that property tax basis?

If different regions have different needs for public services, we would like to equalize those but this actually a very difficult thing to do in practice because in order to impose—in order to equalize on the expenditure side, you have to take account both of needs and of costs and it turns out to be the case—I do not know what the situation is in Japan—it turns out that those things are quite often offsetting, that jurisdictions that have higher needs often have lower costs and vice-versa. The most important difficulty with equalizing on expenditure side

is the fact that different jurisdictions—you cannot equalize for differences in quality of public services.

A couple of other important arguments that affect equalization. In countries that decentralize the income tax system, the income tax system is progressive and people of different income levels pay different tax rates. The way that equalization occurs in that circumstance is to equalize on the basis of different income classes of people. Divide the population up into different income classes and equalize on the basis of how many people in each income class different jurisdictions have, stratification. I guess the most important difficulty faced by equalization is that it involves a value judgment in order for you to want to equalize, people have to accept, there has to be consensus for sort of social citizenship. There has to be a consensus that people are entitled to the same level of public services no matter where they reside.

### **6-3. Block Conditional Grants**

A second form of transfer is matching grants and in the literature, this is a traditional argument for correcting for interjurisdictional spillovers. And, in principle, I guess that is true but I think that my own view is that matching grants, the usefulness of matching grants, has been vastly overstated, that there is no way that matching grants—there is no way that the level of externalities or spillovers associated with local jurisdictions are anywhere near what matching grant formulas would suggest they are, 50 percent. Matching grants, I think, are most useful when you are trying to get lower jurisdictions to initiate programs. So, for example, if you want to initiate, to take an example, a national childcare program, nursery program or something like that, then—and that is a responsibility of the lower jurisdictions—the way you get the thing started is by having a matching grant but once it is in place, there is no need to match the expenditures of lower jurisdictions. Instead, what you should use are the category that I have called “conditional grants” by which I mean block conditional grants that you make transfers to lower jurisdictions on the basis of needs somehow objectively measured, but you make those transfers conditional; that is to say you impose broad conditions on the grants that the jurisdictions must satisfy if they are to receive those grants and if they do not satisfy those requirements, you cut back the amount of grant; if they do satisfy them, you give them the full grant. This is basically the way our social transfer program works. We have a social transfer, a block grant, for healthcare. The provinces provide healthcare and the only conditions that are imposed on the provinces are very broad conditions. Conditions including healthcare must be universally accessible, it must not restrict people who are moving in and out of the province from being eligible; it must be universally available and accessible to everybody and so on. And I think that block conditional grants which have these very broad

conditions imposed on them and which are formula based are the most suitable kind of grants for the main expenditures that sub-national governments do in the social area.

#### **6-4. Policy Harmonization**

Okay, one more category, one more component of the fiscal arrangements, what I would call policy coordination and harmonization, which is not to be underestimated. Well, I should say it is not to be underestimated in the federation. When you have two levels of government which have independent responsibilities, inevitably if the federal government wants to influence what the provinces do, they cannot do so without having some form of cooperative interactions with the lower level government while in principle they could make financial transfers that impose conditions on the provinces, but for practical, political reasons, there has to be some coordination and harmonization.

And harmonization can serve many useful purposes. Harmonization can improve the efficiency and the internal economic union in a way that conditional transfer cannot. You cannot give conditional transfers and set out conditions that precisely preclude provinces from behaving in a distortionary way with respect to other provinces. It is better to have an agreement that provinces abide by that preclude them from behaving in discriminatory ways with respect to residents of other provinces. Similarly, you might have agreements that implement common standards of vertical equity across jurisdictions. You might have agreements that harmonize tax systems. We have a tax harmonization agreement in our country and I think it is analogous to what you have here where the central government collects the taxes for provinces that agree to participate and the provinces have complete discretion over the rates that they set, as long as they abide by the nationally agreed to base.

And harmonization can also rationalize provincial regulations. Harmonization can be a substitute for the use of conditional grants as a way of achieving national objectives but harmonization is difficult. It is especially difficult if you have to get the agreement of all of the governments involved because unanimity is very difficult to achieve, especially where redistributive issues are concerned, so either you have to have an agreement that allows provinces to join freely or you have to have an agreement that has some effect that the federal government uses some leverage to get provinces to agree to and that has some way of settling disputes if provinces do not agree to do it. So, the federal government can be both the facilitator of these agreements and an enforcer.

And, finally, an issue that arises in all federations and perhaps one that is quite close to the kind of work that you do in this ministry, it has to do with process; what is the process by

which changes are made in fiscal arrangements? One of the problems we have in my country is the Department of Finance entirely controls the transfer system. As a consequence, all decisions with respect to the transfers to the provinces are taken as part of the budgetary process. That means they are taken in secrecy and people only find out about them when the budget comes out and they are liable to change year by year as the budget changes. So, there is an argument to be made for separating, or at least dividing some arms length body that has a longer term perspective that perhaps acts in an advisor compassion that takes out of the budget the longer term decisions that are associated with setting up a rational transfer system.

## **7. Conclusion**

Okay, so I will just conclude with a few comments. Just to reiterate what I was emphasizing that the reason why decentralization occurs in multilevel governments is to, at least economic reasons, there may be political and cultural reasons, but the economic reason is to enhance the efficiency with which important public services are delivered, particularly public services that are delivered to households and to firms. But the process of decentralization can at the same time cause distortions in the internal common market because all of these sub-national jurisdictions are taking uncoordinated independent decision, can compromise vertical equity objectives, can induce fiscal inefficiency and fiscal inequity because different jurisdictions have different capacities to provide public good services and can cause these horizontal and vertical fiscal externalities that I did not spend too much time on.

The role of the fiscal arrangements is to counter these adverse effects and to allow decentralization to occur in a way that does not harm the efficiency and equity of the national economy. Equalization system is a critical component. It is necessary for maintaining fiscal equity—social citizenship if you like—in all parts of the country. Equalization is an instrument not for redistributing income across households but an instrument for insuring that all households have comparable access to public services.

Equalization system is much more complicated. The more decentralization there is and the more diverse, or more heterogeneous if you like, are the decisions that are taken by the local authority and, of course, the less national solidarity there is.

Block conditional grants are also useful for achieving national standards in the design of social programs that have been decentralized and I would say that the case for specific matching grants is not as strong, except as a way of initiating programs.

Well, I finished right on the dot of 6:00, so I guess we have some time for discussion, I hope.

## **8. Questions and Answers**

### **Moderator speaking:**

Thank you very much. We would like to go the question and answer session. So is in Japanese or in English. I told him that we are originally a domestic ministry but we need to have some help from Mr. Higaki, who is going to translate into English for us. Any questions?

### **8-1. Canadian Constitution Article 36**

#### **Questioner:**

Well, I would like to make the first question. As you mentioned in your lecture that the Canadian Constitution which was amended in 1982, so it had Article 36, Section second, which is committed to the federal government to operate the equalization program, so we would be much interested in that clause. So we are talking about the Constitutional Amendment in broadly, we are very interested in establish a clause of the local finance. So, how do you evaluate the Article 36 and how was the background to amend the Constitution and how do you evaluate right now its significance or its meaning?

#### **Professor Boadway:**

Section 36 is a very important section of our Constitution and let me just briefly tell you what it is. Canada used to be a colony of the United Kingdom, as you may know. We became independent in 1867 and we had a Constitution in 1867, which I guess is also an important year in Japan from what I understand. However, when we became independent and got a Constitution, we did not become completely independent, because the right to amend the Constitution resided in the British House of Commons, so whenever we wanted to amend the Constitution, we had to go to the British House of Commons and this was a bit troublesome, as you can well imagine. So, the main impetus behind amending the Constitution in 1982 was to repatriate the Constitution and at the time we have a very visionary Prime Minister by the name of Pierre Trudeau who had a view of a Constitution which was quite different than the one that we had. And he wanted to do a number of things. He was from Quebec but he also was a federalist and so he wanted to make the Constitution more attractive to people in all parts of the country.

One of the most important things that he introduced in the Constitution was what was called a "Charter of Rights and Freedoms" which we did not have before. Now, it turned out that introducing a Charter of Rights and Freedoms was not to everybody's liking and so part of the bargaining process was to come up with this Section 36, which in some sense was

a way of making the poorer provinces feel secure. There was actually another element to this repatriation that was important as well; there was also a Section 35, which is not important for our purposes, but Section 35 enshrined into the Constitution the rights of the aboriginal people so it essentially put into the Constitution the right of the aboriginal peoples to their treaty rights and self-government. In any case, Section 36 was put in as part of the bargaining process; it was not put in as part of a conscious effort to introduce the principle of equalization. Nonetheless, it had been a very important addition to the Constitution and what it says—there are two parts to it—one part says that the federal government and the provinces are committed to providing—just to paraphrase it—equality of opportunity across the country to furthering regional development and to providing central public services to all Canadians; that was Section 36.1. It is sort of used as the motivating force behind the social transfer system.

Section 36.2 is equalization principle and I think I mentioned earlier what it says. It says that the federal government is committed to making equalization payments so that all provinces can provide comparable levels of public services at comparable levels of taxation. Now, these principles, even though they are set to be commitments of the federal government, lawyers agree that they are not commitments that Courts could actually impose on the government, so they are really more commitments in principle with moral strength rather than—the Courts could not turn around and say to the federal government, “You are not providing enough equalization payments, you have to spend more” because we have a strict parliamentary rule that spending has to be decided on by the Parliament. Nonetheless, it is a very important clause and it is also a section that is mirrored in a lot of other countries' constitutions. Germany, for example, has a comparable clause in their Constitution, so that has been a Constitution, is actually one that is quite interesting to look at because it was designed only in 1994 or at least leading up to 1994 when the apartheid regime finished and it sort of drew on the experience of many countries around the world to try and put into the Constitution quite far-reaching social obligations on the governments in Australia. So, I think constitutionalizing these principles is quite important and I think it has had a big influence. Our equalization system is consciously designed with those principles in mind.

## **8-2. Autonomous Decision-Making by Lower Government**

### **Questioner:**

I am from the (inaudible). you said the meaning of decentralization is not only budgetary decentralization but also autonomous decision-making responsibility. So, today in Japan nowadays raising tax authority should be decentralized, then local government can make the decision autonomously. But you say raising tax and spending money is not sufficient for decentralization, so what do you mean with autonomous decision-making responsibility?

### **Professor Boadway:**

This is one place where federations may differ from unitary states. A federation is almost by definition defined as a government system where different levels of government have spheres of exclusive responsibility so, for example, in the Canadian Constitution, it is very clear that provinces have got areas of responsibility where they have “exclusive legislative authority”, exclusive legislative responsibility and you will find the same if you go to the United States and other countries. And, similarly, the provinces have the right to levy a wide variety of taxes according to the Constitution and what that means is that their legislature—they all have their own legislatures that are accountable only to themselves; the federal government cannot force provincial legislatures to do anything, cannot interfere with the way provincial legislators design their programs in their areas of jurisdiction. That is really—I am not really sure if that is clear but that is what I mean by autonomous decision making where what the provinces do is entirely up to the provinces.

Now, I think it is fair to say that in many non-federal countries—I mean you know the case of Japan much better than I do—but I know is some non-federal countries, for example, Scandinavian countries, local government responsibilities are determined by national legislation and the national legislature can change those responsibilities and moreover the national legislature can enact laws about how the regional and local jurisdictions have to design their school programs or their care for the elderly or their daycare programs or whatever it may be. And so I would say in that context they do not have exclusive responsibility. That is what makes the system of transfers very important in a federal country because transfers are the main vehicle for the central government to—I was going to use the work bribe—but give an incentive for the provinces or states to enact programs in a way that does not violate national objections. Is that more or less clear?

### **8-3. Equalization and Conditional Grants**

#### **Questioner:**

I would like to thank you very much for your very enlightening lecture on the equalization system. You mentioned that there are several systems of equalizing among the various jurisdictions. First of all, in our ministry we have in mind the equalizing transfer that does not have any conditionalities for the local government but you also said that the conditional grant is also useful for equalizing among the various jurisdictions. I was very interested in that comment but, at present, we are facing the very hard issue of decentralization in Japan and officials in our ministry put preference for the unconditional transfer, equalizing transfer, concerning the program grant. I think there is less discretion for the local governments so I would like to ask you about what the image in your country, the share of equalizing transfer among the provinces and the share of block grant. You said that block grants were used in the social areas so, first of all, the quantitative share of each tool and, secondly, I would like to ask you if you have any theoretical preference among these of the equalizing transfer and the block grant.

#### **Professor Boadway:**

Okay. A lot of my answer is going to be a little bit accounting. We have two—the way we do it is we separate the equalization function from the social transfer function. And the argument is that the federal government has an explicit equalization commitment in Section 36.2 of the Constitution. But they also have a joint commitment with the provinces to ensure that certain types of social programs are provided to all citizens in health, education and welfare. And so there are these two major programs.

Now, the equalization program is a program that only goes to the provinces who have below average fiscal capacity. It does not go to the wealthier provinces of whom—there are three provinces that do not get it, three or five, and five or six, six or seven that do get it. And it is completely unconditional. It is determined entirely by relative need. At the same time, we have these transfer programs. And there are two transfer programs. There is one program called Canada Health Transfer, whose purpose is solely for the federal government to provide money to the provinces in support of their health care system and there is another one called the Canada Social Transfer, which is a transfer that is made to provinces to support their expenditures on social welfare and also education.

Now, these programs have very broad conditions attached to them. When I say they are conditional block grants, I do not mean they are conditional in the sense of dictating to the provinces that they have to have 12 years of schooling and they have to do this and they

have to do that. They do not do that at all. They are basically equal per capita transfers that have very broad conditions attached to them that say that the provinces have to operate universal health care, publicly-funded, universal health care systems that are accessible to all citizens that are comprehensive in the kinds of services that they provide. They do not even define those terms but the federal government then from time to time says, well, you are not providing services that are accessible because you are charging fees so we are going to cut back the transfer. They do that from time to time.

The purpose of these social transfers is really to give the federal government some, how would I say it, some moral sway and some power to be able to say to the provinces, you know, you should be designing these health care systems, which are your exclusive legislative responsibility, you should design them in a way that abides by some national standards.

The block transfers and equalization are roughly comparable in magnitude. The poorer provinces maybe get up to 40 percent of their budgets from those kinds of transfers. The richer provinces maybe only get—the richest province might only get eight percent of its budget from the transfers. And that is the way they work. When I use the term conditional in that context, the conditions are very, very broad. In fact, the provinces rebel at any conditions. The provinces do not want the federal government to attach any conditions on the health care transfer so it is a big political debate.

In principle, you could combine the two. You could say let us join up all of these transfers and let us allocate them so as to achieve equalization objectives but let us at the same time impose these broad conditions on the provinces who receive them. You can certainly do that.

#### **8-4. Matching Grants**

##### **Questioner:**

I would like to ask about the matching grants. What kind of matching grants the federal government of Canada has? What kind of area and what kind of a target is one thing. The next thing is, are there any matching grants go to the municipalities of the provinces is the second question. And the third question is a completely different question. I am very sorry to say this because Canada and the United States are located in North America so sometimes we think that two countries are very similar but I think it is completely different. You were talking about the importance of fiscal equity as a federal nation and so in that point of view, what do you think about the fiscal policy of the United States?

## **(1) Matching Grants in Canadian Federation**

### **Professor Boadway:**

Okay. I better leave the third one until the third question.

On the matching grants, we have very few major matching grants. When health grants were first introduced they were 50-50 percent matching. We used to have a 50-50 percent matching transfer for welfare. Those were all converted into block grants with very general—once the programs were established, they were converted into block grants. The only matching grants we have now are relatively minor ones for national highways. We also have national shared cost transfers for immigration. This is something you probably do not worry about too much but in Canada we have substantial immigration and immigration is a federal responsibility but it imposes costs on the provinces because when immigrants come in they tend to locate in certain regions and they have the right, of course, to get all of the services. So the federal government makes a transfer to the provinces to support the cost of absorbing new immigrants into their population.

There are some minor conditional transfers in the area of agriculture, I think, but very, very limited use of matching traditional transfers. Now, what was the second question before I get to the United States?

## **(2) Matching Grants to Local Municipalities**

### **Questioner:**

The second question is, are there any matching grants directly go to the municipalities from the federal government?

### **Professor Boadway:**

This is a very big issue in Canada. The reason it is a very big issue is because the municipalities are completely under the control of the provinces. I mean, the provinces are not run like little federations, they are run more like unitary states. They legislate what the municipalities are allowed to do and as the country becomes more urbanized, you have, for example, the city of Toronto is one-tenth the size of Tokyo, of course, but by Canadian standards it is quite a bit place. And they feel that they do not have enough fiscal responsibility and enough revenue so there has been a big debate in Canada about whether the federal government should make transfers to the municipalities and one of the things that they did in the most recent budget was they agreed to give the provinces a share of the petroleum revenue from the excise tax on petroleum, the argument being that cities were responsible for a lot of transportation services. That is very controversial.

### **(3) Difference of Federation System between Canada and U.S.**

Not as controversial at the U.S. question, though, because this is a big issue in Canada. You are right to say that Canada and the U.S. are very, very different when it comes to issues of equity and I am not saying it is good, bad or indifferent; it is a matter of personal preference. Canada has a state which is much more similar to European states in terms of social programs than the U.S. We have universal health care, publicly-funded. We have all public universities. We have quite a different system—we have a welfare system which essentially the U.S. does not really have a universal welfare. We have a welfare state, which is very different from the U.S.

There is a lot of pressure in Canada to change our system for competitive reasons. We export 60 percent of our GNP, 80 percent of that goes to the U.S. There is a lot of pressure to reduce our taxes to make our economy more competitive and there is a lot of pressure to reduce social spending, to privatize elements of the health care system and so on. So this is a very big issue and equalization and conditional grants play right into that issue because it is argued that they encourage people to stay in poorer jurisdictions. So, the answer is, yes, we are very different and, yes, it does put a lot of pressure on many policymakers.

### **8-5. Coordination among Provinces**

#### **Translator:**

He asked a question about how to make the system. For example, in Canada there are only 15 provinces or states but in the United States, for example, there are 50 states, and in Japan there are 47 prefectures. So are there any differences to make a compromise to implement the systems like taxation reform and financial reform? Are there any differences to make a compromise according to the number of the states and the number of provinces?

#### **Professor Boadway:**

The number of provinces is 10 and it is likely never to change. Well, we could go to nine if we have a separation of one of our provinces. At the moment it is 10 and we hope that we stay that way. The provinces are very different in size. They go from 10 million to 150,000 in various different sizes, yet they have the same responsibility. I think the advantage of having 10 provinces as opposed to 50 states is that coordination is a lot easier to achieve, especially if you have sort of two or three very big ones and a bunch of small ones; it is much easier to coordinate policy and I think that is why, for example, we have been able to introduce a tax harmonization system which is quite a bit more harmonized and coordinated than they have been able to do in the U.S. with 50 states.

Financial regulation was that?

**Translator:**

Yes. For example, financial regulation for the taxation.

**Professor Boadway:**

We have a big problem with financial regulation because the Canadian Constitution, when it was written, did not appreciate the difference between death inequity and things like that. So, the federal government is responsible for banking, for example, and for insurance, but the provinces are responsible because of some obscure clause in the Constitution, they are responsible for bankruptcy, for equity markets, basically, for capital markets and there has been some attempt to try and harmonize the regulation of capital markets but it has been very difficult because the big provinces, one had their own stock market. They do not want to harmonize stock markets for fear that everybody is going to set up in Toronto and Montreal and Vancouver are going to lose their stock markets so harmonization of capital markets has been very, very difficult.

Similarly, provinces are responsible for labor market regulation. They control the professions, they control doctors, accountants, lawyers, carpenters, plumbers and this has caused a lot of problems with barriers to movement across the provinces and we have not been able to resolve that through negotiations so even though we only have 10 provinces, not all of the issues have been resolved.

**New speaker:**

Thank you very much for your answer.

## **8-6. Gross and Net System for Equalization**

### **Questioner:**

I would like to express our thanks for your lecture. I think I would like to ask you the so-called issue of net versus gross income. So, in the case of Japan where the vertical fiscal gap is very large, so every local jurisdiction could be equalized to ( ), both upward and downwards and gross scheme. So how do you evaluate the issue of net versus gross income? What is your opinion about that?

### **Professor Boadway:**

That is a very good question from my co-author. Yes, we have a gross system in Canada, which means that we equalize the poor provinces up but we do not equalize the rich provinces down and that is a very big problem. It is a very big problem because the richest provinces are much, much richer than the poor ones. We have a province in Canada that has something like the third biggest oil deposit in the world and they are just raking in the money right now. Yes, I certainly would favor a net scheme but it is very difficult to do a net scheme if you do not have a very big vertical fiscal gap, which is what I think you are saying.

One way to approach it, to go back to an earlier question, is to combine the social transfers and equalization into one big thing and use that as a vehicle for implementing a net scheme. I do not know if you are familiar with the Australian system but the Australian system is one where the vertical fiscal gap is very large. The states raise very little revenue. They have a very sophisticated equalization system and it applies to all states. Effectively, every state gets something but because there is such a big vertical physical gap, they are able to equalize all of the states to a common standard by giving the top states so much less than the bottom states. Of course, their disparity across states is very small compared to ours but, yes, I mean, you have put your finger on a problem that with our system you would not want to copy.