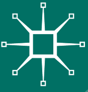

FEDERALISM AND INTERNAL CONFLICTS

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Fiscal Federalism and Diversity Accommodation in Multilevel States: A Comparative Outlook

Edited by

Francisco Javier Romero Caro · Alice Valdesalici

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Alice Valdesalici
Editors

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Preface: The Money's Elephant and the Legal Response

1. Money is the elephant in the room of diversity accommodation claims. A look at the areas where such claims are more acute shows an evident link between financial issues (broadly understood) and demands for more autonomy or even statehood by minority groups (also broadly understood). Looking more specifically at the bigger-scale conflicts, where sovereignty over a given territory is contested, one could easily identify two main ramifications of such trend. On the one hand, secessionism is growing in areas where the control over natural resources and their revenues is at stake. These are usually poor territories, typically located in the global South, very often predominantly inhabited by a population that differs from the majority of the respective State in ethnocultural, linguistic or religious terms. On the other hand, conflicts arise over the share of tax revenues to be kept in and controlled by the territory where the claim emerges, usually in the global North. In such cases, the affected territory is typically richer than the average of the country it belongs to and secessionist claims grow in proportion to the degree of frustration for failed assertions for more financial autonomy. Commonly, most of such territories are also characterized by a degree of ethnonational, linguistic or (less frequently) religious difference from the majority population of the country. No need to list examples of the two typologies here: the reader can simply close the eyes and think of them. For sure, many will pop up in his/her mind. Like the elephant in the room.

There may be many reasons why this elephant is understudied in law and political science. Financial details are normally not the bread and butter of such disciplines, and not many scholars in (comparative) federalism and territorial studies deal with them. Furthermore, and probably more importantly, the financial and more broadly the economic factor is overshadowed by the diversity element. Ethnonational, cultural, linguistic or religious diversity is incomparably more analyzed than the economic driver for autonomy, secession and statehood, and when the two are linked, the former always prevails, as the ownership of resources and revenues is considered a group right inherent to self-determination, whereas financial claims are not. Therefore, it is more effective to frame a request for more autonomy or statehood in ethnocultural than in economic terms, and after all it is really difficult to disentangle the two sides of the same coin.

2. States, like any other human phenomenon, are born and die. Despite the assumption of eternity underlying every constitutional compact, history shows that the creation of new States by separation of a territory from a country to which it belonged (secession) is a very frequent phenomenon. Since 1990, 30 new States have been created, about twice as many have been formed in the last half century, and 129 have arisen since the end of World War II. Excluding cases of decolonization, a good third of these States came into existence by secession. Including them, two-thirds of the existing States are estimated to be the result of secession. And with the exception of the rare internationally-led processes (as with Timor Leste, Montenegro, South Sudan, most recently Bougainville), the others originally represented cases of illegitimate secession, almost always then healed by international recognition.

In short, to make secession processes illegitimate, as most of the constitutional orders do, does not prevent them from taking place. On the contrary, secessionist drives have intensified in recent years, and many processes (some only attempted) have been initiated in this direction. Often, claims for independence and statehood take root in a given territory as an upscale of frustrated (real or perceived) demands for more autonomy. One could argue that too little attention to the quests for more autonomy, and the fact that when autonomy is granted, it is given with little or no endorsement, are among the factors that have led to an increase of independentism in the last couple of decades, in parallel to a more conflictive policy style in the vast majority of the world's countries.

Be it as it may, the driver of territorial conflicts, irrespective of whether they lead to secession or not, is always disagreement about the ownership: of resources, of revenues, of land, ultimately over the machinery that governs property distribution, i.e., the State. This is not surprising, as property has been the engine of the whole Western legal tradition and, with different (more collective) nuances, of the entire world. Property and control over it are pre-legal, anthropological propellers for conflicts and its conflict potential is likely to be inevitable.

Next to the anthropological factor, the economic one plays a significant role. Secessionist claims are motivated by the (alleged) convenience of having an independent State. Such expediency can be the property of important natural resources or control over areas that are economically stronger than the rest of the national territory and large enough, in terms of surface but also and especially in terms of gross domestic product, to be considered economically self-sufficient. The latter is the case in all significant Western European secessionist claims, such as in Scotland, Catalonia or Flanders, where economic factors fuel long-rooted ethnonational and cultural claims. Instead, where the driver of fiscal equalization is not supported by strong ethnocultural elements, secessionist assertions, while present, are in fact but much less significant, such as in the North of Italy or in Bavaria. Conversely, economically weak territories in the global North do not develop significant secessionist drives, even when they are ethnoculturally diverse, as the consideration of economic non-self-sufficiency prevails over historical, ethnic or political aspects. In the global South, this is more likely to happen as minority groups in resource-rich territories are frequently oppressed and the quest for autonomous control over resources goes hand in hand with the hope for more political freedom. Overall, there is no doubt that the combination of the economic and the ethnocultural factor makes the claims way stronger than the presence of only one of the two.

3. The causes of conflicts need to be identified in a non-hypocritical way. While hard to admit, they essentially boil down to property, ownership, resources, money, very often combined with ethnonational claims that however also ultimately assert group ownership over a given territory and its resources. Recognizing the causes of a problem helps solve it.

Here is where law comes into play as the only possible instrument for conflict settlement, at least in a peaceful way. Law is the only alternative to violence and law means procedures, especially when the outcome of a

dispute cannot be predetermined. If a conflict cannot be avoided (and it probably can't, if it is rooted in pre-legal, anthropological factors), it can be channeled, regulated, broken down into smaller and more manageable disputes. The impact of a conflict can be minimized by scaffolding it with legal provisions. This is ultimately what law is about and the whole history of constitutionalism is the story of gradually placing under the rule of law phenomena that were previously left to the rule of force (to the "normative power of the factual", in the words of Georg Jellinek). Against this background, it is not surprising that contemporary constitutional law devotes growing attention to conflicts of sovereignty, with a view to constitutionalizing them.

This book is a brick in the legal wall that contemporary constitutionalism is building to incapsulate and regulate conflicts over territories. It helps to cast light on how fiscal federalism (i.e., the rules on the financial relations among different levels of government in multi-layered systems) contributes to ease or to fuel territorial tensions. All its case studies are examples of multi-layered governance systems with different degrees of territorial tensions but also with a differently developed rule-of-law machinery to deal with them. The comparative chapters identify common trends and diverging paths of the inextricable link between financial mechanisms and ethnicity. By doing so, the volume shows the importance of comparative federal studies overall and of fiscal federalism in particular to the preservation of peace, to the accommodation of diverging claims and to the regulation of scarce resources in an ever complex world.

The study is the outcome of a research carried out by the Institute for Comparative Federalism at Eurac Research in Bolzano/Bozen supported by the Autonomous Province of Bolzano. While representing an important achievement in the advancement of this area of studies, it also opens up new questions that demand for further research, as is required in a rapidly changing world.

Bolzano/Verona, Italy Francesco Palermo

Francesco Palermo is Head of the Institute for Comparative Federalism at Eurac Reserach Bolzano/Bozen, Italy and Full Professor of Comparative Public Law at the University of Verona, Italy.

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The inception of this book can be traced back to the pre-pandemic world when a project proposal was initially submitted under the EU's Marie Skłodowska-Curie program in collaboration with the Institute for Comparative Federalism at Eurac Research and awarded the Seal of Excellence. Through the funding provided by the Province of Bolzano/Bozen—South Tyrol, under the Seal of Excellence Call, Dr. Francisco Javier Romero Caro had the opportunity to develop the DATE project (Diversity Accommodation through Territorial Equalization) under the supervision of Dr. Alice Valdesalici.

The project DATE has explored, from a constitutional and comparative point of view, the role of fiscal arrangements as a tool of territorial integration with the aim of determining if and to what extent equalization mechanisms can be conceived as an instrument to reduce territorial tensions and accommodate diversity. DATE explored the (dis)integrative effects of equalization mechanisms in territorial sub-units that currently face or have faced a secessionist challenge, in order to determine if and to what extent they work in a way that foster integration, or rather the opposite. Within the project, an innovative set of seven indicators has been developed. These indicators have been applied to the three case studies in Canada, Spain and the United Kingdom (see Chapter "The United Kingdom's Territorial Funding Arrangement: A Holding Together Tool?"), but they can be used as a benchmark for international comparison, even beyond the scope of the DATE project.

In June 2022, as the culminating event of the project, a conference has been organized at the Institute for Comparative Federalism titled "Fiscal Federalism and Diversity Accommodation in Multilevel States: A Comparative Perspective." The conference aimed to delve into the intricate relationship between fiscal federalism and diversity accommodation. It served as a catalyst for our ambitious endeavor of compiling a book on this subject. We would like to express our warm appreciation to the panelists and attendees who actively participated in the conference, generously sharing their knowledge and experiences. We are also grateful to those who joined us subsequently and kindly agreed to contribute to the publication of this book. Furthermore, we extend special thanks to our colleague Petra Malfertheiner, whose unwavering dedication and tireless efforts were instrumental in making this conference a resounding success. Without her invaluable contributions, this conference would not have been possible.

We would like to express our gratitude to Francesco Palermo, the Head of our Institute, for supporting us in pursuing this idea and for his thought-provoking preface. Our thankfulness extends to our esteemed funders, the Province of Bolzano/Bozen and Eurac Research, whose contributions have been instrumental in ensuring that this book is widely accessible through open access. Additionally, as editors, we would like to extend our thanks to the anonymous reviewers and the editorial team at Palgrave for their assistance. We would also like to give special recognition to Blythe Gilbert, Bastian Karge, Megan Kelly and Ella Russell for their exceptional support and assistance in the preparation of the manuscript.

Bolzano/Bozen, September 2023 Francisco Javier Romero Caro
Alice Valdesalici

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Diversity Accommodation and Fiscal Federalism: Relevance of the Topic and Rationale for Case Selection

Francisco Javier Romero Caro and Alice Valdesalici

The Theory of Diversity Accommodation

The accommodation of diversity is one of the greatest challenges that modern societies must face. In addition, today, many federal systems encounter a loss of solidarity and an upsurge of interregional disparities. These have exacerbated dormant tensions and intergovernmental conflicts that, in certain cases, could even give rise to secessionist movements. Multilevel government (either in federal or regional form) plays a key role in managing diversity and reducing the risk of secession. This has led to decentralization being presented by some scholars as the antidote for secessionist/nationalist movements (Kymlicka, 1998). However, contrasting views also spice up the debate (Sorens, 2015). Moreover, history has not proven any one of these theories.

Although conflicts and secessionism arise from multiple factors, traditionally, the literature on diversity accommodation has predominantly

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focused on differences from ethnonational, cultural, linguistic, or religious diversity (Gagnon & Iacovino, 2007) and not on the economic driver for autonomy or national recognition. The study of fiscal instruments and financial relations (i.e., fiscal federalism) has, for the most part, been left aside, even though the latter has a critical role in this respect (Sorens, 2015). Although the financial dimension is a vital component of any system of shared government, as the lack of resources to finance constitutionally assigned competences would render these inoperable, reducing autonomy to an empty vessel, the nexus between diversity accommodation and fiscal federalism remains to a large extent understudied (Weingast, 2014). In addition, the financial dimension almost never being mentioned in the literature on diversity accommodation. Along the same line, fiscal federalism has been analyzed from other angles, paying attention to matters such as the allocation of financial resources and the powers thereof (Anderson, 2010), as well as the functioning of financial relations among different levels of government (Boadway & Shah, 2009; Schnabel, 2020), but without drawing much interest from the literature on nationalism and minority accommodation and to the contribution the first could give to the latter (and vice versa) in terms of research advancements.

The Many Facets of Diversity and the Relevance of Fiscal Federalism

Starting from a flexible and broad definition, diversity can be understood as the condition or fact of being different or varied. The sources of this diversity can be multiple, as Hansjörg Blöchliger and Andoni Montes-Nebreda explain in Chapter 2. Diversity and federalism have traditionally gone hand in hand since the need to integrate these differences, to achieve unity in diversity, has been the *raison d'être* of the federal model since its inception. In fact, federalism can be conceived as a bridge between diversity and unity, as an instrument to accommodate differences within a common state.

Diversity has many facets, different determinants, and dimensions that may fuel intergovernmental conflicts if they are not properly addressed and/or accommodated. These differences go beyond the paradigm of traditional federations that aimed at integrating diversity in ethnocultural terms, mainly focused on language and religion. Modern federations, especially in the global south, as Palermo notes in the preface of this book,

have shown that diversity is a much broader and complex phenomenon to which new dimensions are added. History, for example, is another factor that can lead to diversity. The legacy of former regimes, particularly those derived from European colonization, has shaped the territorial and societal structures of certain countries. Thus, beyond the traditional differences in language, religion, ethnicity, or culture, it is possible to identify other characteristics such as variations in the size of land and population, the existence of minority groups (like indigenous populations), or socioeconomic and geographical inequalities, at times derived from the concentration of natural resources in a given territory, from whose heterogeneity different facets of diversity are further derived. Diversity, therefore, presents a challenge for multilevel systems as it requires specific treatment. In other words, different factual situations must be given different treatment, which, in legal terms, usually takes the form of asymmetries (Sahadžić, 2020). Such asymmetries, as illustrated by Blöchliger and Montes-Nebreda, can also extend to the fiscal domain, with fiscal instruments and institutions playing an important role in accommodating diversity.

Given the above, this book explores the link between diversity and fiscal federalism from two different but complementary angles. This is because it does not only focus on how much diversity has affected intergovernmental fiscal relations but also inquires on to what extent fiscal federalism has had an impact in accommodating diversity. Both questions are addressed by experts from different disciplines in a selection of multilevel states with the ultimate goal of presenting a comparative outlook on how intergovernmental financial relations have contributed to integrating diversity.

The Rationale for Case Selection

Defining federalism and identifying the number of federal countries is no easy task. In fact, there is no universal agreement on what federalism means, nor on the number of federal countries, with scholars dissenting on different classifications (Gamper, 2005). Similarly to the approach followed by the concept of diversity, this book adopts a broad understanding of federalism, focusing on its practical meaning (Palermo & Kössler, 2017). In a nutshell, a federal system implies the existence of at least two tiers of government that act in an independent and coordinated manner (Wheare, 1963), combining self-rule and shared rule

(Elazar, 1987). Adopting this open definition of a federal system allows us to have great variety in our case selection, going beyond the traditional federations and including different multilevel states from all geographical areas of the world,[1] portraying, at the same time, as many diversities as possible.

The same applies to fiscal federalism, with the book aiming at integrating the discussion on the role of fiscal constitutions as a determinant, among other factors, not only of financial relations but also of the inherent dynamics of a federal system (Palermo & Kössler, 2017). In this regard, fiscal constitutions are understood in a broad sense, including not only rules "formally incorporated in some legally binding and explicitly constitutional document," but also unwritten rules like "customary, traditional, and widely accepted precepts" (Buchanan & Wagner, 1977, p. 24). This approach entails three key consequences for the book. First, it stresses the importance of "[contemplating] the Constitution as a whole, considering provisions not specifically directed [at] fiscal matters and taking into account the federal structure created by the Constitution" (Dam, 1977, p. 272). Second, it justifies the inclusion of all sources of law which govern the subject matter but do not have formal constitutional status. In this case, substance prevails over form, as these rules deserve to be thought of as quasi-constitutional in nature. Third, it gives weight to economic rules and, most importantly, to political facts that impact the interpretation and implementation of the rules and determine how a system functions and evolves. The starting point is that the degree of fiscal decentralization and the existence and eventually the increase of interregional disparities might play a key role in exacerbating conflicts. To be investigated is, however, if and to what extent these elements are also determinants in sparking or accommodating secessionist/nationalist claims. This is done by putting financial relations into the broader context of the federal structure of a certain system. In order to do this, the book explores the rationale and management of intergovernmental conflicts on finances within a selection of countries, integrating in the analysis the internal dynamics that result from them. This is done on the assumption that a process designed to accommodate a subnational entity could have

[1] The geographical areas are drawn from the classification provided by Loughlin et al. (2013). For the purposes of this book, Africa (South Africa) ; Asia (India) ; Europe (Italy, Spain, and the United Kingdom); North America (Canada); South America (Brazil); and Oceania (Australia).

negative repercussions on other subunits, creating a sentiment of alienation and hindering future processes of ratification or implementation in legal or constitutional form. Thus, the book endeavors to shed light on the role that fiscal federalism plays in diversity accommodation in multilevel states by exploring and assessing the role of fiscal arrangements as a tool of territorial integration (*versus* disintegration), with special emphasis on determining if and to what extent different types of arrangements can be conceived as an instrument to reduce (or enhance) territorial tensions and accommodate diversity.

These elements are addressed from a comparative perspective, including the greatest possible number of diversities. Following this rationale, the book features several representative case studies (Australia, Brazil, Canada, India, Italy, South Africa, Spain, and the United Kingdom), focusing on the different aspects and components fiscal constitutions are built on. The ultimate aim is to investigate how different manifestations of fiscal federalism can contribute to the accommodation of diversity. This book aims at providing the reader with a diverse and comprehensive set of case studies, exploring both traditional (Australia, Brazil, Canada, and India) and contemporary federations (South Africa and Spain), including regionalized (Italy) or devolved states (the United Kingdom) in order to enrich the understanding of these phenomena by identifying common trends while evaluating different solutions to similar dilemmas. At the same time, this case selection has the added value of featuring a wide range of diversities, which are thoughtfully addressed in the different chapters of the book. Each chapter delves into specific dimensions of diversity, examining, among others, various cultural backgrounds, socioeconomic statuses and perspectives, providing a comprehensive exploration of the multifaceted nature of diversity.

For instance, differences in the size of the various jurisdictions that make up a federal state can pose a challenge when distributing fiscal resources. Will Sanders explores in chapter 3 how Australian fiscal equalization, one of the strongest models among federations worldwide, has managed the diverse sizes of the subnational jurisdictions, primarily in population, but also in economy and land area. The incorporation of the Commonwealth territories into the equalization program in the 1980s increased the diversity of size among constituent units and led to methodological developments in assessing comparative fiscal capacities. The challenge posed by this is explored in two divergent cases: the Northern Territory, with just 1% of the national population—over

a quarter of its population being Indigenous—but spread across 17.5% of the national land area, which has raised questions for Australian federal finances that have not loomed in other states, and Western Australia, once regarded as "small" but has become financially "big" and has used this new status to challenge the established system of full fiscal equalization between subnational jurisdictions, toward a system of reasonable equalization.

Another source of diversity are territorial socioeconomic inequalities. These have been one of the main drivers behind the design of the transfer system in Brazil. As Gabriel Junqueira and Gabriella Alcaraz argue in Chapter 4, this has crystallized into a system that accommodates diverse fiscal capacities by significantly reducing inequalities arising from own revenues. However, a part of the transfers end up not exerting a redistributive function but rather increasing inequalities. Also, the distribution of the equalization funds presents inefficiencies that favor small states and municipalities regardless of their socioeconomic development level. Despite that, changes seem unlikely in the near future due to the difficulty of channeling territorial interests in broad political coalitions to approve redistributive fiscal reforms.

Diversity, in a more traditional sense, also covers the existence of different national communities within a state. This is precisely the case in Canada, where the English-speaking majority coexists with other national communities, such as the French-speaking community in Quebec or the various Indigenous Peoples spread throughout the federation. Against this background, Jennifer Wallner, in Chapter 5, attempts to identify the concrete elements of fiscal federalism that may contribute to—or detract from—the empowerment of internal minority national communities. Wallner explores features such as the representation and participation in the management of fiscal arrangements; the independence of the revenue base that is available to internal communities; and the conditions and time horizons that are associated with the arrangements, exposing how fiscal federalism has contributed to the achievement of self-rule for some internal minority communities while continuing to disempower others.

Diversity in India is a tapestry woven from its vast geographical variations, historical influences, and a multitude of ethnic, linguistic, and cultural groups. This has resulted in conflicts that sometimes embedded a secessionist component. Chapter 6 by Chanchal Kumar Sharma delves into the role of fiscal equalization, showing that its absence fosters

anxiety in low-income states, while excessive equalization demoralizes high-income states. In contexts of economic injustice, marginalized minorities often become politically engaged, seeking institutional avenues to express their grievances. When the state fails to provide such channels, these minorities may resort to violence. Initially, the Union government attempted negotiations and concessions, but as military confrontation escalated, it inadvertently reinforced the forces it aimed to suppress, creating a cycle of reinforcement in secessionist crises.

Although Italy is often perceived as a homogeneous country, it has a significant diversity in terms of language, geography, and, especially, socioeconomics. Its late regionalization process, with the delay in the implementation of the ordinary regions, means there is still some way to go in accommodating the country's diversity and, especially, the growing demands for greater differentiation. In fact, today's Italian legal and political landscape is witnessing a renewed debate on the relationship between differentiation, autonomy, equality, and solidarity. The emergence of these claims for change could trigger intergovernmental conflicts. In Chapter 7, Antonia Baraggia and Benedetta Vimercati intend to reflect, from a diachronic perspective, on the development of fiscal federalism in Italy. For this purpose, their focus is not only on the provisions in the Constitution, but also on the case-law and all the external or non-institutional factors that have contributed to shaping Italian fiscal federalism. Their final aim is to explain how the Italian legal system has sought to build its own fiscal federalism by reconciling naturally dynamic and contrasting principles such as those of decentralization and unity, autonomy, and equality.

South Africa showcases significant diversity in terms of "racial", ethnic, economic, social, cultural, political, linguistic, geographic, and administrative aspects. As Tania Ajam illustrates in chapter 8, the country faces pockets of concentrated wealth alongside extensive regions plagued by severe poverty, inequality, and unemployment. The territorial structure of the country reflects the historical transition to democracy, wherein the creation of nine South African provincial governments was a concession to the white minority. However, these provinces were granted limited exclusive functions and had minimal revenue-raising capabilities. Over the past two decades, there has been a trend toward centralization, further diminishing the already limited powers of the provinces and increasing their dependence on intergovernmental grants from the national government.

The creation of the Spanish State of Autonomies was driven by the need to accommodate the existing diversities in terms of language and culture. In Chapter 9, Violeta Ruiz Almendral explores the transformation of the constitutional framework concerning tax and finance power decentralization, juxtaposing Spanish fiscal federalism within the broader context of the European Union. Ruiz Almendral focuses on the central role played by the Constitutional Court in mediating conflicts, a role that has become particularly relevant due to the limited effectiveness of intergovernmental dispute resolution mechanisms. Finally, the analysis concludes by looking forward, speculating on the potential future trajectories of Spanish fiscal federalism, and identifying room for further cooperation between the central government and the Autonomous Communities.

Traditionally a unitary country, the United Kingdom has progressively regionalized since the enactment of devolution in 1999, allowing for greater autonomy in its constituent nations, reflecting its internal diversity. In Chapter 10, Francisco Javier Romero Caro explores, from a legal perspective, the internal architecture of the United Kingdom's territorial funding arrangement, the Barnett formula, to investigate its integrative and disintegrative effects concerning Scotland. The chapter aims to evaluate if and to what extent the Barnett formula can be conceived as an instrument of nation-building that contributes to reducing territorial tensions and accommodating diversity, in the end reversing disintegrative trends. This is done by evaluating the integrative and disintegrative potentials of each element of the internal architecture of equalization mechanisms.

Overall, the book delves into the intricate relationship between diversity and intergovernmental fiscal relations, aiming to shed light on the mutual relationship between fiscal federalism and diversity accommodation and to understand the impact of the former on the latter, and vice versa. The preliminary assumption for this investigation is the recognition that fiscal federalism possesses both integrative and disintegrative potential, and the extent to which it achieves integration or disintegration hinges on its ability to effectively accommodate diversity or, alternatively, exacerbate dormant tensions. As such, comprising a compilation of chapters authored by recognized experts in the field, the book not only examines the central theme of intergovernmental fiscal relations through diverse case studies, but also lays the foundations for the establishment of a robust theoretical framework that shall enable to foster a comprehensive

exploration of this phenomenon from various perspectives. With contributions from disciplines such as law, economics, and political science, it presents a multifaceted analysis of fiscal federalism, thereby highlighting its intricate interplay with the accommodation of "diversities" and, consequently, paving the way for a comparative discussion on the role of fiscal arrangements in multilevel systems, particularly with regard to their capacity to ease diversity accommodation.

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Diversity and Asymmetric Arrangements as Drivers of Fiscal Federalism: A Comparative Overview

Hansjörg Blöchliger and Andoni Montes-Nebreda

Introduction

"Diversity" and "asymmetry" are closely intertwined with the analysis of fiscal federalism, or more broadly, the institutions of multilevel governance. While, diversity, and in particular its accommodation, is seen as one of the reasons why multilevel governance institutions have spread all over the world during recent decades (Gagnon & Tremblay, 2020), asymmetric arrangements, often explicitly enshrined in the institutional legal framework, are used in different countries as tools to pursue diversity accommodation (Sahadžić, 2020).

Although asymmetric arrangements are sometimes considered to be isolated features of a select few federations, it is increasingly recognised

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in scholarly literature as an intrinsic element of federalism (OECD, 2019; Sacchi & Salotti, 2014). In fact, even most formally unitarian but decentralised countries show some degree of institutional heterogeneity (e.g. United Kingdom, Italy, or Spain). Furthermore, in contrast to the critical view of asymmetric arrangements expressed by scholars such as Tarlton (1965) or Sorens (2015), the position towards them has recently become more favourable (Watts, 2000).

Still, despite the increasingly positive understanding of the core role of asymmetries within federalism, the difficulty of classifying and measuring them makes their analysis a particularly complex task. Identifying and translating cross-jurisdictional heterogeneities into comparable figures might seem challenging, but it is essential to exploring and establishing empirical relationships between federal arrangements on diversity and economic policies.

As pointed out by Romero Caro (2022), research on addressing diversity within countries has traditionally focused on constitutional and legal recognition of national identities and minority rights. Because of this, the literature has not paid much attention to links between diversity and fiscal aspects of federalism—despite their importance (Weingast, 2014). Acknowledging this gap, this book will address questions such as: To what extent has fiscal federalism—or more generally, arrangements of asymmetric fiscal decentralisation—had an impact in accommodating diversity? How does diversity affect intergovernmental financial relations?

This chapter introduces the underexplored fiscal federalism-diversity debate, and is organised as follows: after a brief introduction, the second section provides a definition of diversity and explores its role as a driver for fiscal federalism. It also discusses the limits of measuring diversity and asymmetry, and presents recent proposals to overcome these difficulties. The third section will focus on how asymmetric fiscal federalism arrangements can be used to accommodate diversity. The fourth section addresses how to measure diversity and asymmetric arrangements, presenting the OECD methodology to measure fiscal decentralisation, and proposes that it could be extended to measure asymmetries. Section five explores the relationship between diversity and asymmetries. The final section concludes by inserting the term "menu-federalism" into the discussion as a useful method for approaching the topic.

Drivers of Fiscal Federalism

Why do some countries embrace fiscal federalism? What key factors determine whether a country will become fiscally decentralised? In response to these questions, this paper identifies three main drivers of fiscal decentralisation. The first driver is *history*. Current institutions are shaped by the past, and sometimes react against an excessively centralised past. Regarding the former, the decentralised character of some European monarchies' rule, such as the Habsburgs' (Ingrao, 2019), during the Middle and early Modern Ages can still be perceived in the institutional frameworks of several European countries (e.g. Austria). Regarding the latter, decentralisation was set up in some other jurisdictions to break away from unitary and autocratic periods (e.g. Spain), as decentralisation was identified with transition towards democracy (Hooghe et al., 2016). Finally, traumatic historical events can also produce federated systems—as it was the case in Germany after World War II.

The second driver is *economic efficiency*. The Netherlands and some Nordic countries (Bos, 2013), transited towards more decentralised fiscal arrangements for the sake of economic efficiency. Consistently, decentralised arrangements provided local governments with more tax and/or spending power by following the subsidiarity principle, as suggested by the First Generation of Fiscal Federalism (Oates, 1999). Institutional reforms undertaken in recent years in Italy, France, or Portugal have moved in a similar direction and followed the same rationale. In these cases, the intermediate levels of government (regions) are meant to play a more relevant role, presenting a deeper federal tenor than in the former cases. Diversity may also play a role in economic considerations, as pursued efficiency gains will be larger the more heterogeneous jurisdictions are. Therefore, incentives for efficiency-promoting decentralisation will be more powerful the larger and more diverse jurisdictions are (Table 1).

Finally, *diversity* can be the third driver of fiscal decentralisation. Whether diversity has political, religious, cultural, or ethnic sources, federalism is often an opportunity to accommodate for this by granting minorities the possibility of self-government in policy areas such as education, or by guaranteeing that their voice is heard in federal policy debates. In addition, in recent years, economic disparities in development and per capita income have emerged as a new reason for fiscal decentralisation, as some jurisdictions have started calling for higher tax and spending

Table 1 Drivers of fiscal decentralisation/federalism

Historical causes	*Economic efficiency*	*Diversity*
• Federal or unitary tradition of monarchies • Historical shocks, such as World War II	• Subsidiarity principle: • Information gains • Policy mix diversity • Yardstick competition	• Cultural • Religious • Ethnic • Political • Economic disparities

autonomy (e.g. Lombardy, Veneto, and Emilia-Romagna in Italy, or Catalonia in Spain) or lower levels of fiscal equalisation (e.g. Alberta in Canada, or Catalonia and the Balearic Islands in Spain) based on economic strength.

What Does Diversity Mean?

Since "diversity" is recognised as one of the key determinants of federalism, it is important to define and classify this notion. According to the most basic definition, diversity refers to the existence of differences that can manifest within several of the following areas:

Cultural

Cultural diversity is usually defined by the coexistence of multiple languages within a community. Sometimes, one language will be predominant in the whole country, with other minority languages spoken in specific jurisdictions—such as in Spain, France, or the Netherlands. In other cases, the hegemonic language will differ across jurisdictions because the inhabitants do not all share a common language—as is the case in Belgium, Switzerland, and Canada. Although linguistic diversity is the most evident in the cultural field, cultural diversity can also include spaces such as artistic creation or mass and social media. If the population of a country shares no common language, its common spaces are at risk of fragmentation.

Religious

Faith is another area where diversity can be expressed. In a globalised context where international migration has become more common, no religiously homogeneous country exists anymore. While migration has not led to federalisation on the grounds of religion yet, pre-existing large-scale religious diversity is behind some institutional decentralisation reforms, particularly in African and Asian countries.

Ethnic

Cohabitation of different ethnic groups—such as minorities living heterogeneously across the territory of the country, or minorities that constitute majorities in specific jurisdictions—can also require specific federal accommodation. Ethnic differences are often deeply intertwined with differences in culture and religion. When this sort of diversity is not correctly addressed, tension between ethnic groups can lead to violent clashes and even civil wars or secession. Examples of federations brought about by ethnic diversity can be found in South Africa, Bosnia Herzegovina, Ethiopia, and Pakistan.

Political

These aforementioned differences often encourage political diversity. Probably the most evident sign of political diversity is the creation of so-called non-national political parties and social organisations, such as trade unions. These organisations do not operate in all jurisdictions, and only participate in elections in territories that share common characteristics and goals. These features can oscillate between the existence of a differentiated/separated national feeling, or a deep fragmentation caused by cultural, religious, or ethnic diversity. The Belgian case best exemplifies political diversity, although its fragmentation is caused largely by linguistic differences. Political diversity brought about by contested notions of nationhood also exists in Spain and the United Kingdom.

Economic

Finally, diversity can refer to differences in economic performance. Income per capita and levels of development play a crucial role, but so

do the relevance of certain economic sectors, labour market performance, and demographic structure. Low-income jurisdictions will often call for lower levels of decentralisation or higher shares of federal equalisation, whereas high-income jurisdictions will call for the opposite (Blöchliger & Vammalle, 2012). When economic disparities become unbearable, demands for asymmetric arrangements become more likely. Both the asymmetric devolution process in the United Kingdom and the special autonomy status provided to some northern Italian regions are good examples of this phenomenon, both of which grow in significance as territorial inequalities increase.

Measuring Diversity and Asymmetric Fiscal Arrangements

Little attention has been paid to the question of diversity measurement within decentralisation literature. To address this, Mathieu and Guénette (2017) proposed the Societal Culture Index, which consists of twelve indicators grouped into six pillars. This composite index measures the degree of autonomy that multinational federations provide to minorities so they can sustain their "societal culture". However, this index does not measure diversity itself. The presence of constitutional asymmetries that can be found among the set of proxies is used to measure national recognition. The authors computed the Societal Culture Index using Catalonia, Quebec, and South Tyrol as examples.

A suitable design for a Federal Diversity Index could calculate a composite indicator based on items for the four diversity categories enumerated in previous paragraphs (cultural, religious, ethnic, and political), together with proxies for economic disparities. We propose structuring this index around three main pillars: existence of diversity, depth of diversity, and fragmentation (Table 2).

Asymmetries in Fiscal Federalism Arrangements

Adequate diversity management is often key for countries to prevent secessionist pressures and remain united (Alesina & Spolaore, 2005; Tarlton, 1965). Because federalism provides multiple tools to respond to the need to account for diversity within the institutional framework, it is often presented as an intermediate alternative to both unitary and

Table 2 Proposed criteria for a federal diversity index

	Existence/size of diversity	*Depth of diversity*	*Fragmentation*
Cultural	Number of minority languages spoken	Share of population that speaks a minority language	Share of population that does not speak the majority language
Religious	Number of minority religions professed	Share of population that professes a minority religion	Share of population that lives in a jurisdiction where professed minority religion is hegemonic
Ethnic	Number of minority ethnic groups	Share of population that is part of an ethnic minority group	Share of population that lives in a jurisdiction where a minority ethnic group is the majority
Political	Number of jurisdictions contested by non-national parties	Share of vote held by non-national parties	Share of population that lives in a jurisdiction governed by a non-national party
Economic	Ratio largest/smallest jurisdiction in population terms	Variance of regional income per capita	Share of population that lives and works in the jurisdiction where it was born (lack of labour market geographical mobility)

Source Own elaboration

secessionist calls. Federalism's main benefit is its capacity to provide differentiated responses to diverse situations. Indeed, according to the first generation of authors of the theory of fiscal federalism (Oates, 1999), the main difference between the unitary and decentralised models is the unitary state's lack of capacity to provide geographically tailored policies. Policy-tailoring is just one kind of beneficial asymmetric arrangement available for federations.

What Is Meant by Asymmetry?

Congleton (2015) defines asymmetric decentralisation as an arrangement whereby different subnational governments of the same level have different political, administrative, or fiscal powers. Other authors have a

broader understanding of asymmetry. According to Watts (2000), asymmetries are the varying degrees of autonomy and power that represent the political expression of diversities. Accordingly, Watts (2000) classified asymmetries according to four criteria:

- Politically or capacity-driven asymmetries: while the former would be driven by diversity, the latter would respond to economic efficiency reasons. For example, better fiscal or human capital endowments could encourage the recognising of higher decentralisation levels within large municipalities.
- *De jure* or de facto asymmetries: constitutionally declared institutional heterogeneities versus asymmetries which emerged from the distinct application of a homogenous legal framework.
- Central or peripheral asymmetries: Canada or Australia are some examples of federations that provide a lower level of decentralisation to peripheral "centrally administered territories" where fewer people generally live, in contrast to central or core jurisdictions. This criterion could also be applied to analyse federal models where it is the federal/central government that governs the capital region, as is the case of the United Kingdom.
- Temporary or permanent asymmetries: asymmetries that are temporarily enforced during the first years of federal reforms and which become consolidated over time (e.g. in Spain).

In accordance with this classification of asymmetries, Watts (2000) proposed nine main areas from which asymmetries are likely to emerge:

- Population, territory, and wealth.
- Degree of autonomy and powers.
- Fiscal power.
- Representation in federal institutions.
- Particular bilateral negotiation for intergovernmental relations.
- Role of regional political parties.
- Degree of uniformity on the application of the constitutional block.
- Importance placed on the constitutional amendment process.
- Degree of uniformity imposed on subnational constitutions.

This list goes far beyond fiscal institutions, as it provides a comprehensive overview of potentially asymmetric institutional arrangements in federal or quasi-federal/regional countries. Table 3 provides a list of asymmetries in the fiscal domain in several federal, quasi-federal, or regionalised countries. Since this chapter deals mainly with asymmetries in the fiscal domain, we will follow the categories as established by the OECD (2020).

Measuring Fiscal Decentralisation

It is said that as many federal models exist as there are federal countries, meaning that although similarities across federal arrangements occur, identical fiscal decentralisation frameworks do not exist. These country-by-country specificities and nuances add complexity, which makes measuring and comparing fiscal decentralisation arrangements difficult. In addition, the multi-faceted character of decentralisation makes it challenging to capture existing distinctiveness through a single indicator (Blöchliger, 2015). In this section, some of the most commonly used quantitative variables will be enumerated and their limits discussed, then recently developed qualitative indicators will be proposed as an alternative approach. This will be done for four main fiscal decentralisation arrangements examined by the OECD (2020): public expenditures, revenue, fiscal constitutions, and asymmetries.

Expenditure Autonomy

Subnational public expenditure share is the most common variable used to quantitatively describe degree of decentralisation within government budgeted spending. A higher rate of subnational spending is interpreted as higher spending autonomy for local and intermediate government levels. In addition to aggregate spending figures, recent OECD data offers separate numbers for ten policy areas under the Classification of Functions of Government (COFOG) criteria.

$$\frac{\text{Subnational public spending}}{\text{Total public spending}}.$$

However, although these ratios can offer a glimpse of the extent to which subnational governments are decentralised, they fail to capture the

Table 3 Examples of asymmetric fiscal institutions in decentralised countries

	Canada	*Spain*	*Indonesia*	*Italy*	*United Kingdom*
Tax autonomy	Provinces can delegate tax collection to Canada Revenue Agency	Basque Country, Navarre, and Canary Islands have greater tax autonomy than the rest of the regions		Five regions (Aosta Valley, Friuli-Venezia-Giulia, Sardinia, Sicily, and Trentino-Alto Adige/Südtirol) are entitled to a (varying) share of national taxes collected on their territory. Additionally, they are vested with more tax authority over devolved taxes when compared to ordinary regions	Scotland and Northern Ireland have greater tax autonomy than Wales. No devolution at all in England
Spending autonomy	Menu-federalism. Provinces can either opt in or opt out of some responsibility areas For example, Quebec has its own pension system	The Ceuta and Melilla city-regions have less spending autonomy than the rest of regions (e.g. healthcare and education provided by CG). Local spending responsibilities vary depending on size	Five provinces have a special status, with greater autonomy. Local spending responsibilities depend on size	The five regions with special status have on average greater competences and as such, wider spending autonomy. However, the extent to which this occurs varies from case to case, as every special entity bilaterally negotiates with the State the competences that each one of them is vested with	Scotland has greater autonomy over social protection spending

(continued)

Table 3 (continued)

	Canada	*Spain*	*Indonesia*	*Italy*	*United Kingdom*
Regional funding system	Different arrangements for provinces and territories	Foral regions are excluded from equalisation. A particular arrangement exists for Canary Islands within the regular funding system	Particular funds for special status provinces	The five regions with special statutes have lower transfer dependency	The three devolved governments are funded through the so-called block grants, which get updated according to the Barnett formula. However, this leads to large differences in transfers received
Local funding system	Particular local funding model for each province/ territory	Different arrangements for large, small, and touristic municipalities, and for those located in foral regions	Specific "Village Fund", which is a local equalisation fund targeted at small and rural villages	All Northern special regions oversee local finance, whereas in all the others (ordinary regions plus Sicily and Sardinia) this depends on the central authority	Metropolitan devolved authorities and City-Regions enjoy larger autonomy than regular cities, as well as special funding arrangements

Source Own elaboration

actual degree of autonomy (Blöchliger & King, 2007; OECD, 2021), and can lead to misleading results. Ratios explain which level of government executes expenditure or provides funding for public services, such as healthcare or education, but neglect to explain which level of government sets access and provision requirements, determines staff compensation, purchases supplies, or how much oversight higher levels of government exert. All these elements, not just funding, define what constitutes the actual level of subnational spending autonomy.

Therefore, considering the limitations of purely quantitative methodologies based on National Account Statistics, scholars have proposed alternative approaches based on qualitative measures in order to shed some light into this issue. The spending autonomy indicators developed

by Dougherty and Phillips (2019), based on the Bach et al. (2009) classification of spending autonomy, represent a good example. This approach identifies a series of measurable indicators by codifying survey responses (Fig. 1).

This exercise is carried out for five policy areas: education, long-term care, transport services, housing, and healthcare, which are among the most frequently decentralised policy areas. Both the sub-indicators within policy areas and the aggregate indices for the five policy areas are computed by applying two alternative aggregation methods. First, there is the random weights method—which in this case assumes that all indicators should have the same relevance in determining indicator's final values. Next is the country-product dummy method—which is meant to address problems of missing values by taking into account country, autonomy aspect, and policy area fixed effects. Because both approaches are very similar, only the outcomes of the latter approach (country-product dummy method) will be reported here.

As noted in Fig. 2, there is a strong correlation between the degree of spending decentralisation reported by both approaches. Overall, the quantitative approach usually overestimates the actual subnational spending capacity, as it disregards SNG's (subnational governments)

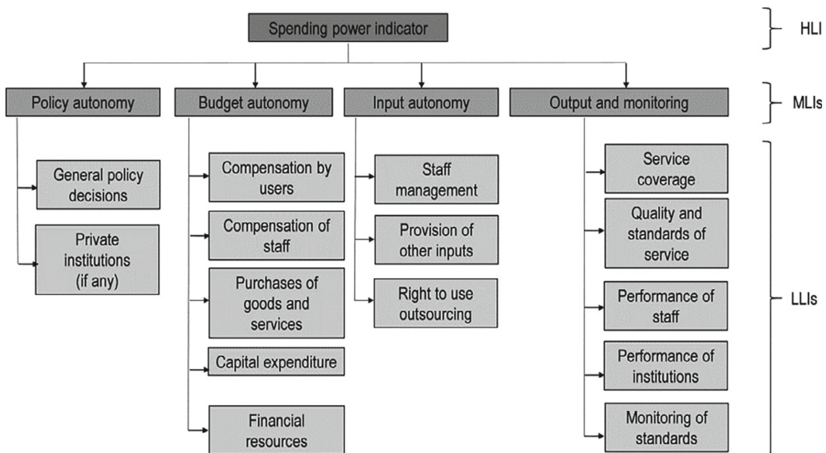

Fig. 1 Set of indicators used by OECD's spending autonomy composite index (*Source* Dougherty & Phillips, 2019)

actual decision-making capacity over the money spent. This upward bias is particularly noticeable in the case of Iceland. Conversely, the quantitative approach seems to underestimate the actual sub-central spending power in the United Kingdom and New Zealand, where low budgetary figures do not adequately represent actual spending autonomy.

Following the same rationale, Kersting et al. (2020) adapt OECD's methodology to the context of Catalonia in Spain and provide figures for spending autonomy on healthcare, education, and social protection. The overall results portray actual autonomy as being lower than suggested by purely quantitative variables, as is the case in most other OECD countries. Finally, other qualitative spending autonomy measurement methodologies can be found for education (OECD, 2004), healthcare (Paris et al., 2010), and the aggregate of public policies (Abdelhak et al., 2012).

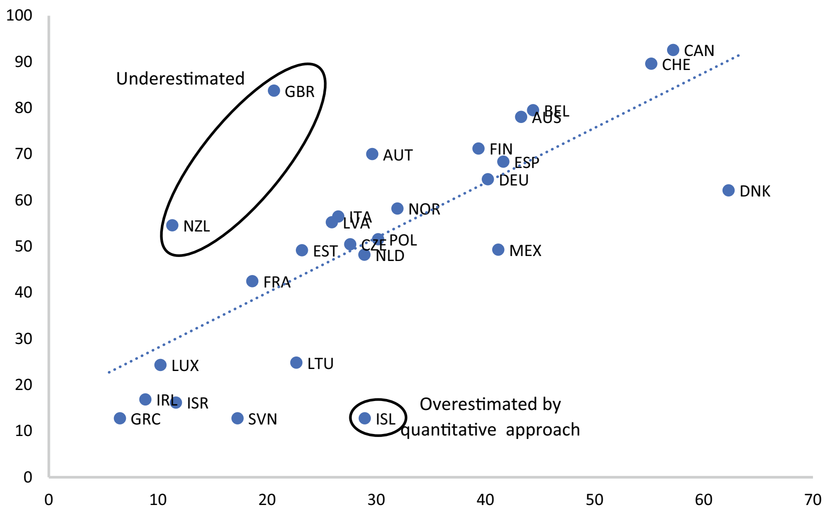

Fig. 2 Qualitative (*y*-axis) vs. quantitative (*x*-axis) spending decentralisation (2019) (*Source* Authors' calculation, based on OECD [2021] data[1])

[1] *Note* Quantitative figures report subnational spending out of total public spending for 2019, while qualitative figures report estimates of the composite indicator for spending autonomy using the country-product dummy approach. Line represents the linear trend.

Despite the unquestionable usefulness of composite indicators to describe complex information in a synthetic way and to allow cross-country comparisons, some authors have expressed concern about its implementation. Usually, this criticism points out the high discretion of their design and that aggregation can sometimes lead to important information losses (Mazziotta & Pareto, 2013).

Regarding asymmetric arrangements in expenditure autonomy, the variable to observe would be the variance of expenditure autonomy across regions. To calculate this, it would be necessary to access data regarding levels of expenditure autonomy not only at the country-aggregated level, but also on a region-to-region basis. Although this approach is currently possible for individual countries, the lack of cross-regional comprehensive databases on subnational public finances makes it impossible to compute quantitative results.

Revenue Autonomy

The share of subnational tax revenues is the variable that has traditionally been used to measure the degree of tax autonomy granted to local and regional/state governments. Naturally, the higher the share of total tax revenue determined, collected, or owned by local and regional governments, the higher the degree of tax autonomy.

$$\frac{\text{Subnational tax revenue}}{\text{Total tax revenue}}$$

However, this quantitative indicator has some shortcomings when determining the actual level of tax autonomy. For instance, it does not clarify whether the design and/or collection of decentralised tax revenues are shared across levels of government or not, or which tax elements (rates, brackets, bases, breaks, reliefs) and steps of the taxing process (legislation, administration and collection, inspection) the SNGs control.

The OECD tried to address this issue by designing a taxonomy of taxing power that could help better understand what is the actual power of SNGs to determine revenues. According to this definition, the highest level of tax autonomy is where the SNG has full authority over tax rates and tax bases, which includes the power to set the rates of taxation and to define what constitutes the tax base. By contrast, tax-revenue sharing schemes are considered to be the decentralisation approach which provides the lowest level of autonomy. It should also be noted that, as

pointed out by Blöchliger and Kantorowitz (2015), even when qualitative indicators suggest high levels of tax, SNGs could be discouraged to make use of it through centrally set tools such as intergovernmental transfer schemes (Table 4).

Table 4 OECD taxonomy of taxing power[2]

Category	*Description*
Autonomy over tax rates and reliefs	The recipient SNG sets the tax rate and any tax reliefs without needing to consult a higher-level government
	The recipient SNG sets the rate and any reliefs after consulting a higher-level government
Autonomy over tax rates	The recipient SNG sets the tax rate, and a higher-level government does not set upper or lower limits on the rate chosen
	The recipient SNG sets the tax rate, and a higher-level government sets upper and/or lower limits on the rate chosen
	The recipient SNG sets the tax rate, and a higher-level government sets limits on the annual revenue or levy increase
Autonomy over tax reliefs	The recipient SNG sets tax reliefs
Tax-sharing arrangements	There is a tax-sharing arrangement in which the SNGs determine the revenue split
	There is a tax-sharing arrangement in which the revenue split can be changed only with the consent of SNGs
	There is a tax-sharing arrangement in which the revenue split is determined in legislation, and where it may be changed unilaterally by a higher-level government, but less frequently than once per year
	There is a tax-sharing arrangement in which the revenue split is determined annually by a higher-level government
Central government sets tax rates and reliefs	The recipient SNG has no control over either the tax rate or tax reliefs

Source OECD (2021)

[2] Alternatives within each category are ordered from highest to lowest tax autonomy level.

Figure 3 compares the subnational revenue shares with subnational tax autonomy of a selection of OECD member countries. While the former variable includes all tax revenue entering SNGs' budgets (including those coming from tax-sharing schemes, thus without autonomy over tax design), the latter variable includes only revenue streams over which SNGs can determine tax rates or tax reliefs. Again, there is a strong correlation between results for both approaches. Larger differences are recorded in the cases of Germany, Latvia, United States, Poland, and Canada, with little to no variance in the rest of the countries considered. The German case is particularly remarkable, as it ranks fifth using the revenue share (quantitative) approach but is considered highly centralised if the tax autonomy indicator is used. This can be explained by the fact that the largest revenue flows for German SNGs come from a share in the PIT and VAT, whose design SNGs can only change collectively in the Bundesrat.

The same difficulties when measuring asymmetric arrangements in spending autonomy also influence measuring revenue autonomy. Information about the decision-making power each subnational jurisdiction is

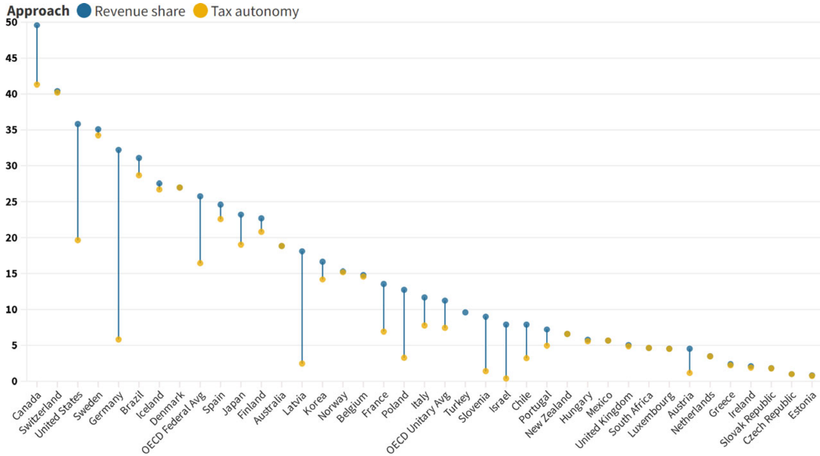

Fig. 3 Subnational revenue share (% out of total) vs. subnational tax autonomy (2018) (*Source* Own elaboration, based on OECD [2021] data[3])

[3] *Note* subnational tax autonomy is measured as the share of subnational revenue over which SNGs do have power regarding tax rates and reliefs, or just tax rates.

vested with regarding each tax figure is necessary for this model. Once this information is gathered, tax autonomy variance can be computed as a proxy for revenue asymmetries. The highly data-demanding nature of this exercise explains why it has not been attempted yet.

Intergovernmental Fiscal Transfers

Intergovernmental fiscal transfer schemes are intrinsic to every federation or fiscally decentralised jurisdiction. Indeed, when spending autonomy is larger than tax autonomy—a phenomenon called "vertical fiscal imbalance"—transfers are required to address this imbalance. Transfers can also reduce disparities in tax capacity and spending needs across jurisdictions. Such transfers are usually known as "fiscal equalisation". It is relatively common for transfers designed to close vertical and horizontal imbalances to be intertwined within the same intergovernmental transfer framework.

Traditionally understood quantitative ratios measure the share of subnational budget covered by intergovernmental transfers. Dependence ratios can be computed based on both income and expenditure statistics. However, the actual autonomy which transfers grant to SNGs can vary according to their design. For example:

- Are grants earmarked for a specific policy area or programme?
- Are transfers paid as block grants, or as matching grants?
- How are transfers funded? Which level of government pays for transfers (vertical/horizontal)?

The transfer programmes that provide the greatest level of autonomy are non-earmarked grants, as they come without strings attached. Generally, fiscal equalisation transfers fit this description. Block grants also provide significant levels of autonomy. Conversely, earmarked grants, which must be devoted to pursuing centrally defined policy objectives, and matching grants, whose amount varies together with the funding devoted by SNGs, allow the central government to exert a stronger control over subnational entities. Finally, when transfers are horizontal, meaning they are funded by revenue raised by the same level of government that will receive them, less central control is exerted—although even horizontal transfer schemes are usually arranged by the federal government.

Different visualisation strategies help to better compare intergovernmental fiscal transfer arrangements across countries. Figure 4 displays the amount of fiscal equalisation measured as a percentage of total government expenditure. Among the selected OECD countries, Australia, Japan, Germany, and Korea are the ones where the size of equalisation is largest with respect to total expenditure carried out by the public sector. Still, there are also differences across these countries—as Japan and Korea heavily rely on cost equalisation, while the German equalisation system is mainly based on revenue equalisation.

Some countries deliberately apply several equalisation models or formula when disbursing transfers across jurisdictions, resulting in different levels of per capita funding. Examples of such asymmetries can be found at the regional level in Spain, the United Kingdom, Canada, and Italy. They are even more common at the local level, when rural, depopulated, or small municipalities are supported by a different transfer scheme than large and dynamic cities and capitals—as is the case in Canada or Spain. Some asymmetries might also be implicit and the result of inconsistent transfer formulas, such as when revenue disparities increase rather than decreasing after transfers.

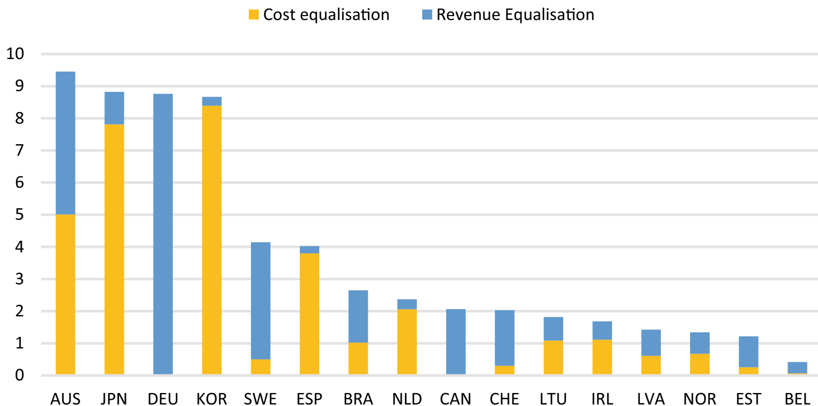

Fig. 4 Cost and revenue equalisation (% of total government expenditure) (2017) (*Source* OECD, 2021)

When looking for a feasible measure for asymmetric intergovernmental fiscal transfer arrangements, variance among SNGs in funding per capita—adjusted to differences in spending needs–may represent the best choice. This could be a less data-intensive approach and would capture disparities coming from both explicit and implicit asymmetries.

Fiscal Constitutions

Fiscal constitutions are defined as the set of rules and frameworks which guide fiscal policy and are enshrined in fundamental laws (Blöchliger & Kantorowitz, 2015), such as federal constitutions or high-ranking institutional laws—often known as basic or organic laws—which enjoy a quasi-constitutional status. As this concept is so broad, scholarly literature has devoted efforts to systematise its analysis by elaborating a list of measurable elements of fiscal constitutions. For instance, following the rationale for qualitative composite indices previously examined, Blöchliger and Kantorowitz (2015) identified five building blocks of fiscal constitutions, and a set of indicators that could help to quantify "decentralisation" in each of those blocks:

- Autonomy: the extent to which SNGs can design and implement their own fiscal policy.
- Responsibility: the degree to which SNGs are subject to budget constraints and must face the consequences of their own fiscal policy.
- Co-determination: the extent to which SNGs participate in federal fiscal policy determination.
- Budget frameworks: the degree to which fiscal rules and budgetary stability and financial sustainability frameworks constrain discretionary fiscal policy across government levels.
- Stability: ease with which fiscal constitutions can be reformed (Fig. 5).

By pairing each fiscal constitution block with a series of indicators, the authors can build a composite index. The proposed composite index allows the classification of fiscal constitutions into three different types: integrated, quasi-decentralised, and decentralised fiscal constitutions. In addition, Blöchliger and Kantorowitz (2015) compute two more related variables. First, the "completeness" index measures whether a certain

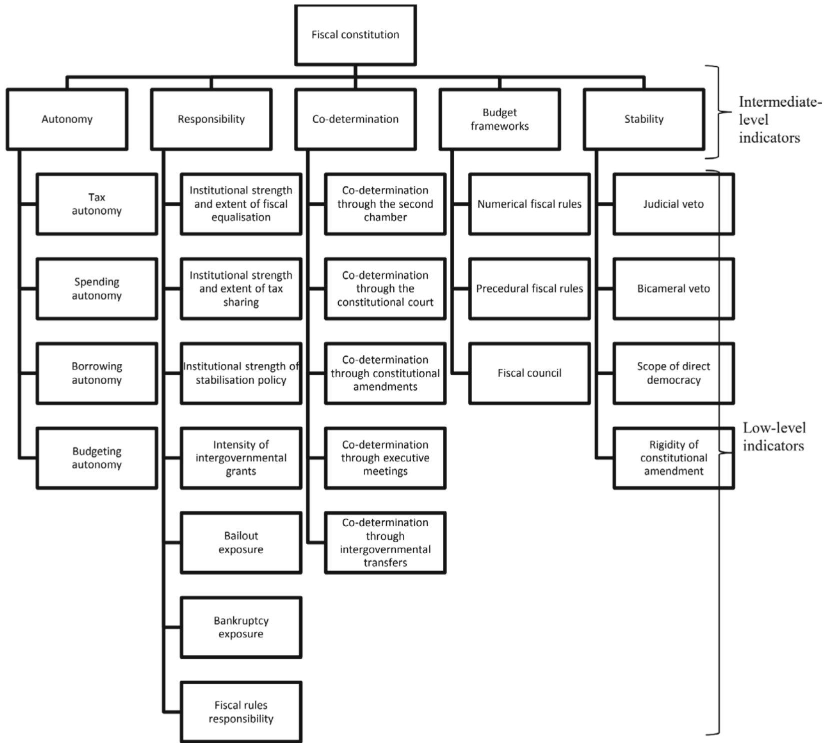

Fig. 5 Fiscal constitutions, Indicator tree (*Source* Blöchliger & Kantorowitz, 2015)

feature (e.g. transfers, fiscal rules, councils) is listed in the fiscal constitution or not. Second, the "coherence" index measures whether fiscal constitutions provide similar degrees of autonomy across the five building blocks, with more balanced and coherent decentralisation schemes being preferable.

Figure 6 presents the results of the degree of constitutional decentralisation and its coherence between the five building blocks. While the United States, Canada, and Switzerland reach the highest constitutionally guaranteed values of decentralisation (represented by the numerical value of the diamond), India, Canada, and Spain feature the highest level of constitutional coherence (represented by the length of the vertical

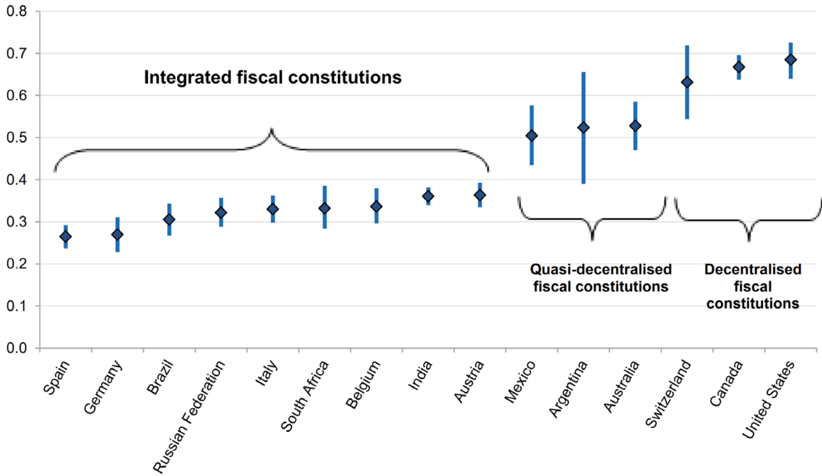

Fig. 6 Degree of constitutional decentralisation and coherence (*Source* Blöchliger & Kantorowitz, 2015)

bar). Argentina's and Switzerland's constitutions are relatively incoherent, in that they combine elements of high and low decentralisation across constitutional building blocks.

Fiscal constitutions emerge as the key explanatory element in all the asymmetric arrangements examined before—as tax and spending autonomy, intergovernmental transfers, and fiscal rules are determined by fiscal constitutions. Indeed, replicating the constitutional decentralisation degree composite indicator across subnational jurisdictions would provide an answer to the question of the level of asymmetries within a country in qualitative terms.

Exploring the Relationship Between Diversity and Asymmetry

Do asymmetric arrangements necessarily mean higher inequality? And do asymmetries feed diversity? These questions have become a key issue in the debate on the political economy of federalism (Bird & Ebel, 2006; Martínez-Vázquez et al., 2017). To empirically explore the links between diversity and asymmetries, it would be necessary to compute and to

measure the degree of asymmetry in fiscal federalism frameworks. Since empirical studies on this topic have not been carried out so far, we will consider the topic from a theoretical point of view.

Does Diversity Accommodation Necessarily Lead to Larger Asymmetries?

Previous sections have presented asymmetries as a tool to address diversity. But does diversity have to be addressed by setting up asymmetric arrangements? In our view, two conditions need to be fulfilled: diversity needs to be "geographically concentrated" and the baseline degree of decentralisation of the country needs to be lower than that demanded by the jurisdictions that host the minority group. Our analysis assumes the existence of democratic inclusive institutions, as it is difficult to envision that calls for higher decentralisation driven by diversity would be taken seriously by an authoritarian regime.

When only one jurisdiction is different, and thus diversity is heavily concentrated (e.g. the French-speaking minority in Canada in the province of Quebec, and, to a lesser extent, political diversity across entities in the United Kingdom), asymmetries are more likely to arise—as long as the overall degree of decentralisation within the federation as a whole does not satisfy the desire for autonomy within that jurisdiction. When diversity is scattered across virtually all jurisdictions (e.g. ethnic diversity in India, linguistic diversity in Belgium), then federalism is likely to be symmetric. Even if diversity is "concentrated", no asymmetric arrangements will be needed if the level of decentralisation provided to all jurisdictions is at least as high as the level of autonomy claimed by the dissenting jurisdiction (Congleton, 2015) (Fig. 7).

However, the fact that asymmetries are less likely to be established when diversity is scattered across jurisdictions does not necessarily imply that managing diversity in that federation will be easier. In fact, each minority group could have different needs and the focus of their demands could be very different. Vice versa, when diversity is concentrated, it can be easier to identify a region's specific needs and provide targeted solutions to accommodate them, even if they translate into higher asymmetries.

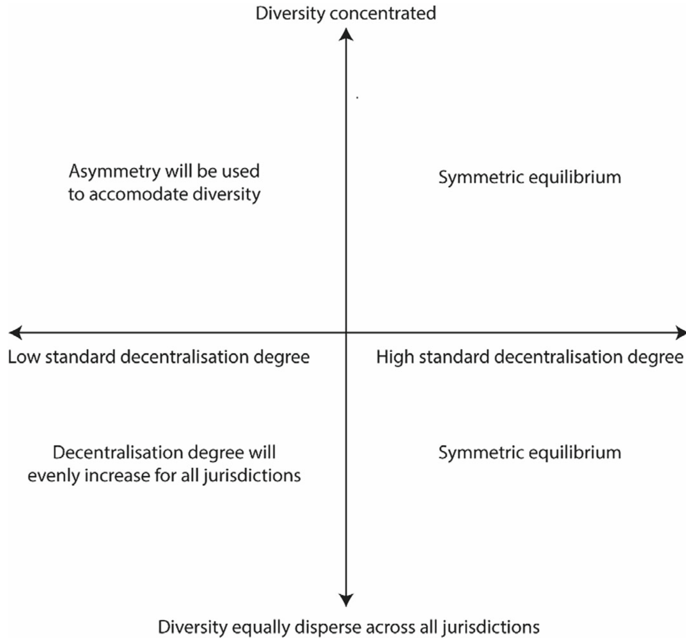

Fig. 7 When are asymmetric arrangements used to address diversity? (*Source* Own elaboration)

Does Asymmetry Contribute to Increased Disparities?

When focusing on fiscal federalism, political diversity and economic disparities are the two types of diversity directly involved. In particular, the discussion surrounding diversity and asymmetries usually deals with attitudes towards interjurisdictional inequality. In addition, during recent decades, a decrease in cross-country inequalities has been accompanied by increasing levels of inequality within countries themselves (Bartolini et al., 2016). Because of this, the relationship between decentralisation, asymmetries, and the rise of economic disparities has gained increasing attention.

Some scholars have tried to disentangle the fiscal decentralisation-inequality link, with results being contradictory and often dependent on the context, data, or methodology used (Martínez-Vázquez et al., 2017). Additionally, a lack of data has hindered studies which focus on the

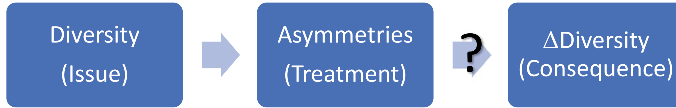

Fig. 8 The diversity-asymmetry vicious circle (*Source* Own elaboration)

relationship between asymmetry and inequality. At first glance, explicit asymmetries that provide different treatment to some subnational jurisdictions could result in an increase in economic and/or political disparities. However, even if asymmetries represent a policy response to accommodate diversity, a vicious circle could still emerge: to accommodate diversity, asymmetric arrangements would be set up, which could then lead to disparities rising further, until any scope for further asymmetry would be exhausted. For instance, this is the conclusion reached by Ishiyama (2022) regarding Ethiopian asymmetric ethnic federalism (Fig. 8).

However, there is no empirical evidence that asymmetric fiscal federal arrangements result in greater political or economic disparities than symmetric fiscal decentralisation (see Martínez-Vázquez et al., 2017 about the likelihood of emergence of subnational political parties). In addition, the implicit asymmetric results of formally symmetric institutional arrangements also potentially lead to similar consequences. As an example, regional policy provided by unitary governments, although being formally "symmetric" as the same investment allocation formula is applied to all territories, translates into uneven allocation. Indeed, low-income jurisdictions will receive proportionately more funding, as the aim of the policy is to close the development disparities among different regions. This is just an example of how formally symmetric policies could provide asymmetric results while, if successful, producing a disparity-decreasing effect at the same time.

As it is not clear which cause determines the outcomes of the asymmetry-diversity relationship, literature on the subject is divided. Watts (2000) or Brand (2008) defends the positive aspects of asymmetries for diversity accommodation—offering a long list of examples of de facto and *de jure* asymmetries. On the other hand, Tarlton (1965) or Sorens (2015) warns about the risks of asymmetries for the political stability of federations. In their view, asymmetries might make preserving harmony and unity difficult, and thus strengthen calls for symmetrical arrangements. Similarly, Bird and Ebel (2006) postulate that asymmetries could heighten

feelings of comparative affront or discrimination within the regions where special regimes are not applied, thus aggravating the political conflict that asymmetries aimed to ameliorate.

These risks could be particularly serious in cases where calls for asymmetric arrangements do not emerge due to cultural, religious, ethnic, or political diversity, but instead as a consequence of economic disparities. In fact, recently observed movements calling for differentiated fiscal arrangements for subnational jurisdictions have sprung up in high-income regions, such as in northern Italy or in the Spanish region of Catalonia. Following a similar rationale which aimed at lowering federal redistribution, the high-income Canadian province of Alberta held a referendum in 2021 debating whether equalisation payments should be eliminated from the Constitution.

Accommodating Diversity: Is Menu-Federalism the Solution?

This chapter has examined the existence of several kinds of diversity and the potential ability of asymmetric federal arrangements to accommodate them. However, asymmetric arrangements also carry risks. In this context, the key challenge lies in how to make use of asymmetry for diversity accommodation in a way that is fair. Fiscal federalism institutions have two tools that could contribute to the solution: fiscal equalisation and menu-federalism.

Fiscal equalisation represents the main instrument for horizontal federal redistribution. This transfer programme aims to ensure that disparities in tax capacity and needs across territories do not translate into large differences in access to and quality of local public services. In addition, to correct efficiency-related issues—such as intergovernmental spillovers or excessive tax competition—fiscal equalisation transfers could ensure that the consequences of asymmetries in fiscal decentralisation do not reach levels that are harmful for political stability. Indeed, even if different arrangements would be applied in different jurisdictions, disparities in results would be nuanced, making asymmetries compatible with the perception of common regime territories that the system is fair.

However, there are some concerns about the usefulness of fiscal equalisation. First, asymmetries could also alter the redistributive power fiscal equalisation arrangements have. Second, fiscal equalisation is commonly contentious. Finally, even if fiscal equalisation achieves equitable results

in terms of access to and quality of local public services, that does not necessarily imply that perceptions will match reality. In fact, as it is quite common to mix up fiscal equalisation's actual objectives with those of regional policy—namely to decrease territorial economic disparities—(Dougherty et al., 2022), a successful fiscal equalisation programme that operates in a country with large economic disparities may be wrongly perceived as ineffective. Regional policy might emerge as a viable alternative to fiscal decentralisation institutions as a whole, because this arrangement would be perceived as being "fairer", despite the existence of asymmetries.

Menu-federalism involves designing fiscal federalism arrangements *à la carte* for each subnational jurisdiction. For example, it allows each SNG to unilaterally decide on the desired level of tax autonomy, and thus on the degree of transfer dependence desired. Interestingly, Bell et al. (2021) propose a creative approach to menu-federalism that combines autonomy-on-demand with fiscal co-responsibility. This means that incentives are employed to discipline the use of autonomy by requiring that SNGs face the consequences of their fiscal policy. This way, menu-federalism would allow for the existence of asymmetrical fiscal arrangements, without incurring the risk that the public would perceive these arrangements as discriminatory. In fact, all jurisdictions would have the possibility to devise their own arrangement, thereby reinforcing the legitimacy of the model.

These alternatives demonstrate that, overall, the existence of asymmetries does not necessarily have to be regarded as undesirable, as there are several ways to prevent redistributive side-effects. If asymmetries are coupled with fiscal equalisation, regional policy, or menu-federalism, they could preserve systemic fairness. Despite this, it must be noted that asymmetries are likely to make federalism a more complex institutional framework.

As this chapter notes, more data on diversity and asymmetries is needed. Otherwise, it is impossible to produce empirical evidence on this relationship. A novel approach could depart from the current index on fiscal constitutions by extending the current methodology used to determine the degree of decentralisation to the subnational level. Comparing variance across jurisdictions could provide a glimpse of the extent to which asymmetric arrangements are in place. This exercise could be complemented by adding new indicators to calculate the existence, relevance, and depth of differential treatment given by fiscal federalism frameworks to certain subnational jurisdictions. Asymmetries would thus

be detected where tax and spending autonomy differs across territories, or where special/charter regimes were reported. The more pronounced these heterogeneities and the greater the number and size of jurisdictions affected, the more significant the asymmetries are.

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Fiscal Equalization in Australian Federalism: Managing Diversity of Size Among Subnational Jurisdictions

Will Sanders

Introduction

Fiscal equalization between subnational jurisdictions has been an important part of Australian politics and public policy since its establishment as a federation in 1901, growing stronger over the decades through developments in the 1930s and 1980s. In recent years, Australia has been recognized internationally as having one of the strongest systems of fiscal equalization among federations worldwide (Brenton, 2020; Dougherty & Forman, 2021). However, this may now be changing. Following legislation in 2018, Australia's system of full fiscal equalization between subnational jurisdictions, which has lasted four decades, is transitioning to one of partial equalization over a six-year period to 2027. These changes are discussed in the penultimate section. Earlier sections provide an historical account spanning 130 years before the current changes.

Historically, Australian fiscal equalization has managed the diverse sizes of the subnational jurisdictions, primarily in population, but also in

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economy and land area. Of concern has been the relative financial needs and capacities of different jurisdictions, both to raise revenue and to spend on services in a way that sustains some sense of commonality across the Australian polity. How this concern has been overtaken by the current change is suggested in the last two sections.

This chapter begins with the six self-governing British colonies that came together at the end of the nineteenth century to constitute Australia as "one indissoluble federal Commonwealth."[1] It progresses through the early twentieth century to the formation of the Commonwealth Grants Commission (CGC) in 1933, which then advised on six-way division of revenues between the states for the next 50 years. A subsequent section notes the addition of two new subnational jurisdictions in the 1980s, two territories of the Commonwealth granted local self-government. This increase from six to eight constituent units also increased the diversity among subnational jurisdictions and coincided with the CGC's development of a more generalized method for achieving fiscal equalization among them.

Late in the chapter, two divergent cases are explored that have emerged during this period of eight-way fiscal equalization, shaping Australian fiscal federalism into the twenty-first century. The first case concerns the least populous of the Australian subnational jurisdictions, the Northern Territory, with 1% of the national population spread across 17.5% of the national land area. With over a quarter of its population being Indigenous, the Northern Territory has raised questions for Australian federal finances that have not loomed so large in other subnational jurisdictions. The second case explores how a jurisdiction that was once regarded as "small," Western Australia, has become financially "big" and has used this new status to challenge the established system of full fiscal equalization between subnational jurisdictions.

[1] This phrase comes from the Preamble to the *Commonwealth of Australia Constitution Act 1900*, passed by the British parliament in Westminster at the request of the federating colonies. Sections of this Act are cited extensively through this chapter without further referencing.

Constitutional Origins: Foundations for Commonwealth Financial Dominance

In the 1850s, five British colonies in the east and south of the Australian continent were granted self-government: New South Wales, Victoria, Queensland, Tasmania, and South Australia. This self-government was still overseen by Britain however, and by the 1880s a federation movement had emerged focused on the idea of replacing continuing British authority with a central Australian parliament. By 1890, this Australian federation movement had developed to the point of holding conventions of colonial politicians who developed and debated drafts of a constitution for the proposed new Australian parliament. Additionally in 1890 a sixth British colony on the Australian continent, Western Australia, was also granted self-government and began sending representatives to these federation conventions.

As early as the first convention in 1890, it was agreed that the "basic principle" for "distributing powers" between the two levels of Australian government would be that a limited set of specified functions would be assigned to the new central parliament and that "residual powers" would remain with the self-governing colonies that would become states (Norris, 1975, p. 4).[2] This was seen as following the model of the United States of America and rejecting the centralist model of Canada "which delegated powers to the Provinces and left the residue to the national parliament" (Norris, 1975, p. 4).

Many of the specified powers of the new Commonwealth Parliament came to be set out in 39 sub-sections of Section 51 (s. 51) of the proposed Australian Constitution.[3] Some of these specified powers, like defense, immigration, and external affairs, were clearly intended to take over authority from Great Britain.[4] Others were designed to manage issues that had emerged among the self-governing colonies. Primary among

[2] This principle finds expression in s. 107 of the Australian Constitution.

[3] While the first thirty-five sub-sections of s. 51 list substantive policy areas, the last four are more procedural, covering "matters referred" by the States, matters arising from the Constitution and matters previously "exercised only by the Parliament of the United Kingdom or by the Federal Council of Australasia." This last body was established by an Act of the British parliament in 1885 in response to the federation movement in Australia. The "Asia" part of its title related to ideas of New Zealand and Fiji also possibly being parts of the imagined federation, which faded during the 1890s (Irving, 1997, p. 3).

[4] These subjects are covered respectively by sub-sections vi, xxvii, and xxix.

these was inter-jurisdictional trade and commerce, which had become contentious through different customs duties being imposed by and between colonies. Hence the first sub-section of s. 51 of the Australian Constitution gave the new central parliament power to make laws with respect to:

(i) trade and commerce with other countries, and among the states:

In support of this first power in s. 51, s. 90 gave the new parliament an "exclusive" power to "impose duties of customs and of excise," while s. 88 stated that these would be imposed "within two years after the establishment of the Commonwealth." More substantively, s. 92 insisted that "On the imposition of uniform duties of customs, trade, commerce, and intercourse among the States ... shall be absolutely free."

Together, these four constitutional provisions set the scene not only for free trade and commerce within Australia, but also for the potential financial dominance of the Commonwealth. This potential was reinforced by the second sub-section of s. 51, which gave the new parliament power to make laws with respect to:

(ii) taxation; but so as not to discriminate between states or parts of states:

The qualifier of this second head of concurrent Commonwealth power in s. 51 expressed an egalitarian ethos which would become a hallmark of Australian fiscal federalism in the years ahead.[5]

Customs and excise duties accounted for three quarters of tax revenue in the self-governing colonies at the end of the 1890s, and the import of giving this power to the Commonwealth was "fully appreciated by the drafters of the Constitution" (Groenwegen, 1983, p. 174). One metaphor used in the 1890s was that a "common tariff'" was the "lion

[5] The powers of the Commonwealth Parliament listed in s. 51 are often referred to as "concurrent," though this word is not used in the Australian Constitution. The term concurrent has become used to distinguish s. 51 powers from some that are explicitly a power "exclusive" to the Commonwealth, as in s. 90 and s. 52. If the Commonwealth does not legislate on a subject listed in s. 51, State laws on the subject continue to operate. If the Commonwealth does legislate, those laws prevail over inconsistent State laws by s. 109 of the Constitution.

in the way" of Australian federation, which would either kill federation or be killed in achieving it. Writing about the constitutional origins of Australian federalism a century later, Galligan (1995) argued that the lion of common customs was surprisingly easily slain, but that "dividing up its carcass was fiendishly difficult." He saw the "troubled founders" as wavering between "distribution on a per capita basis and distribution on a contribution basis," each of which would have "major impact on the financial positions" of some "colonies-cum States" because of "substantial differences in the structure" of their budgets (pp. 216–221). The "outcome was a compromise" blending "contribution and per capita formulas" in the short term, while in the longer term "leaving fiscal distribution ... for the parliament to determine" (Galligan, 1995, pp. 220–222).

For a period of 10 years after federation, s. 87 of the Constitution obliged the new Commonwealth to retain for its own annual expenditure only "one fourth" of "net revenue … from duties of customs and of excise," with the "balance" to be paid to the several states, or applied toward the payment of interest on debts of the several states taken over by the Commonwealth.

For five years after uniform duties (and thereafter until the Commonwealth Parliament provides otherwise), s. 93 prescribed that customs duties would be "taken to have been collected" in the state of "consumption" of a good and credited to "the several States" accordingly. After those five years, under s. 94, the new central parliament could provide for "the monthly payment to the several states of all surplus revenue of the Commonwealth" on "such basis as it deems fair."

One other section of the Australian Constitution which laid financial foundations for the years ahead was s. 96, which gave the Commonwealth power to "grant financial assistance to any state on such terms and conditions as the parliament thinks fit." This set in train claim-making by the less populous states in the early years of the twentieth century because they felt vulnerable to the economic dominance of New South Wales and Victoria. It also led to a later process of Commonwealth intervention in policy areas in which the national parliament had no clearly specified power. These two distinct stories arising from s. 96 are explored in later sections. For now, s. 96 can simply be seen as another constitutional contributor to the potential financial dominance of the new central Commonwealth Parliament and government.

Early Economic Positions, Small State Claims, and Commonwealth Growth

During 1898 and 1899 all six Australian colonies voted at referendums in favor of federation. Majority support was clear, but not overwhelming. The less populous colonies faced a conundrum, which was summarized 75 later as follows:

> The small colonies in fact were in a dangerous position. On the one hand should federation not come about, then New South Wales could well go protectionist under William Lyne and thereby deprive them of the one remaining free market on the continent. On the other hand, should a small colony reject the Bill and the others accept, then under the federal tariff the self-isolated colony would be treated as a 'foreign' state and thereby rendered destitute. Hence the vital question for the small colonies became not could they afford to federate, but rather could they afford not to. (Norris, 1975, pp. 27–28)

In the event, all six colonies joined, avoiding both these scenarios. But the concerns of the small colonies then played out within the new federation, as claim-making under s. 93 then s. 96 of the Constitution.

Table 1 gives some idea of the demographic and economic positions of the six Australian states at the time of federation. New South Wales and Victoria together then accounted for about two-thirds of Australia's population and production value, particularly in manufacturing. These central more populous states were deeply divided, however, between protectionist Victoria, which derived revenue from a broad range of tariffs, and free-trading New South Wales, which relied on a narrower range of tariffs on intoxicants and "abundant revenue from the sale of public lands" (Galligan, 1995, p. 220). The other four states had populations ranging from 13% (Queensland), through 10% (South Australia), to just under 5% (Tasmania and Western Australia). Among these four, the two outlying states with large land areas, Queensland and Western Australia, contributed more to national production than their population shares, in Western Australia's case about double. Conversely, Tasmania and South Australia (along with Victoria) contributed slightly less to national production than their population shares (see Table 1).

While in demographic terms, Tasmania and Western Australia occupied similar positions at federation, in economic terms they were very different. Western Australia had experienced a mining boom in the 1890s and

Table 1 Population and economic "disparities between the colonies at federation," 1900–1901

	NSW	*Victoria*	*Tasmania*	*South Australia*	*Queensland*	*Western Australia*	*Australia*
Population (000s)	1360	1196	173	362	494	180	3765
	36%	32%	4.6%	10%	13%	4.8%	100%
Production value ($m)	77.9	61.6	10.1	20.6	33.9	25.1	229.6
	34%	27%	4.4%	9.0%	15%	11%	100%
Manufacturing value ($m)	19.4	15.9	2.3	4.7	6.9	4.3	53.5
	36%	30%	4.3%	8.8%	13%	8.0%	100%

Note Created from the Commonwealth Year Book No. 1, 1908

had "revenue and expenditure per capita nearly three times the national average," based on high tariffs. Tasmania, in contrast, had "a restricted tax base and modest public expenditures," considerably less than the national average (Galligan, 1995, p. 220). In order to maintain anything like their pre-federation financial positions, both Western Australia and Tasmania needed more than a per capita share in the distribution of Commonwealth revenue from customs and excise, but for very different reasons economically.[6]

Tasmania complained as early as 1903 that it was "not receiving the full share of revenue due to it" under the s. 93 "consumption" state provision for customs duties, due to the "book-keeping system," and that the uniform Commonwealth tariff was having adverse effects on both "Tasmanian industry and the government's finances" (May, 1971, p. 3). Western Australia also complained about effects on its finances, and that some of its imports (like sugar) were made unnecessarily expensive by tariffs protecting producers in eastern Australia (May, 1971, p. 3).

By 1906, at annual heads-of-government meetings known as the Premiers' Conference, the four less populous states were lobbying together for a "system of *per capita* payments" to come into effect on the expiration of s. 87 in 1910 (May, 1971, p. 4). The Commonwealth agreed to this demand in 1909, with payments of 25 shillings per capita for the next 10 years specified in the *Surplus Revenue Act 1910* (May, 1971, p. 5).[7] Western Australia wanted more however, and immediately negotiated an annual special grant under s. 96, slowly declining over the 10 years.[8] Tasmania's ongoing complaints were rewarded in 1910 with a Royal Commission, which a year later "confirmed Tasmania's losses under federation" and recommended a special grant under s. 96 over the next

[6] Under s. 95 of the Australian Constitution, Western Australia was given five years after the imposition of uniform customs in which it could still impose duties on goods from other States.

[7] This translates to $2.50 per capita in the decimal currency introduced in Australia in 1966.

[8] In 1910–1911 this payment was for the equivalent of $500,000 in modern Australian currency and was to reduce in subsequent years by increments of $20,000. Also, half of this grant was financed by reductions in per capita payments to the other States (May, 1971, p. 5).

10 years (May, 1971, p. 5).[9] May summarized the situation by 1912 as follows (Fig. 1):

> Within the first dozen years of federation, therefore, the governments of both Western Australia and Tasmania were receiving special grants on account of the adverse economic and fiscal effects of federation on their finances. But the declining scales of payment suggest that it was still thought that these states' financial difficulties were transitory. (May, 1971, pp. 5–6)

The other big development during these early years of federation was growth in Commonwealth expenditure, to a level unexpected by the Constitution's drafters a decade earlier. The new Federal government was now spending all its revenue from customs and excise, and in 1910 ventured into land taxation. Expenditure growth was partly due to Commonwealth expansion into social policy, like invalid and old-age pensions from 1908, but was also due to defense expenditure that was larger than expected, including the development of a standing army. This last expenditure item grew even faster during the second decade of federation, with Australia's commitment of troops to World War I. Groenewegen has summarized Commonwealth finances of this second decade as follows:

> In 1914, a progressive estate duty was introduced and the potential yield of the Federal land tax was increased by widening the base and raising the rates. In 1915, the Commonwealth introduced a progressive income tax, in 1916 an entertainment tax, and in 1916-17 a war-time profits tax. As a result of the war, Commonwealth expenditure rose from $40 million to $200 million which, despite the introduction of new taxes, was substantially financed by borrowing and resulted in the national debt in 1918-19 being $600 million. The enduring legacy of the war was an annual interest bill of approximately $40 million and a liability for repatriation payments which settled down to about $16 million after peaking at $60 million. The war substantially increased the relative size of the Commonwealth budget. (Groenewegen, 1977, pp. 174–175)

[9] This was to be $240,000 per annum initially, reducing to $100,000 over the ten years.

Fig. 1 Map: Australia's six states and two self-governing Commonwealth territories, showing boundaries and capital cities

This growth of direct Commonwealth expenditure in the second decade of federation did not reduce the grievances of the small states against emerging Commonwealth policy. Tariff increases in 1921, 1926, and 1928 fed the idea that secondary industries developing in New South Wales and Victoria were being protected, along with the finances of those states. The *Navigation Act 1921* aimed to "promote the growth of an Australian mercantile marine," which again the small states feared would be primarily in New South Wales and Victoria. The 1910 legislation for annual per capita grants only lasted until 1920, after which these payments

became discretionary for the Commonwealth. Premiers' Conferences during the early 1920s saw proposals for future revenue sharing put by the states, but debated inconclusively. In 1926, the Commonwealth "lost patience and announced termination of the *per capita* subsidies" (Maxwell, 1967, p. 3). Rather than a final move, this announcement terminated years of haggling and precipitated finalization of a financial agreement in 1927, in which per capita payments to the states were retained and so too were special disadvantage grants. The main changes of 1927 were that "future Commonwealth and State borrowing was placed under a Loan Council" and "existing State debts were taken over by the Commonwealth" (Maxwell, 1967, p. 3). This increased the Commonwealth's financial power over the states, even though state treasurers were members of the Loan Council alongside the Commonwealth.

Western Australia's concerns about tariffs led in 1924 to the Commonwealth announcing a *Royal Commission on the Finances of Western Australia as affected by Federation* (May, 1971, p. 10). Tasmania sought a similar commission of inquiry focused on its finances in 1925 and, after positive indications from Prime Minister Bruce, prematurely established its own Disabilities Committee to prepare its case (May, 1971, p. 11). The Commonwealth pulled back from a second royal commission on the finances of a state, but the combination of inquiries in Western Australia and Tasmania in 1925–1926 was clearly potent (May, 1971, pp. 12–13). Then in 1927, South Australia appointed its own Royal Commission to examine its deteriorating finances. The Commission argued for a special disadvantage grant for South Australia and precipitated a Commonwealth Royal Commission on this topic in 1929 (May, 1971, pp. 18–19). As a result of this flurry of inquiries, Western Australia and Tasmania continued receiving annual disadvantage grants and South Australia received its first special disadvantage grant in 1929–1930, just as the Great Depression was starting.

From 1929, submissions from Tasmania and South Australia to inquiries of the Commonwealth Parliament's Joint Committee of Public Accounts began arguing for a permanent body of expert appointees to assess all state claims for special financial assistance. Reports of this Joint Committee on Tasmania in 1930 and 1931 and South Australia in 1931 endorsed this idea (May, 1971, pp. 35, 201). The elevation of Tasmanian Joe Lyons to Prime Minister in January 1932 gave the idea another boost, and by early 1933 a bill was before the parliament for the establishment of a Commonwealth Grants Commission. This was despite

lack of enthusiasm from Western Australia, where Lyons had traveled to promote the idea, but had received a hostile reception (May, 1971, p. 37). The Western Australian parliament and people were focused on the idea of secession and held a referendum on this issue in April 1933. Despite a strong pro-secession vote, this came to naught when a British parliamentary committee during 1934 ruled invalid a petition from the Western Australian parliament requesting that the referendum result be given effect.[10] In the meantime Western Australian politicians, along with others, had to consider the Bill before the Australian Commonwealth Parliament in May 1933.

May (1971) has described debate on the Commonwealth Grants Commission Bill as "uninspired," with many parliamentarians speaking to pet topics and failing "to grasp what the bill was all about" (pp. 37–38). He has argued that despite "widespread concern in the small states, intelligent appreciation of their basic problem was confined to an expert few" and that it was these experts "who provided the real pressure for the creation of the Grants Commission" (May, 1971, p. 38). Nevertheless, the Bill was passed into law without substantial opposition, though the number of Commissioners was reduced from five to three, as too was their term of appointment in years (May, 1971, p. 38).

Table 2 presents population shares of Australia's subnational jurisdictions each three decades since federation. Focusing on changes from 1901 to 1931, Tasmania and South Australia seem justified in their fears of industrial and population centralization. As Australia's population grew from 3.8 million to 6.6 million in these three decades, Tasmania's population share fell from 4.6% to 3.5%, while South Australia's fell from 9.5% to 8.8%. Conversely, New South Wales's population share increased from 36.0% to 39.2%, at the expense not only of Tasmania and South Australia, but also of Victoria, whose population share fell most of all in these three decades from 31.6% to 27.5%. There was certainly some justification for thinking that New South Wales was dominating population growth (and hence economic growth) in the southeast of Australia during these first three decades of federation. The situation was somewhat

[10] 66% of voters supported secession and the Western Australian parliament petitioned the British parliament to give effect to this referendum result. The British parliamentary committee ruled the petition invalid as, under the Statue of Westminster 1931, a petition required the support of the Australian Commonwealth Parliament. 1933 Western Australian secession referendum—Wikipedia Viewed 4 April 2023.

different, however, in the more outlying, large-land-area jurisdictions of Queensland and Western Australia, which both increased their shares of the Australian population significantly in these three decades to 14.2% and 6.6%, respectively. No Australian state was in population decline during these decades, but they were growing at very different rates.

Later discussion will return to the population numbers for more recent years in Table 2. But for now, changes from 1901 to 1931 set the scene for discussing the role of the new Commonwealth Grants Commission (CGC) from 1933.

Advising on Six-Way General Revenue Sharing: The First 50 Years of the CGC

The first three members of the CGC, appointed in July 1933 for three years, were:

- a Tasmanian economist and former government statistician, L.F. Giblin, who by 1933 had become the Professor of Economics at Melbourne University,
- a Victorian lawyer, former parliamentarian and minister with an interest in public finance, F.W. Eggleston, and
- a South Australian merchant, J.W. Sandford.[11]

Among these, Giblin was probably the most deeply informed, having been Tasmanian government statistician during the 1920s and part of the Disability Committee preparing that state's submission to the Commonwealth Parliament's Joint Committee of Public Accounts during 1930 (May, 1971, p. 21).

Having received submissions from the states in late 1933, these original members produced the CGC's first report in July 1934. They tried to establish "the principles upon which grants were to be allocated" and a method for annually calculating their amounts. They rejected the common idea that grants should be related to "disabilities" of states flowing from federation and Commonwealth policies, opting instead for "a method of assessment based on budgetary needs relative to certain

[11] Western Australian parliamentarians complained about the lack of a representative, but to no avail (May, 1971, p. 39).

Table 2 Populations of Australian states and territories at 30-year intervals since federation, plus land areas

Population (000s)	*NSW*	*Victoria*	*ACT*	*Tasmania*	*South Australia*	*Queensland*	*Western Australia*	*Northern Territory*	*Australia*
1901	1375	1210	Nil	175	364	507	194	Unknown	3825
	36.0%	31.6%		4.6%	9.5%	13.2%	5.1%		
1931	2566	1804	9	228	577	930	434	5	6553
	39.2%	27.5%	0.14%	3.5%	8.8%	14.2%	6.6%	0.07%	
1961	3952	2955	62	353	979	1540	755	45	10,643
	37.1%	27.8%	0.6%	3.3%	9.2%	14.5%	7.1%	0.6%	
1991	5930	4437	291	468	1451	2994	1647	167	17,387
	34.1%	25.5%	1.7%	2.7%	8.3%	17.2%	9.5%	1.0%	
2021	8189	6649	432	541	1773	5221	2681	246	25,739
	31.8%	25.8%	1.7%	2.1%	6.9%	20.3%	10.4%	1.0%	
Land area	800,810	227,945	2358	68,017	984,274	1,730,172	2,526,646	1,348,094	7,688,126
Sq Kms	10.4%	3.0%	0.3%	0.9%	12.8%	22.5%	32.9%	17.5%	

Note Australian Bureau of Statistics 2006 (to 1991), Australian Bureau of Statistics (2021)

'normal' standards of expenditure and revenue raising" among the six states (May, 1971, pp. 58–59). Despite adverse reactions, this first report led to larger grants to the three claimant states in 1934–1935 than in the previous year, and the CGC members persisted with their approach in a second report in 1935 (May, 1971, p. 61). By their third report in 1936, these original members of the CGC had consolidated their comparative "needs approach" arguing that "special grants" under s. 96:

> are justified when a state through financial stress from any cause is unable efficiently to discharge its functions as a member of the federation and should be determined by the amount of help found necessary to make it possible for that state by reasonable effort to function at a standard not apparently below that of other states. (May, 1971, p. 63)

While this statement of the CGC's approach was becoming clearer, there was still some opposition, partly because it led to smaller grants for South Australia and Western Australia in 1936–1937 than in the previous year, but partly also because Western Australia was still attracted to the federal disabilities approach and the Commonwealth Treasury had reservations about the comparative fiscal needs approach even though no longer arguing against it. Tasmania also showed in 1936–1937 that, even when accepting the fiscal needs approach, it could produce quite different calculations from those of the CGC (May, 1971, pp. 63–68).

The "outstanding feature" of the CGC's work during these "formative years," May (1971) argued four decades later, was that:

> it quickly gained the general, if not unqualified, support of states and Commonwealth and was successful in establishing a set of principles and methods as the basis of a system of special grants, which has been received with only minor modification by subsequent Commissioners. (pp. 68–69)

The explanation for this, according to May (1971), was partly the CGC's status as an "expert and politically independent body," partly its "reasoned argument," but also that its "statement of principles" had "something to please everyone" and enabled it "to combine flexibility and broad judgement with at least some appearance of objective scientific analysis" (pp. 69–70). The dominant figure in achieving all this was L.F. Giblin, whose "impressive influence" was "the most outstanding single feature" of these early years (May, 1971, p. 65).

Neither Giblin nor Sandford sought reappointment to the CGC when their terms expired in 1936. They were replaced by G.L. Wood, an Associate Professor of Commerce at Melbourne University, and G.L. Creasey, a Tasmanian accountant. Eggleston remained chair until 1941, at which point he was succeeded by R.C. Mills, Professor of Economics at the University of Sydney. Summarizing membership of the CGC up to 1970, May noted that there had always been "at least one … academic economist" and that appointments implicitly and de facto "have recognized a need to appoint members from the claimant states" (May, 1971, p. 44). Together with a procedure which took submissions from claimant states annually, this pattern of appointments led to the CGC being seen as an expert economic body that was sympathetic to the financial challenges of small states but would take a measured approach.

The CGC turned the raw politics of small state claim-making into a more technical exercise in which state and Commonwealth treasury officials argued fine points of public expenditure, revenue raising, and accounting. Looking back from 1970, May argued that while "the states have generally been in broad agreement" with the CGC's "principles and methods," they have "shown little hesitation in pressing their own views against the interests of the other claimant states" when the "interests of individual states have clashed." He also noted that, while the position of the claimant states appearing before the GCC had been "roughly that of a plaintiff, seeking to establish a case for grants as large as possible, the Commonwealth Treasury cannot be correspondingly regarded as a defendant" (May, 1971, p. 80). He observed that the Commonwealth Treasury had not always been that active in annual discussions, had not always sought to reduce the size of grants, and had "been concerned more with the broader questions of the Commission's basic approach than with the details of calculations." One example, which emerged with economic recovery from the late 1930s, was how calculation of the financial needs of claimant states related to "a budget standard of the non-claimant States" that was in surplus (May, 1971, p. 81). The Commonwealth Treasury argued that a "balanced budget" should set "the upper limit to assistance" and the CGC decided in favor of this approach in 1942, while also noting that the surplus in the non-claimant states was due to "abnormal wartime expenditure and policies" (May, 1971, pp. 81–82). The claimant states argued against this decision, but reluctantly accepted it over the next few years. By 1947, the non-claimant states were back in deficit, and the arguments of the claimant states were

now more supportive of a balanced budget standard. By 1957, with the non-claimant states in ongoing deficit, the CGC "reverted to a deficit standard," as in its early years (May, 1971, pp. 84–85). But Commonwealth Treasury continued into the 1960s to argue for a balanced budget standard.

One of the most significant developments in the history of Australian fiscal federalism was the Commonwealth's uniform income tax scheme of 1942. One piece of legislation imposed a Commonwealth income tax which had priority over state income taxes. In compensation, another piece of Commonwealth legislation, the *State Grants (Income Tax Reimbursement) Act 1942*, provided that states who levied no income tax would receive a grant from the Commonwealth equal to their average income tax revenue in 1939–1940 and 1940–1941. Under s. 6 of this Act, a Treasurer of a state could apply to the CGC if they felt that grant was "insufficient to meet the revenue requirements of the state" (CGC, 1995, p. 53). Over the next three years, first Tasmania, then Western Australia, then South Australia, all made such applications, in addition to their more usual annual submissions to the CGC as claimant states under the 1933 legislation. These applications ended in 1946, when the Commonwealth's uniform income tax scheme transitioned from a temporary wartime measure to an ongoing peacetime feature of Australian federalism (CGC, 1995, p. 58).

The uniform income tax scheme increased the Commonwealth's financial dominance within Australian federalism, making the states even more dependent on money shared with them by the Commonwealth.[12] Into the 1950s income tax reimbursement grants were the largest amount of money shared, and the formula for doing so was based on population with some adjustment "for sparsity of settlement and proportion of school children" (Prest, 1980, p. 474).[13] Grants to claimant states based on the annual calculations of the CGC were for smaller amounts. For example, in 1958–1959 the income tax reimbursement pool was £175 million, while

[12] This financial dominance is sometimes called Vertical Fiscal Imbalance. I have tried to avoid this technical, economic language, but acknowledge its usefulness as a shorthand with the acronym VFI. The technical, economic language for equalized revenue sharing among subnational jurisdictions is Horizontal Fiscal Equalization or HFE.

[13] Prest's paper was originally published anonymously in 1959. Prest was a member of the CGC from 1953 till 1965, at which time he was Professor of Economics at the University of Melbourne.

the CGC-recommended grants to the three claimant states totaled £20.75 million (Prest, 1980, pp. 474–476).[14] But these smaller amounts determined by CGC calculations were still seen by states as worth pursuing. Indeed, in 1958 both Victoria and Queensland lodged applications (with the Prime Minister) to become claimant states before the CGC (1995, p. 64). These applications were not referred to the CGC, but rather precipitated a special Premiers' Conference in March 1959 to discuss federal financial relations more generally (CGC, 1995, p. 65; Maxwell, 1967, pp. 13–16).

During the 1950s, the non-claimant states were becoming dissatisfied with their income tax reimbursement grants based on adjusted population, and New South Wales and Victoria even belatedly challenged the Commonwealth's uniform tax scheme in the High Court in 1957 (CGC, 1995, p. 64; Holmes & Sharman, 1977, p. 140). While these two big-population states lost their High Court challenge, Victoria's 1958 application to become a claimant state, along with Queensland, was a continuation of the battle. The non-claimant states wanted significant revision of revenue sharing back toward them.[15]

While the special Premiers' Conference in March 1959 was "inconclusive," it was agreed that the Commonwealth "should develop proposals" for the regular Premiers' Conference in June that year (CGC, 1995, p. 65). Those proposals sought to expand the large general revenue sharing grants based on an adjusted population formula, and to "reduce to two the number of states which would in future regularly apply for special grants recommended by the Grants Commission" (CGC, 1995, p. 65; Maxwell, 1967, p. 14). The proposals were accepted by the Premiers of the six states, with "minor modifications" and some haggling over grants for that year. The large general revenue sharing amounts would henceforth be called "financial assistance grants rather than tax reimbursement grants" (CGC, 1995, p. 65). South Australia agreed to cease being a claimant state, partly due to the success of its industrial

[14] These figures in £ need to be doubled to make them equivalent to the Australian $ introduced in 1966. See Maxwell (1967, p. 10) for a tabular comparison of formula grants and CGC supplements from 1947 to 1959.

[15] Maxwell (1967, p. 5) explains that Victoria had fared poorly in the 1942 tax reimbursement formula, being a low taxing State in the years leading up to the Commonwealth's uniform income tax scheme. This disadvantage tended to be continued in revised formulas in the late 1940s and 1950s.

development during the 1950s.[16] This left just Western Australia and Tasmania as claimant states before the CGC during the 1960s.

A consequence of these changes from 1959 was that the special grants recommended by the CGC declined in importance compared to the larger Commonwealth financial assistance grants distributed on the adjusted population formula. The non-claimant states pressed claims for additions to their financial assistance grants through the annual Premiers' Conferences, while the claimant states focused their special pleading on annual CGC submissions. By 1968 the budgetary significance of Western Australia's special grant had declined to around 5% of its recurrent revenues, and it decided to withdraw from claimancy status before the CGC in return for a $15.5 million addition to its financial assistance grant for each of the next two years (CGC, 1995, p. 68).[17]

With five of six states by 1970 taking their chances with political bargaining over Commonwealth financial assistance grants at annual Premiers' Conferences, and only Tasmania focused on its annual submission to the CGC arguing for a special grant, the CGC seemed to be fading in significance and possibly destined for abolition (CGC, 1995, p. 69). But in fact, during the 1970s, the CGC had something of a renaissance. In 1970, the Commonwealth decided that "all four less populous States" could in principle be claimants before the CGC, and in 1971 that they would be assessed against a two-state standard averaging New South Wales and Victoria (CGC, 1995, p. 90).[18] Queensland immediately took the opportunity to become a claimant state and remained so throughout the 1970s, receiving substantial special grants (Groenwegen, 1983, p. 178).

In 1973, the Whitlam Labor government passed a new *Grants Commission Act* which defined the purpose of calculations as "making it possible for a State, by reasonable effort, to function at a standard not appreciably below the standards of other States" (CGC, 1995,

[16] Table 2 shows that South Australia's share of the Australian population had risen from 8.8% in 1931 back up to 9.2% in 1961.

[17] By contrast Tasmania's special grant still contributed around 17% of its recurrent revenues, down from 20% a decade earlier (CGC, 1995, p. 68).

[18] During the 1960s, when there were only two claimant States, there had been extensive debate over whether the standard against which they were assessed should be the other four States or just New South Wales and Victoria (CGC, 1995, pp. 88–89; May, 1971, pp. 120–122).

pp. 82–83). In addition, Labor moved the Commission out of the Prime Minister's portfolio into a new portfolio of Special Minister of State, to reinforce its independence. Over the next few years, a new member of the Commission, ANU Professor of Accounting and Public Finance R.L. Mathews, played a major role in moving its calculations to a "direct assessment method," compared to the previous "modified budget result comparison method" (CGC, 1995, p. 96). This also reflected a broadening of the Commission's role during the Whitlam years to look at local government financing, in which a modified budget result method was not feasible (CGC, 1995, p. 115).

Under the Fraser Coalition government in 1976, the word "Commonwealth" was restored to the Commission's name and its role in local government funding was restricted to advising on state-level division of funds (CGC, 1995, pp. 107, 122).[19] More importantly, in 1978 the CGC was tasked, in legislation, with undertaking a general review of "tax sharing relativities" among the states. This led to four reports published over the next decade, which effectively set the foundations for a new era in which CGC "relativities" calculations would be used to determine the distribution of *all* general revenue, between not only the six states but also the two Commonwealth territories which moved to self-government in the late 1970s (Northern Territory) and late 1980s (Australian Capital Territory). The story of this era of eight-way sharing of general revenue is told in a later section, but first there is a complementary story to be told from the 1920s to the 1970s about Commonwealth use of s. 96 to grant financial assistance to the states for specific purposes.

Specific Purpose Payments: Another S. 96 Story

From 1923 the Commonwealth started making grants to the states specifically for the development of roads. Five percent of money was reserved for Tasmania and the rest was divided among mainland states as described

[19] The party structure on the right of Australian politics has comprised a Liberal Party based in the cities and a Country Party based in rural areas dating back to the 1920s, which changed its name to the National Party in 1975. These two right parties have been in long-term Coalition, whether in government or opposition. In Queensland this led to a merged Liberal National Party in 2008. In the Northern Territory there has been a single Country Liberal Party since 1974. In other jurisdictions the Liberal Party and National Party remain separate, but in Coalition. Hence Coalition is commonly used as a descriptor of party structuring on the right of Australian politics.

by Jay (1975, p. 67): "three-fifths in proportion to population, two-fifths in proportion to area, as a rough estimate of needs." States were also asked to match these Commonwealth grants. The motivation for these arrangements was later summarized thus:

> These grants represented a supplementation of state expenditures in an area of state responsibilities which was of special interest to the Country Party element in the national government, with some pressure on the states to contribute to priorities determined by the national government. (Jay, 1975, p. 67)

In 1926–1927 the Commonwealth imposed a customs duty on imported petrol and an excise duty on locally produced petrol. Road grants to the states were seen as an appropriate use of revenue from these two duties, now without the requirement of matching contributions from the states. As motoring expanded during the 1930s and 1940s, so too did these specific purpose payments to the states for roads, with a variety of conditions attached over the years (Jay, 1975, pp. 66–86).

A second set of specific purpose payments to the states emerged from 1927, with the Commonwealth agreeing to take on the servicing of state debts through the Loan Council. While these payments to the states were specifically to meet interest charges on loans, Jay has argued that they were more like general revenue sharing in that they "did not compel the states to meet expenditure which they would not otherwise have undertaken," but rather freed "an equivalent amount of state revenue for expenditure as the states think fit" (Jay, 1975, p. 43). Despite this lack of "effect on State priorities," these payments to meet interest on state loans were specific purpose payments and are included as such in figures given in Table 3.

A third set of specific purpose payments from the Commonwealth to the states began in 1946, promoting the development of public housing for people with low incomes (Jay, 1975, pp. 102–105). From then on Commonwealth specific purpose payments to the states became common policy mechanisms, starting in the health field from 1949 (tuberculosis hospitals), in education from 1951 (universities), and spreading rapidly to other policy fields over the next two decades.

All grants of financial assistance from the Commonwealth to the states have occurred under s. 96 of the Constitution, so differentiation of grant types needs to refer to other characteristics. Following summary statistics

Table 3 Commonwealth financial assistance to states, selected years 1942–1943 to 1980–1981

Year	*General revenue sharing using adjusted population or tax reimbursement formula*	*Claimant state grants using CGC calculations*	*Specific purpose payments*	*Total financial assistance from Commonwealth to states*
1942–43	$68.1m 72.4%	$4.4m 4.7%	$21.6m 23.0%	$94.1m
1946–47	$84.3m 58.7%	$9.5m 6.6%	$49.8m 34.7%	$143.5m
1951–52	$240.0m 62.7%	$21.0m 5.5%	$121.6m 31.8%	$382.6m
1958–59	$410.0m 61.9%	$41.5m 6.3%	$210.6m 31.8%	$662.1m
1964–65	$681.4m 61.9%	$31.7m 2.9%	$391.6m 35.4%	$1104.7m
1971–72	$1756.3m 70.6%	$23.8m 1.0%	$708.0m 28.5%	$2488.1m
1975–76	$3503.1m 45.5%	$38.8m 0.5%	$4,152.8m 54.0%	$7694.7m
1979–80	$5415.9m 51.3%	$12.4m 0.1%	$4706.1m 44.6%	$10,549.4m

Note Groenwegen (1983, p. 178)

compiled in the 1980s (Groenwegen 1983), three categories of financial assistance to the states are identified in Table 3, described as general revenue sharing using an adjusted population or tax reimbursement formula, special grants to claimant states based on CGC calculations, and specific purpose payments. Table 3 shows specific purpose payments growing from 23% of Commonwealth financial assistance to the states in 1942–1943, the first year of the uniform income tax scheme, to 35% in 1964–1965, and reaching 54% in 1975–1976 after the centralizing policies of the Whitlam Labor government (December 1972 to November 1975). Under the Fraser Coalition government's new federalism policy in the late 1970s, state budgetary autonomy was more respected and specific purpose payments dropped back to 45% of Commonwealth financial assistance to the states by 1980. Table 3 also shows how claimant state grants using CGC calculations were only ever in the range 4–6% of total

Commonwealth financial assistance to the states and fell well below this during the 1960s and 1970s. The largest category of Commonwealth financial assistance to the states throughout the four decades covered in Table 3, except for a couple of years in the mid-1970s, was "general revenue shared using either an adjusted population or tax reimbursement formula," outside the CGC's fiscal equalization calculations. It was the application of CGC methods to this larger pool of money from the 1980s that would confirm the CGC as a central institution of Australian fiscal federalism during in the decades ahead.

Advising on Eight-Way General Revenue Sharing: The CGC's Relativities Approach Since the 1980s

Under the *States (Personal Income Tax Sharing) Amendment Act 1978*, the Fraser Coalition government asked the CGC to undertake a review in line with the "principle" that Commonwealth payments to the states:

> should enable each state to provide, without imposing taxes and charges at levels appreciably different from the taxes and charges imposed by the other states, services at standards not appreciably different from the standards of the government services provided by the other states. (CGC, 1995, p. 139)

This principle of fiscal equalization between the states had great continuity back to Labor's 1973 legislation and the first three reports of the CGC between 1934 and 1936. What was changing in the 1970s were the methods and procedures through which this principle was implemented. The direct assessment method suggested that various expenditure disability and revenue capacity factors could be measured in standardized state budgets and summed to give a total state factor, or relativity, compared to all other states. The idea was that these relativities could be applied to all Commonwealth general revenue sharing in all states, on a per capita basis, to produce annual financial assistance calculations which would effectively combine the first two columns of Table 3, the formula-based grants and claimant state grants. States would no longer be divided into claimants, who appeared before the CGC, and non-claimants, who generally did not. Rather all states could make submissions and argue points about expenditure and revenue capacity

factors before the CGC, contributing to an annual set of relativity numbers.[20]

These procedural and method changes were significant, and it took four review reports, published by the CGC in 1981, 1982, 1985, and 1988, to establish them as an acceptable future approach for the principle of fiscal equalization between the states. At each step, there were losers among the states, who had to be convinced that this approach was going to be fair in the longer term, and who argued for short-term adjustments to soften immediate losses (CGC, 1995, pp. 137–158). In addition, in the 1985 review the newly self-governing Northern Territory was added as a seventh self-governing subnational jurisdiction, and in 1988 the Australian Capital Territory was added in anticipation of self-government there from 1989 (CGC, 1995, pp. 158–175, 208–237).

As well as the fiscal equalization principle, which was now well entrenched in CGC legislation, Ministers would regularly add issues to the CGC terms of reference for consideration. In the early 1980s there was an attempt to roll specific purpose health grants back into general revenue sharing, so the CGC was tasked with developing a set of health relativities alongside the more general per capita relativities (CGC, 1995, p. 150). For its 1985 review, the CGC was instructed to "exclude from its assessments payments of financial assistance in 1983–84 ... received by Tasmania" because of the Commonwealth's 1983 decision to intervene and stop construction of the proposed Gordon-below-Franklin dam (CGC, 1995, p. 159). Another issue which repeatedly emerged was the treatment of state "business undertakings" that were largely off-budget, but which sometimes had recurrent budget implications (CGC, 1995, p. 160).

The differential impact of the 1984 introduction of Medicare on state and territory health systems was a ministerial term of reference for the CGC's calculations in 1988, requiring again health relativities alongside more general relativities (CGC, 1995, pp. 168, 172). Another ministerial term of reference for 1988 raised ideas of "the efficient allocation of resources across Australia" as a potential counterbalance to the principle of fiscal equalization, to which New South Wales, Victoria, and

[20] Because the standard of assessment was still the large-population States, the focus of CGC procedures continued to be disadvantages and disabilities of small-population States. Occasional claims of large-population State disadvantages have also been made (e.g., higher wage costs).

the Commonwealth Treasury all responded supportively (CGC, 1995, pp. 169, 172–173). The CGC's response was to acknowledge that fiscal equalization did have "some consequences" for allocative efficiency, but that these were "not serious enough to warrant any significant changes in the manner in which the fiscal equalization process is carried out" (CGC, 1995, p. 173). It argued that it "must respond to its terms of reference by basing its assessments on fiscal equalization considerations alone," and that it was the "responsibility of governments to resolve any conflict between equalization and efficiency" (CGC, 1995, p. 174).

The CGC's response to ministerial terms of reference in the 1980s was to explore them while also adhering to the principle of fiscal equalization laid down in its legislation. Responding governments were respectful of the CGC's focus on fiscal equalization, while also being willing to make short-term adjustments to the financial assistance for particular states. More mundanely, some problems of timing for the 1988 review led the CGC to suggest a five-year review program, with more basic annual updates in between (CGC, 1995, p. 174).

At the Premiers' Conference in 1988, due to a worsening budget balance, the Hawke Labor Commonwealth government imposed a $650 million reduction in financial assistance grants to the states and territories. The CGC's relativities from the 1988 review were accepted by all as the basis for distribution, but with the proviso that the "base level" of both "general revenue and hospital grants" for each jurisdiction would not fall below the previous year 1987–1988 (CGC, 1995, p. 175). This was the beginning of a five-year period of financial stringency during which general revenue sharing was constrained, while specific purpose payments to the states and territories returned to over half of Commonwealth financial assistance (Department of Finance, 1996, p. 3; Galligan, 1995, p. 229; Groenwegen, 1994, p. 171). This in turn led to a period in which the states and territories pushed for a guaranteed proportion of Commonwealth financial assistance to be directed to them as general revenue, which the Howard Coalition Commonwealth government delivered in 1999 as part of its introduction of a goods and services tax (GST).

All revenue from the GST would be committed to general revenue sharing with the states and territories in accord with CGC relativities. This was the first time Commonwealth legislation had guaranteed the

size of the general revenue sharing pool (Summers, 2002, p. 101).[21] This intergovernmental agreement on the use of GST revenue was questioned during the first year of the Rudd Labor Commonwealth government in 2008, but re-affirmed, thus making the agreement a more secure bipartisan commitment for the longer term.

The effect of the GST guarantee on federal finances could be seen clearly by 2006–2007. The GCG summarized federal finances at that time as follows:

- The Commonwealth collected 81% of public sector revenue and was responsible for 61% of outlays;
- The states and territories collected 17% of public sector revenue and incurred 33% of outlays;
- The states and territories were, as a consequence, on average dependent on the Commonwealth for 55% of revenue;
- Of this 55%, 32% now came from GST general revenue sharing, while specific purpose payments had declined back below half to 23% (CGC, 2008, p. 8).

Averages, however, are deceptive when there is diversity of size among subnational jurisdictions. Later in the same publication, the CGC noted that around an Australian average of 45% own-source revenue, states and territories varied as shown in Table 4.

Raising only 17% of its own revenue over the previous quarter century, the Northern Territory was highly dependent on Commonwealth systems of financial assistance, both through general revenue sharing and specific purpose payments. This is one reason this chapter concludes with a case study of the Northern Territory's inclusion in the fiscal equalization system within Australian federalism. To do so, another set of figures are introduced, which are the relativities for the states and territories calculated by the CGC for selected years from 1993 to 2021, including all years in which CGC undertook a methods "review" (labelled with an R in

[21] Groenewegen notes that Fraser's new federalism from 1976 did guarantee certain proportions of personal income tax collections to be dedicated to general revenue sharing. However, he goes on to argue that "points of understanding negotiated when the new system was introduced were never fully adhered to by the Federal Government" (Groenwegen, 1994, p. 181). The "Federal Government" is another way in which Australians refer to the Commonwealth.

Table 4 States and territories, own-source revenue as proportion of total revenue, 1980–1981 to 2006–2007

	NSW	*Victoria*	*ACT*	*Tasmania*	*South Australia*	*Queensland*	*Western Australia*	*Northern Territory*
Average proportion	49%	48%	39%	30%	39%	41%	46%	17%

Note CGC (2008, p. 75)

Table 5) plus one "update" year (labelled with a U) between each review. In the 1993 review, the CGC adopted a population-weighted average of all eight subnational jurisdictions as the relativity standard of 1.0 against which each jurisdiction was assessed.[22] The CGC (1995) argued that this change in method would make it "easier to understand the model and to follow the changes in the position" of each subnational jurisdiction over time (p. 194). It has also meant that CGC publications since tend to start from 1993 as the base year, due to the complexity of comparisons before then (CGC, 2016).

Figures in Table 5 show stability of relativities over time in most instances, but also some significant changes that have emerged among the subnational jurisdictions over the last three decades. For population numbers at the beginning and end of this thirty-year period, refer to 1991 and 2021 figures in Table 2.

In the left two columns of Table 5 are the large-population jurisdictions of New South Wales and Victoria, with relativities consistently below (and fiscal capacities above) the weighted national average of 1.0. As a small-population jurisdiction within this heartland of the south-eastern Australian economy, the Australian Capital Territory (ACT) initially also had a relativity below 1.0 in the 1990s but has crept up in the two decades since to 1.1 and occasionally 1.2. The other two small-population, slightly more peripheral, south-eastern jurisdictions of Tasmania and South Australia have relativities consistently above (and fiscal capacities below) those of these three most central jurisdictions. Tasmania sits

[22] Over the previous decade Victoria had been used as the standard with a relativity of 1.0 against which other jurisdictions were measured.

Table 5 Per capita relativities in eight subnational jurisdictions, select years 1993–2020

	NSW	*Victoria*	*ACT*	*Tasmania*	*South Australia*	*Queensland*	*Western Australia*	*Northern Territory*
R1993	0.79844	0.80587	0.94204	1.53897	1.27997	1.14009	1.16392	5.42252
U1996	0.84258	0.82469	0.70526	1.72075	1.24074	1.07765	1.04376	5.79195
R1999	0.88394	0.80925	1.00072	1.81617	1.23721	1.03071	0.91827	5.93271
U2001	0.90659	0.84728	1.17180	1.61763	1.19270	1.01194	0.96943	4.61118
R2004	0.83474	0.83645	1.21415	1.71446	1.23050	1.06971	1.03819	5.00336
U2007	0.86380	0.88206	1.24724	1.68662	1.23141	1.01143	0.93616	5.09597
R2010	0.95205	0.93995	1.15295	1.62091	1.28497	0.91322	0.68298	5.07383
U2012	0.95312	0.92106	1.19757	1.58088	1.28472	0.98477	0.55105	5.52818
R2015	0.94737	0.89254	1.10012	1.81906	1.35883	1.12753	0.29999	5.57053
U2018	0.85517	0.98670	1.18070	1.76706	1.47727	1.09584	0.47287	4.25816
R2020	0.91808	0.95992	1.15112	1.89742	1.35765	1.04907	0.44970	4.76893

Note CGC (2016, p. 3; 2018, p. 2; 2020, p. 1)[23]

consistently between 1.5 and 1.9, with South Australia between 1.2 and 1.5.

In the right three columns of Table 5 are the three jurisdictions with land areas over a million square kilometers: Queensland, Western Australia, and the Northern Territory (see bottom line of Table 2 for land areas). Among these large-land-area jurisdictions, our two concluding case studies delve into one instance of stable relativities, Northern Territory, and one instance of significant change, Western Australia.

Northern Territory: Greater Indigenous Population Diversity Which Questioned General Revenue Sharing

It took six reports, from 1979 to 1986, for the CGC (1995) to integrate the Northern Territory into its methods and calculations for fiscal equalization (pp. 213–221). The issues raised were often procedural and administrative, about disentangling Northern Territory finances from the

[23] CGC reports are delivered in the first quarter of the calendar year and provide relativities figures for the financial year starting in July: i.e., the 2020 report provides relativities for financial year 2020–2021.

Commonwealth's and standardizing the budget of the new self-governing jurisdiction in CGC calculations. But there were also more substantive issues to address, which reflected the Northern Territory's greater demographic diversity compared to any of the six states. With just 1% of the Australian population, spread over 17.5% of the Australian land area, the Northern Territory increased markedly the diversity of size among subnational jurisdictions that was being managed through fiscal equalization (see Table 2). In addition, around a quarter of the Northern Territory's population identified as Indigenous, which was roughly ten times the national average; plus, a significant portion of this Indigenous population lived outside urban areas in small "discrete Indigenous communities," ranging in population from a couple of thousand down to under a hundred.

To cope with this greater degree of demographic diversity in the Northern Territory, the CGC developed new expenditure disability factors in its calculations. Among these were a population "dispersion" factor and a "service delivery scale" factor (CGC, 1993b, pp. 37, 55). Also in 1993, the CGC devoted a whole chapter of its main report on relativities to issues around "Funding for Aboriginals and Torres Strait Islanders" (CGC, 1993a, pp. 63–68). This latter noted that the two major Aboriginal land councils in the Northern Territory had made submissions to the CGC in 1993, along with some other Indigenous organizations and the national Aboriginal and Torres Strait Islander Commission (ATSIC).

ATSIC's submission to the CGC in 1993 "expressed concern" about "inadequate accountability requirements" when subnational jurisdictions were, through CGC calculations, provided with additional funds to "meet identified needs in Aboriginal services programs" (CGC, 1993a, p. 64). The CGC's response was to point out that it had "no charter … to monitor expenditures" of subnational jurisdictions, either "for Aboriginal-specific programs" or in any other service area (CGC, 1993a, p. 64). Its charter was to advise on general revenue sharing, following the principle of fiscal equalization laid down in its legislation, but not to direct or monitor expenditure in subnational jurisdictions. Another theme in the 1993 submissions from Indigenous organizations was whether the principle of fiscal equalization could be applied to Aboriginal and Torres Strait Islander communities, including in the distribution of ATSIC funds. On this the CGC was more positive, arguing that it was possible and that the CGC had expertise to contribute, but also noting that it "would require

a reference from government; the Commission has no power to initiate such an inquiry (or any other) of its own volition" (CGC, 1993a, p. 67).

In 1999, the CGC was given terms of reference by the Commonwealth Minister for Finance to inquire into "the needs of groups of indigenous Australians relative to one another across government and government-type works and services," and over the next two years it produced a substantial *Report on Indigenous Funding* (CGC, 2001). But not much came from this work, particularly once ATSIC was destined for abolition from April 2004 (Robbins, 2004).

A third theme in the 1993 submissions to the CGC from Indigenous organizations was that funding for "essential services to remote Aboriginal communities" should be provided "direct to Aboriginal local governing bodies," rather than as "untied" general revenue to the Northern Territory government (CGC, 1993a, p. 67). This could be seen as a call for local Aboriginal self-government in remote areas. Alternatively, it could be seen as a call for greater use of specific purpose payments, which as part of their conditions would flow to Aboriginal community organizations through the Northern Territory government, rather than leaving decision-making discretion to the Territory (Sanders, 1995, pp. 6–8). Either way, the concern of Indigenous organizations was that general revenue received by the Northern Territory on account of its remote Aboriginal communities and population might not end up being spent on them, but rather on services for non-Indigenous residents in the capital city Darwin (Crough, 1993, pp. 93–99, also Westbury & Dillon, 2019, p. 52). But again, the CGC noted that these matters were "outside the scope" of its "responsibilities" and were for "governments to consider" (CGC, 1993a, p. 67).

What was in scope for the CGC in 1993, and has continued to be since, has been producing an annual relativity figure for the Northern Territory to sit alongside those for the other seven subnational jurisdictions, thereby determining the Territory's share of general revenue from Commonwealth tax sources. Table 5 shows that the relativity produced for the Northern Territory has been consistently around five during the last quarter century, meaning that the Territory's share of Commonwealth general revenue is five times what it would be on a per capita basis. In fiscal equalization, this is an order of magnitude bigger than in sharing among the states, either historically or currently. The addition of the Northern Territory since the 1980s has increased the diversity of size

of Australia's subnational jurisdictions and correspondingly increased the degree of horizontal fiscal equalization (HFE).[24]

The CGC's 2020 Review identified the main "drivers" of different fiscal capacities among the subnational jurisdictions. On the expenditure side of the ledger, the top two were "population dispersion" and "Indigenous status." Together these two "socio-demographic characteristics" accounted for "redistribution" away from equal per capita shares of around $5.1 billion across the eight subnational jurisdictions, of which almost $2 billion went to the Northern Territory (CGC, 2020, p. 27). Overall CGC calculations boosted the Territory's budget above equal per capita shares by about $2.4 billion in 2020–2021, or from $2,598 per capita to $12,410 (CGC, 2020, p. 40). This large Commonwealth contribution, following CGC calculations, means that Northern Territory own-source revenue continues to be under 20% and far below the national average (as seen for earlier years in Table 4).

On the revenue side of the ledger, the CGC's 2020 Review identified royalties from mining production as the outstanding driver of different fiscal capacities among subnational jurisdictions, accounting for $7 billion of "redistribution" away from equal per capita shares (CGC, 2020, p. 27). This is a useful starting point for our second case study of recent developments in Western Australia.

Western Australia: Becoming Big and Challenging the System

Table 5 shows Western Australia's relativity sitting close to 1.0 in the period from 1993 to 2004. However, from 2007, this figure fell rapidly, dipping below 0.3 in 2015, before rising back above 0.4 for the last two years presented, 2018 and 2020. The cause of these changes in Western Australia's fiscal capacity was rapidly expanding iron ore mining, which was producing large, somewhat volatile flows of royalty payments to the Western Australian government.[25]

[24] A former Northern Territory Treasury Secretary, AG Morris, was appointed to the CGC in 1997 and served as its Chair for over a decade from 1999. This continued the practice of the CGC having members who understood the financial challenges of small-population subnational jurisdictions.

[25] Volatility related to price more than volume. Iron ore prices peaked at A$186 per metric tonne in 2010–2011 before falling to A$58 in 2015–2016 (CGC, 2022, p. 11).

Around 2010, the Coalition government in Western Australia started complaining that their state was losing its share of GST revenue due to increasing own-source revenue from mining royalties. This was argued to be unfair and a disincentive to further development based on natural resources (Porter, 2011). Attention to Western Australia's complaint was initially limited, but by 2015 it was achieving more traction.[26] The argument in 2015 was that the iron ore mining boom in Western Australia had dipped, and that CGC calculations were not recognizing this as they relied on rolling financial averages from two to four years prior to the year for which relativities were being calculated. Western Australia ran significant budget deficits from 2015, arguing that it was being penalized for its higher income from mining royalties three to five years before.

In May 2017, Coalition Commonwealth Treasurer Scott Morrison directed the Productivity Commission to undertake an inquiry to "consider the effect of Australia's system of HFE on productivity, economic growth and budget management for the states and Australia as a whole." More specific terms of reference reflected Western Australia's critique, as they mentioned "rolling three averages," "states heavily reliant on large and volatile revenue streams," "lagged fiscal impacts," "the effect of producing a disincentive for a state to develop a potential industry," and whether the "aim of comprehensively equalizing states fiscal capacities places too great a reliance on broad indicators" and insufficiently recognizes the "different circumstances" of states (Productivity Commission, 2018, v).

Reporting back to the Commonwealth Treasurer in May 2018, the Productivity Commission acknowledged the "strengths" of Australia's established system of full fiscal equalization, compensating "states for their structural disadvantages," but also pointed to three "significant weaknesses." First, there was "scope for the system to discourage state policy" that was "desirable" in both mineral and energy development and tax reform. Second, the system did not "allow states to retain the dividends of their policy efforts," which both "raises concerns about the fairness of equalisation" and "corrodes public confidence in the system." And third, the system was "very poorly understood by the public and indeed by most

[26] The Commonwealth government changed party persuasion from Labor to Coalition in August 2013, but the arguments being made were more economic than party-based and would need to have been responded to by a Labor Commonwealth government as well.

within governments – lending itself to a myriad of myths and confused accountability" (Productivity Commission, 2018, p. 2). More prescriptively, the Productivity Commission recommended a "revised objective for HFE," which would be to provide subnational jurisdictions with the "fiscal capacity to supply services and associated infrastructure of a reasonable (rather than the same) standard" (Productivity Commission, 2018, p. 18). This, the report argued, would acknowledge "the trade-off between full and comprehensive equalization on the one hand, and fairness and efficiency on the other" (Productivity Commission, 2018, p. 19).

With this critique of the CGC by another expert economic body, the Productivity Commission, the Coalition Treasurer, and Commonwealth Treasury seized the initiative. Although not drawing greatly on the specific reform suggestions of the Productivity Commission, new legislation was quickly devised to change the system presided over by the CGC away from full fiscal equalization. The *Treasury Laws Amendment (making sure every state gets their fair share of GST) Act* was passed by the Commonwealth Parliament in November 2018. This new law, in the short term, sets a level of GST per capita below which no subnational jurisdiction could fall. This would bring Western Australia's relativity back up to 0.7 from 2022 (CGC, 2020, p. 1).[27] In the long term, the new standard against which jurisdictions would be assessed was to be the fiscally stronger of New Souths Wales or Victoria, plus there was to be a six-year graduated transition period extending to 2027 (CGC, 2022, pp. 1–2).

Table 6 shows the effect of these arrangements in 2022. The "assessed" relativities in the first line reflect the CGC's full fiscal equalization methods developed over the last four decades. They are, in effect, the next line in Table 5, which could be labeled U2022. Under these full equalization calculations, Western Australia in 2022 had its lowest relativity ever, at 0.15784. This is because iron ore mining in Western Australia boomed again from 2017, and royalty revenue from it more than doubled over the next three years (CGC, 2022, p. 18).

The "standard state" relativities in the second line of Table 6 represent where Australia's system of fiscal federalism is heading in 2027. Western Australia's relativity is no longer a distinct figure, but rather is matched to

[27] Supplementary payments made outside the legislation effectively brought forward to 2020 this 0.7 floor (CGC, 2020, p. 1).

Table 6 Relativities calculated by CGC in 2022 for financial year 2022–2023

	NSW	*Victoria*	*ACT*	*Tasmania*	*South Australia*	*Queensland*	*Western Australia*	*Northern Territory*
Assessed	1.01373	0.92170	1.15556	1.91658	1.34715	1.09684	0.15784	4.93255
Standard State	0.93448	0.84245	1.07631	1.83733	1.26790	1.01758	0.84245	4.85329
Blended	0.98742	0.89538	1.12927	1.89037	1.32087	1.07053	0.38608	4.90665
GST	0.95065	0.85861	1.09250	1.85360	1.28411	1.03377	0.70000	4.86988

Note CGC (2022, p. 6)

the stronger of New South Wales and Victoria, being Victoria at 0.84245 in 2022. To compensate for Western Australia's increase in relativity in 2022 of roughly 0.7 from the old (0.15784) to the new (0.84245) system, the relativities of all other jurisdictions decrease by about 0.1 (compare first and second lines of Table 6 for seven other jurisdictions). The third line of Table 6 blends the relativities in the first and second lines in a two-thirds/one-third sum as part of the six-year transition arrangements. As this blending produces a relativity for Western Australia in 2022 of 0.38608, this is then increased in the fourth line of Table 6 to the floor of 0.7 set in the 2018 legislation. With this increase in relativity for Western Australia between the third and fourth lines in Table 6, all other seven jurisdictions need to have their relativities pushed down slightly in order to compensate.

While it is the fourth line of Table 6 which gives the relativities that apply to the GST pool in financial year 2022–2023, it is the first two lines which give a clearer sense of the difference between the old system of full fiscal equalization until 2018 and the new system of partial fiscal equalization that Australia is working toward in 2027 because of the 2018 legislation. The CGC has calculated that Western Australia in 2022–2023 is $4.4 billion better off than it would have been under arrangements prior to the 2018 legislation, in a GST distribution pool of $77 billion. Conversely, New South Wales, Victoria, and Queensland are together roughly $3.3 billion worse off and the other four subnational jurisdictions together about $1 billion worse off (CGC, 2022, p. 28). It is reasonable to suggest that by the time the new system is fully implemented in 2027, Western Australia could be more than $10 billion better off, and the other

seven jurisdictions similarly worse off than under the pre-2018 full fiscal equalization system.

How and why Western Australia could successfully challenge Australia's long-established system of full fiscal equalization with relative ease between 2010 and 2018 is an important matter for analysis and debate. Part of the answer goes back to the Howard Coalition government's 1999 dedication of all revenue from the GST to general revenue sharing between the eight subnational jurisdictions. A decade after its introduction, this allowed Western Australia to focus on how little it was receiving from this Commonwealth revenue pool, rather than analyzing fiscal capacity in more aggregate terms, as the CGC has done for many decades. This narrower focus on distribution of the GST allowed Western Australia to frame its revenue from mining royalties as its own concern, which should not disadvantage its share of the GST pool.[28]

As substantial fiscal transfers to Western Australia occur over the next few years, with Australia's transition from full to partial fiscal equalization, the responses of other subnational jurisdictions will also warrant analysis. Under the current legislation, the CGC's annual calculations will still fully assess each jurisdiction's fiscal capacity, producing the annual equivalent of the first line in Table 6 for the year ahead. Any jurisdiction which falls below Victoria and New South Wales in this calculation will then be brought up to the level of the fiscally stronger of these states (with a lower relativity), as occurs for Western Australia in comparison with Victoria between the first and second lines of Table 6. This is only likely to occur for a jurisdiction with a very strong own-revenue flow, like Western Australia with mining royalties.

From 2027, the equivalent move as from the first to the second lines in Table 6 will fully determine GST distribution. These calculations will be there for all subnational jurisdictions to see and argue over. A new politics of Australian fiscal federalism will surely emerge, but its terms will be different from the past four decades, in which CGC methods of

[28] Back in the 1970s Holmes and Sharman (1977, p. 141) anticipated that "peripheral states [...] experiencing fast rates of economic growth from their minerals bases [...] may go through a period of revolt against financial egalitarianism." That analysts could foresee this possibility a half century ago suggests that it is not just the GST arrangement that has led Australian fiscal federalism in this direction. Fenna (2011) also pointed to the way resource-rich regions within federations can successfully challenge fiscal equalization when their economies are expanding more rapidly than other regions, giving Alberta in Canada since the 1970s as another example. See also Eccleston and Woolley (2014).

comparing budget outcomes drove full fiscal equalization between the subnational jurisdictions (Mathews, 1994). Now, the terms of debate are likely to be about what degree of revenue equalization is reasonable, while leaving in place the CGC's expenditure equalization assessment. Western Australia has already successfully argued that better revenue raising than the stronger of New South Wales or Victoria should be rewarded and supported, rather than diluted by full fiscal equalization.

Concluding Discussion

These developments in recent decades in the Northern Territory and Western Australia illustrate some deep continuities in Australian fiscal federalism, while also, in the latter case, driving the current change away from full fiscal equalization. Since the 1980s the Northern Territory has taken over Tasmania's prior position as the most low-revenue jurisdiction with the highest expenditure needs. It has shown how strong claims for additional expenditure are sustainable over several decades, based on the demographic and socioeconomic characteristics of a population that diverges significantly from the Australian average. The Northern Territory's disproportionate sparsely settled Indigenous population enables it to claim expenditure needs that are several multiples higher than any other jurisdiction. Yet, ironically, there has been no mechanism within Australia's fiscal equalization system to ensure that this is how additional revenue from the Commonwealth is spent. This limitation has made Aboriginal land councils in the Northern Territory enduring critics of fiscal equalization, though they have struggled to find pressure points in the system for their concerns (Sanders, 2021, pp. 27–30). The Northern Territory has shown starkly how Australian fiscal equalization accommodates diversity between jurisdictions, but is less accomplished at managing diversity within a jurisdiction.

In the twenty-first century, Western Australia has resumed its historic role of being a high revenue jurisdiction demanding exceptional consideration within Australia's fiscal federal system. It has shown how easily equalization of revenue can be argued against as a disincentive to resource-based regional development in a fast-growing subnational jurisdiction, as it did in the early years of federation. This disincentive applies primarily to jurisdictions with large land areas and potential resource endowments, with relatively small shares of national population. With resource development luck, it could one day also apply to the Northern

Territory. However, in the timeframe examined here, the Northern Territory has joined the Australian fiscal equalization system more like a big Tasmania than a small Western Australia.

Western Australia and Tasmania are notable for being at opposite ends of a demographic and economic spectrum during the hundred and twenty years since federation. In 1901, both these jurisdictions had just under 5% of Australia's population. But in the years since, Western Australia's population share has more than doubled to 10.4%, while Tasmania's has fallen to 2.1% (see 2021 population figures in Table 2). While discussed together as "small" states within Australian fiscal federalism by May in 1971, the reality was always that Western Australia and Tasmania were small in very different ways. Tasmania was established as an early British colony in 1803 and probably enjoyed its relative economic heyday over the next three decades. Once Victoria was established as a separate colony to its north in the 1830s, Tasmania was almost inevitably destined to struggle as a small peripheral island economy within south-eastern Australia. Western Australia, by contrast, was an outlying late starter among the British colonies. It was far enough away from the eastern colonies to grow as a distinct economic entity, developing its own international trading links.

Western Australia's higher share of national production compared to population was evident in the 1890s (see Table 1). This lessened during the twentieth century but has re-emerged in the twenty-first. Table 7 gives Australian Gross Domestic Product (GDP) by state and territory at five-year intervals from 1991 to 2021. At the beginning of these three decades, Western Australia contributed 9.7% to Australia's GDP, which was very close to its population share of 9.5% (see 1991 population figures in Table 2). However, by 2011 Western Australia's contribution to GDP had risen to 15.6%, and by 2021 to 17.5% (see Table 7), which was well above its 2021 population share of 10.4% (see Table 2). In terms of dollars per capita per annum, Western Australia moved in these three decades from close to the national average GDP ($24,800 compared to $24,200) to almost 1.7 times the average ($135,500 compared to $80,500) (see Western Australia and Australia columns of Table 7). This is reminiscent of the economic position Western Australia occupied at federation after its mining boom of the 1890s. In the 2020s however, Western Australia has double its share of the national population compared to 1901, so its booming share of GDP is of far greater national significance.

Table 7 Australian gross domestic product by state and territory, 1991–2021, current prices

	NSW	*Victoria*	*ACT*	*Tasmania*	*South Australia*	*Queensland*	*Western Australia*	*Northern Territory*	*Australia*
1991 GDP $B	154.9	105.7	8.3	8.7	31.8	60.8	40.3	4.7	415.2
%	37.3	25.5	2.0	2.1	7.7	14.6	9.7	1.1	100
GDP per capita $(000s)	26.4	24.0	29.2	18.7	22.1	20.7	24.8	28.4	24.2
1996 GDP $B	192.7	130.1	10.2	11.0	38.6	85.1	55.5	5.4	528.6
%	36.4	24.6	1.9	2.1	7.3	16.1	10.5	1.0	100
GDP per capita $(000s)	31.4	28.8	33.3	23.2	26.3	26.0	31.7	29.7	29.2
2001 GDP $B	255.1	177.4	13.6	13.0	49.6	113.7	75.7	8.2	706.4
%	36.1	25.1	1.9	1.8	7.0	16.1	10.7	1.2	100
GDP per capita $(000s)	39.3	37.5	42.8	27.5	33.1	32.1	40.0	41.2	36.9
2006 GDP $B	332.1	243.3	18.6	18.5	66.4	184.9	122.6	12.1	998.4
%	33.3	24.4	1.9	1.9	6.7	18.5	12.3	1.2	100
GDP per capita $(000s)	49.4	48.4	55.7	37.9	43.0	46.6	60.4	58.3	49.2
2011 GDP $B	445.1	331.0	27.6	25.1	90.8	258.4	221.6	18.4	1,417.9

	NSW	*Victoria*	*ACT*	*Tasmania*	*South Australia*	*Queensland*	*Western Australia*	*Northern Territory*	*Australia*
%	31.4	23.3	1.9	1.8	6.4	18.2	15.6	1.3	100
GDP per capita $(000s)	62.0	60.2	75.6	49.1	55.6	58.2	95.6	79.8	64.0
2016 GDP $B	541.8	394.5	34.4	27.9	99.0	301.1	237.0	22.1	1657.7
%	32.7	23.8	2.1	1.7	6.0	18.2	14.3	1.3	100
GDP per capita $(000s)	70.6	64.8	86.2	54.1	58.0	62.7	93.0	90.6	69.1
2021 GDP $B	643.1	474.1	44.0	34.8	117.7	366.3	361.8	25.1	2067.0
%	31.1	22.9	2.1	1.7	5.7	17.7	17.5	1.2	100
GDP per capita $(000s)	78.7	71.2	102.0	64.3	66.5	70.5	135.5	101.7	80.5

Note Australian Bureau of Statistics

Table 7 shows Tasmania's contribution to Australian GDP in the last three decades moving from 2.1% to 1.7%. Hence Tasmania is being confirmed as an enduringly "small" state within the Australian federation, both economically and demographically, while Western Australia is emerging in both these dimensions as a "big" jurisdiction, growing rapidly from a small, late starting base. Other patterns in GDP shares among states and territories emerging in Table 7 largely reflect Western Australia's upward economic and demographic path. Three of the other south-eastern jurisdictions have fallen in their contribution to GDP over the three decades: South Australia from 7.7% to 5.7%, Victoria from 25.5% to 22.9%, and New South Wales from 37.3% to 31.1%. The two self-governing territories have roughly maintained their contributions to GDP over the three decades, at 2% for the Australian Capital Territory and 1% for the Northern Territory. Only Queensland, along with Western Australia, has increased its contribution to GDP in these last three decades. Most of Queensland's growth in GDP share occurred in the first 15 years from 1991 (14.6%) to 2006 (18.5%), before Western Australia's growth really began to dominate the national figures.

Putting together figures from Tables 2 and 7, it is clear that the long-term demographic and economic trends in Australia since federation have been away from the south-eastern jurisdictions and toward the north and western jurisdictions. The latter, in the right three columns of Table 2, accounted for almost a third of Australia's population in 2021, having been less than 20% at the time of federation. In the right three columns of Table 7, Western Australia, Queensland, and the Northern Territory have grown from 25.4% (9.7 + 14.6 + 1.1) of GDP in 1991 to 36.4% (17.5 + 17.7 + 1.2) in 2021.

Analyzing state and territory shares of national population and GDP over time is, of course, a zero-sum game. It should be noted that as Australia's population has grown from around 6 million in 1930 to 10 million around 1960, 17 million in 1990, and over 20 million in 2020, no state or territory has ever gone into sustained population decline (see Table 2). So, as important as these long-term shifts to the north and west are, they should not be seen as cause for alarm. Indeed to the extent that they lessen the demographic and economic dominance of New South Wales and Victoria, they can be seen as good. But if they are seen as at the expense of Tasmania and South Australia, they can be judged more adversely.

These significant demographic and economic shifts have all occurred under Australia's strong system of full fiscal equalization, which has been comprehensively in place since the 1980s and was evident in its principles from the 1930s. What future demographic and economic trends may emerge under Australia's currently emerging new system of partial fiscal equalization is open to speculation. The obvious suggestion is that shifts toward the north and western jurisdictions will likely increase, and that the south-eastern jurisdictions will continue to slowly lose their demographic and economic dominance. Within these two sets of jurisdictions, however, there will also continue to be winners and losers, which will animate the debate over Australian fiscal equalization in the years ahead. Tasmania and South Australia will surely continue to fight for their additional expenditure needs among the five south-eastern jurisdictions, while the Northern Territory will do likewise among the north and western three. Perhaps some lucky jurisdiction will happen upon a natural resource ripe for development and taxation, like Western Australia has with iron ore and mining royalties in recent years. But this will be a chance event if it occurs, and the more likely scenario is that Western Australia alone will remain the one truly "big" revenue jurisdiction within Australian fiscal federalism over the next decade or two.

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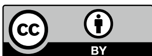

Territorial Inequalities and Fiscal Federalism in Brazil: An Incomplete Path Toward Equalization

Gabriel Junqueira and Gabriella Alcaraz

Introduction

The concentration of industrial and financial economic activities in the South and Southeast, especially in São Paulo, in contrast to the underdevelopment of agriculture and extractivists activities in the Northeast and North, consolidated strong structural economic and social inequalities between Brazil's regions[1] (Cano, 1977). Although there are ethnic and religious heterogeneities in Brazil, several studies highlight the importance of regional inequalities in the construction and evolution of federal institutions. Conflicts between poor and rich regions are identified as the

[1] The process of industrial concentration occurred between 1880 and 1929. The Midwest region would only be significantly occupied by agricultural activities in the second half of the twentieth century.

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F. J. Romero Caro and A. Valdesalici (eds.), *Fiscal Federalism and Diversity Accommodation in Multilevel States: A Comparative Outlook*, Federalism and Internal Conflicts,
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main force that shaped the design of Brazilian political and fiscal institutions. (Arretche, 2010, 2012, 2013, 2020). These institutions, built to benefit poor regions' states and municipalities, also intensified the division of interests between states' representatives in the Congress regarding the fiscal structure and the distribution of transfers, which increased the obstacles to horizontal cooperation in fiscal matters (Prado, 2020). It is also argued that this diversity of interests between industrialized and rural regions and the history of domination of the central government by the rich and densely populated states, especially São Paulo and Minas Gerais (MG), influenced a constitutional deal that over-represented sparsely populated states (agricultural states of the periphery) in both legislative chambers. This institutional setting would have enabled the rich and big to coalesce with small and poor states in order to benefit them disproportionately and block more substantial inter-regional redistribution. Therefore, although the original federal pact created political institutions to protect small and peripheral jurisdictions, these are now (ab)used by the rich states to prevent further redistribution (Rodden, 2009). Some also affirm that states created[2] in the poor regions of the North and Midwest during the military regime (1964–1985) and in the following years, during the constitutional assembly (1987–1988), joined forces with the states in the Northeast to build and preserve a transfer system that involved the redistribution of revenues from rich to poor states (Diaz-Cayeros, 2006). Although there are differences in these arguments, they all share the common idea that territorial cleavages related to structural and economic inequalities have been a major driver of intergovernmental relations and have influenced the overall design of fiscal federalism in Brazil.

In the current chapter, we share this understanding and start from this premise that territorial socioeconomic inequalities are the main diversities to be accommodated in the Brazilian federation. One of the most promising ways to evaluate to what extent this is accomplished is to understand if the fiscal constitution contributes to ensure adequate financing to support similar levels of provision of public goods and services through all Brazilian territories, regardless of their level of income or development. Therefore, the rest of the text will focus on intergovernmental fiscal

[2] From 1964 to 1988, five states were created, four in the North region and one in the Midwest, respectively: Rondonia (RO), Roraima (RR), Amapá (AP), Tocantins (TO), and Mato Grosso do Sul (MS).

relations. Following this introduction, Sect. 1 will present a panorama of regional inequalities in Brazil to emphasize its relevance and dynamics over the last decades. Section 2 shows how regional and territorial elements were imprinted in the fiscal constitution to politically accommodate differences in revenue collection due to economic inequalities. The objective is to present in detail how regional imbalances effectively influenced the design of some of the most important sources of subnational governments financing. Section 3 investigates to what extent the transfer system helps to reduce intergovernmental revenue disparities. Findings indicate that although significant attempts and institutional devices were created to tackle inequalities, the pattern of territorial redistribution of revenues shows that demands for more significant reforms to improve equalization are necessary. However, the complex structure of interests resulting from the institutional legacy and the uneven development of regions in the last decades reduces the likelihood of successful redistribution coalition formation.

Territorial and Regional Inequalities: The Main Diversity of the Brazilian Federation

To provide a clear understanding of the relevance and magnitude of territorial and regional inequalities in Brazil, we start by presenting some historical data. The goal is to situate the state of inequalities at the time of the construction of the main features of Brazilian fiscal federalism and its evolution until recently. We try to show that the spatial configuration of disparities that influenced taxes and transfer design during the 1960s and 1980s has changed over time, and that this influenced a transformation in regional interests and reduced the likelihood of formation of successful inter-regional redistributive coalitions. First, Fig. 1 presents the current territorial configuration of Brazil: divided into 26 states and the capital, Distrito Federal. These states are grouped into five different regions: South, Southeast, Midwest, North, and Northeast.

Socioeconomic inequalities have many dimensions but due to limitations of data availability and the focus on intergovernmental fiscal relations, in this introduction, we concentrate on income and the Human Development Index (HDI), which synthesizes income, education, and health indicators. Since there is a lack of socioeconomic data for the 1960s, we use the poverty and HDI indicators from 1970 to show the

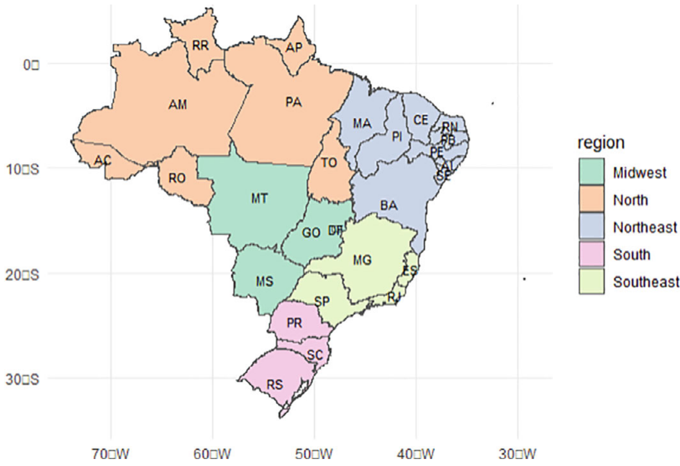

Fig. 1 Map of Brazilian states grouped by regions (*Source* Elaborated by the authors)

state of spatial inequalities when the tax reform of the mid 1960s implemented the main pillars of the current subnational fiscal structure. At the time, the states of the Southeast –especially São Paulo (SP) and Rio de Janeiro (RJ)—and the South, mainly Rio Grande do Sul (RS)—were clearly more developed than the rest of the country (Fig. 2).

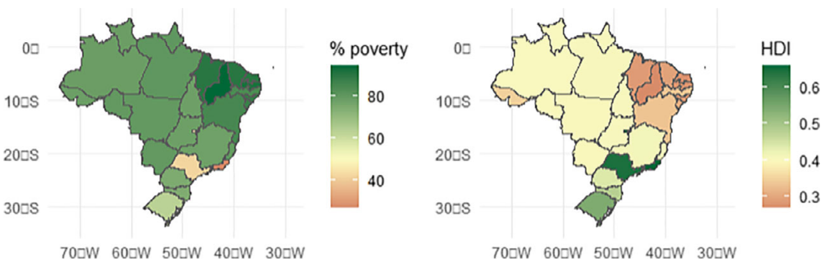

Fig. 2 Map of percentage of poor and HDI for each state (1970) (*Note* Elaborated by the authors with data from IPEADATA. The states of Mato Grosso do Sul (MS), Amapá (AP), Rondônia (RO), Roraima (RR), and Tocantins (TO) did not exist this year, missing data were manually imputed)

The territorial distribution of poverty[3] in Brazil changed considerably over time. While in the 1970s, only two states, São Paulo (SP) and Rio de Janeiro (RJ), in the Southeast region had less than 45% of the population extremely poor, in the 1980s and 1990s, this path extended to other states, especially in the South, such as Rio Grande do Sul (RS), Santa Catarina (SC) e Paraná (PR). The Human Development Index (HDI), which considers a broader range of living capabilities such as education, mirrors this behavior: if lower poverty levels and better living capabilities were highly concentrated in fewer rich states, later more states would be able to reach equivalent levels. Despite those relevant changes, one particular region remains the poorest and with the lowest HDI throughout time, the Northeast (NE). Using data from the decades of 1980 and 1990, the following Figs. 3 and 4 display this trajectory.

Brazil is among the most unequal countries in the world: the Gini coefficient on average from 2010 to 2017 was 0.51 and the country held the 9th position for the most unequal in the world, also held the 79th position in the HDI in 2017 (PNUD, 2018). Furthermore, a clear income cleavage between North and South of Brazil remains. As the South and Midwest concentrate the highest per capita incomes over time, regions in the North and Northeast remain at the lowest levels. Other studies show an equivalent inequality path for education performance, despite

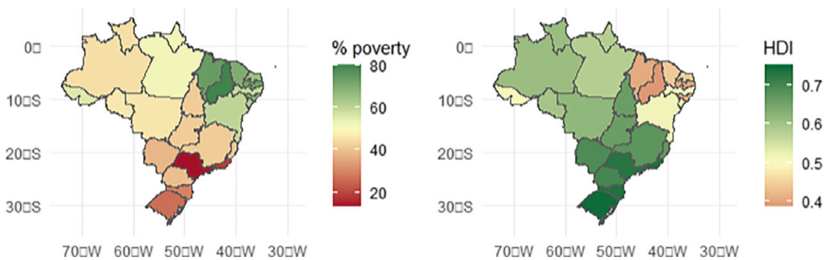

Fig. 3 Map of percentage of poor and HDI for each state (1980) (*Source* Elaborated by the authors with data from IPEADATA. The states of Amapá (AP), Roraima (RR), Rondônia (RO), and Tocantins (TO) did not exist this year, missing data were manually imputed)

[3] Measured by the percentage of people with per capita income below 50% of the minimum wage (in September 1991 with the national currency).

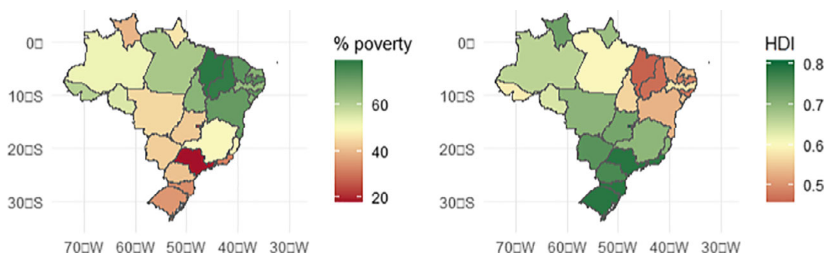

Fig. 4 Map of percentage of poor and HDI for each state (1991) (*Source* Elaborated by the authors with data from IPEADATA)

incremental declines (Arretche, 2016). In this case, Brazil has experienced a significant improvement in providing primary education in the last 30 years, however, the smallest percentage still concentrates in the Northeast. Figure 5 displays regional differences according to income, education, and infant mortality in 2021.

In sum, territorial and regional inequalities were and still are the main diversity to be accommodated in the Brazilian federation. The maps of socioeconomic indicators show that they were relevant in the second half of the twentieth century, when the structure of Brazilian fiscal federalism was built. At the time of the tax reform that created the foundations of the current tax system, the North and Northeast were the poorest regions and the Midwest had similar socioeconomic indicators. Therefore, they were treated differently by the intergovernmental fiscal institutions created in the 1960s. During the next decades, the rapid growth experienced by the Midwest, especially the states of Mato Grosso (MT) and Mato Grosso do Sul (MS), approximated their socioeconomic indicators to those of the rich regions. This transformation and the interests about the transfer system created by institutional legacies have changed the political economy of fiscal federalism and equalization in Brazil. Some states that used to have interests aligned with the poor regions, but now have a dual concern: to benefit from own tax and transfer rules. These and the interests of small states from the North, such as Amapá (AP), Roraima (RR), and Acre (AC), that benefited disproportionately from transfers, have complicated the possibility of coalition formation to improve equalization.

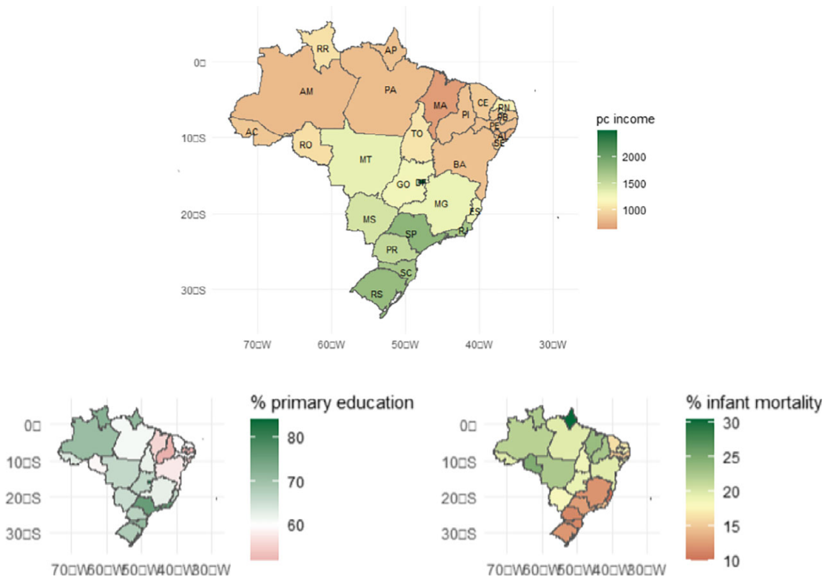

Fig. 5 Map of Per capita income, percentage of people over 25 who completed elementary school and infant mortality by state (2021) (*Source* Elaborated by the authors with data from IPEADATA and PNUD)

Did Territorial Inequalities Influence the Fiscal Constitution Design?

As pointed out in the previous section, territorial inequalities are historically significant. Regional imbalances were important factors to policy formulation by bureaucrats and to consolidate political cleavages over fiscal legislation. This section explores how this socioeconomic diversity has influenced the design and institutional evolution of Brazil's main subnational taxes and transfers: (i) the Tax on the Circulation of Goods and Services (ICMS); (ii) the States' Participation Fund (FPE); (iii) the Municipalities' Participation Fund (FPM); and (iv) the Fund for the Development of Basic Education (Fundeb). These are the major sources of revenue for states and municipalities: in 2021, ICMS and FPE accounted for 9% of the national GDP and were the two main states' revenues. In the same year, considering municipalities' revenues, the local share of ICMS and FPM represented their main sources with

values around 3% of the GDP. More important, these are cases in which regional inequalities were clearly addressed by fiscal legislation and also good examples of the political conflicts that hinder further redistribution. To illustrate this, we describe the main institutional features that addressed territorial inequalities since the last structural tax reform in Brazil in the 1960s.

Tax on the Circulation of Goods and Services (ICMS)

In late 1963, a Tax Reform Commission was established by the Ministry of Finance and ordered a series of academic studies to support the modernization of the tax system. In March 1964, a coup ended this democratic period and gave rise to a military authoritarian regime that lasted until the eighties. Commission reports affirm that this reduced political and institutional obstacles, and allowed for a structural tax reform to be approved in Brazil between 1965 and 1967 (EC 18/65; Lei 5.172/66; and Constitution, 1967). Its main objectives were to: (i) increase tax collection to balance central government budgets; (ii) centralize revenue and decision-making over public finances; and (iii) eliminate cumulative taxes on sales (Varsano, 1996).

The tax on the circulation of goods (ICM) is the Brazilian version of VAT and was created by the 1965–1967 reform to replace the cumulative tax on sales and reduce incidence on interstate transactions. It was innovative for the time and one of the main pillars of tax collection modernization. It was attributed to state governments with limited autonomy: rates should be uniform by product and the maximum rate for interstate transactions would be set by the Senate at 15%. The tax was levied on the state of the origin of the transactions mainly due to the technical challenges faced at the time to monitor and enforce collection on the destination of transactions.

Within a context of significant regional economic and social heterogeneity, as shown in the introduction of this chapter, the taxation on the origin of the production reinforced inequalities. The South and Southeast states concentrated economic production and were net exporters to the rest of Brazil. Therefore, they had a larger tax base than agricultural states of the North and Northeast. In this context, conflicts over the tax soon began and several rate changes were made to accommodate regional interests. The main one was over interstate tax rates and started in 1980 when the Senate differentiated rates for transactions originating in the

two richest and poorest regions. A coalition of less developed states—from the North and Northeast plus Espírito Santo, the poorest state from the Southeast—was decisive to continuously increase this difference until 1989, when the rate for transactions originating from the poor was set to 12% and for operations starting in rich states to 7%. The main idea was that the higher rate to poor regions could partially balance the per capita tax collection between rich and poor regions (Rezende, 2012).

Today's major transfer to municipalities is the local share of 25% of the Tax on the Circulation of Goods and Services, 1.8% of GDP in 2021, and it was also created in the 1965–1967 reform. At first, it did not have any equalization goals: the distribution was made according only to the value added in each jurisdiction. This tended to reinforce inequalities and benefit disproportionately small and medium cities with industrial plants. Recognizing the distortions, in 1980, national legislators allowed each state to distribute up to a quarter of the ICMS share to its municipalities according to own legislation. The original proposition suggested a uniform rule distributing one-third of the ICMS share according to the area and population. The Parliamentary Commission that made changes to the original project argued that the formula was not effective to deal with regional peculiarities and agreed to leave up to one-quarter of the ICMS share to be distributed according to law established in each state.[4] Since then, several states used this autonomy and adopted economic, educational, and ecological variables to this part of the ICMS share transfer. The state of Paraná (PR), for example, in the South, introduced seven extra criteria to the distribution, including the value of agricultural production (8% of the resources), the number of inhabitants in rural areas (6%), and the existence of environmental conservation zones in the city (5%). The state of Ceará, in the Northeast, started adopting educational indicators to the distribution of part of the ICMS share in 1996, when the education spending in the local government budget became an important element of the criteria. In 2007, a reform changed the formula and established performance indicators, such as student approval rates and standardized test results to create incentives for better educational results. This new law also included health and environmental indicators (infant mortality and good management

[4] This is expressed in the draftsman opinion on the project that led to the approval of the Constitutional Amendment nº. 17, December 1980. The history of the decision process is available at: http://www2.senado.leg.br/bdsf/handle/id/181301.

practices in the sector, respectively). Inspired by the case of the state of Ceará (CE), the Constitutional Amendment that created the new Fund for the Development of Basic Education in the National Congress, to be presented below, set an obligatory 10% of the ICMS share to be distributed to municipalities according to educational results. Now, up to 25% of the ICMS share may be distributed according to each state's decision and until 35% may have a more equitable distribution than the one determined by the value added in each jurisdiction.

The democratic Constitution of 1988 added some essential services (such as energy, fuel, and telecom) to the tax base and changed the name to tax on the circulation of goods and services (ICMS). Although there was a proposal to give states autonomy over the tax rate and introduce the destination in tax collection, only the first measure was approved. The last one faced intense federal conflicts, not only between poor and rich states but also due to the special situation of the Midwest states: they used to form the coalition of poor states but due to its economic growth, their socioeconomic and fiscal indicators became closer to the ones of rich regions. These decisions helped to raise distortions and intensify federative conflicts. Now, the autonomy to set internal rates created the possibility for the states to engage in a complex "fiscal war" to attract private investments that has many features of a typical race to the bottom in states' revenues (and municipalities, due to their 25% share of the IMCS) (Rezende, 2012).

Municipalities' Participation Fund (FPM)

Constitutional tax sharing mechanisms with local governments in Brazil began in the late 1940s, when the democratic Constitution of 1946 set the share of 10% of the income tax to municipalities, except state capitals. Each municipality should allocate at least 50% of these resources to public policies in rural areas. Later, in 1961, a constitutional amendment included capitals and added the share of 15% of the federal consumption tax. The exclusion of state capitals at first, and the maintenance of the minimum of 50% to public policies focused on rural areas show that the diagnosis at the time was that inequalities between urban (industrialized) and rural areas resulted in reduced fiscal capacity to provide the basic public goods and services and, therefore, should be tackled with fiscal transfers.

At the beginning of the structural tax reform of the 1960s, the 10% share of the income tax was maintained and a 10% share of the new tax on industrialized goods was added (as the old consumption tax was extinguished). This was called the Municipal Participation Fund (FPM), distributed to local governments according to population only, especially due to the problems involved in obtaining income information at the time. It also benefited small municipalities by the establishment of minimums and maximums coefficients.

The FPM was incorporated by the 1967 Constitution. In the same year, it was clear that the distribution rules penalized large cities by setting a maximum share of the fund below their population share. For that reason, a presidency act set a share of 10% destined to state capitals and 90% to an "interior" cities fund. The capitals' participation was distributed according to the population, the inverse of the average state income and its area (the same criteria as the States Participation Fund, which will be addressed below). With this rule, it incorporated equalizing criteria to reduce the gap between poor and rich state capitals' per capita revenues.

In 1968, following the rise of military power and authoritarianism, the Fund's share in the two federal taxes was reduced by half. This situation only began to reverse in 1975, when a series of constitutional amendments raised the subnational share on the Income tax (IR) and the Tax on Industrialized Goods (IPI) progressively to 17% in 1985.

A FPM "reserve" was created in 1981 to reduce the underfunding of large cities that were not capitals with 3.6% from the "interior's" share (86.4%). As mentioned, the distribution criteria tended to favor small municipalities with more revenues per capita by setting a minimum coefficient. So, this reserve fund implemented the same criteria as the capitals' share.

The 1988 democratic Constitution added social contributions to finance the growth of the welfare-state and decentralized funds and competences to states and especially municipalities. It implemented a centralization of taxation and policy decision-making as well as a decentralization of policymaking (Arretche, 2010). It established a progressive rise to 22.5% in municipalities share in the IR and IPI. Three more

amendments (2007, 2014, 2021) added 1% each to the FPM, resulting in 25.5% of the two federal taxes.[5]

The Constitution also determined a complementary law to regulate the FPM distribution criteria with the "objective to promote the socioeconomic balance between states and between municipalities" (art. 161). Several laws (six from 1989 to 2001) extended the validity of the main aspects of the distribution criteria until today. In 1990, the only significant change fixed the coefficients of each state in the major part of the fund (interior, with 86.4% of the fund) to prevent the creation of new municipalities that could influence the distribution of funds between states. Therefore, the population criteria was restricted to the distribution between cities of the same state and the fixation of limits in the population size influence in coefficients benefited sparsely populated municipalities regardless of their level of income or social demands.

States' Participation Funds

The 1965–1967 reform created the States' Participation Funds with 10% of the same taxes that sustained FPM, such as the income tax (IR) and the tax on industrialized goods (IPI). FPE distribution was made by a formula: 5% area and 95% according to an index based on the population size and the inverse of the per capita income, which favored small and poor states by implementing minimum and maximum index. FPE was also incorporated by the 1967 Constitution (in article 26) and had its share on IR and IPI reduced by half in 1968. This share, however, started to rise progressively from 5% in 1975 to 17% in 1985.

In 1975, poor states of the North and Northeast successfully pressured the central government to allocate a part of the fund exclusively to them. In the first two years, the share was set to 10% and would rise to 20% afterward. The distribution followed the same general criteria (income, population, and area) and 80% of the rest of the fund was distributed between all the states, including the ones from Northeast and North (Prado, 2020).

[5] It is important to mention that the constitutional amendment 112/2021 sets a gradual increase in the FPM percentage, 0.25% in the first year, 0.5% in the following two years, and that will reach 1% in 2025.

The 1988 Constitution established a progressive rise to 21.5% in the income tax and tax on industrialized products for the fund. It also determined the reform of FPE's distribution criteria, but negotiations did not succeed. The conflict between rich and poor regions was at the center of the disputes and the last succeeded in the following year. The complementary law 62/1989 changed the reserve of the fund, destining 85% to the states in the North, Northeast, and added the ones in the Midwest, the three less developed regions in the country. In addition, this law froze each state's coefficients in the fund, which were particularly opposed by states that didn't agree with the static FPE distribution and appealed to the Supreme Court. The resulting distribution created situations that favored mainly small states of the North with significantly higher FPE per capita revenue. It is also important to highlight that in 1988, the Midwest joined the coalition with the North and Northeast but was already going through a structural change that led the region to be the fastest growing economy of the country for several decades. This would put the region in a special position in the revenue distribution structure since their governments generally present high tax and transfer influx.

After several years and laws approved to postpone the validity of these same fixed coefficients, in 2010, the Supreme Court judged some states' claims and declared unconstitutional the articles of the LC 62/1989 that imposed an 85% share of the fund to the states of the North, Northeast, and Midwest and froze states' coefficients. Legislation approved in Congress in 2013 to resolve the issue, namely the complementary law n.143/2013, only introduced marginal changes, and a period of transition of 30 years. All states would receive that same real amount as in 2015 plus 75% of GDP growth. Only the residual of the fund is distributed according to a new criterion based on population and the inverse of the per capita household income. Therefore, the new criteria apply to a small share of the fund which will increase very slowly, and may reach 30% by the end of 2050.

Fund for the Development of Basic Education (Fundeb)

The 1988 Constitution followed the Brazilian institutional legacy and maintained two central aspects of education policy: (i) shared competences between central, state, and local governments; and (ii) a minimum spending on education for subnational governments, equivalent to 25%

of each state or municipality net revenue. These rules tended to reinforce territorial inequalities, by linking spending directly with revenue collection capacity and not clearly defining each level of government responsibilities. Not only did this result in differences in spending per capita but also influenced the emergence of a regional pattern of division of responsibilities between subnational levels of government. This diagnosis is clear in the formulation of the central government's proposal that led to the approval of a Constitutional Amendment in 1996:

> ...the distribution of resources is not compatible with the effective responsibilities in school maintenance. Given the different collection capacities and the fact that constitutional transfers from the Union to States and Municipalities, and from States to Municipalities, do not follow criteria that take into account specific needs, whether in education or in any other area, it results that different subnational governments present substantial differences in their capacity to invest in education.
>
> One of the most striking disparities is the fact that, precisely in the poorest regions of the country, municipalities are responsible for most of the provision of compulsory primary education. In more developed regions, however, State Governments provide most of the assistance. In both situations, however, the volume of resources available in each sphere of government, despite the constitutional binding of a significant part of its revenues (art. 212, CF), is clearly insufficient to ensure minimally acceptable quality education (Brazil, 1995).

To reduce these inequalities, the constitutional amendment n. 14/ 1996 defined competences more clearly and established the Fund for the Development of Fundamental Education (Fundef), beginning in 1998 and lasting until 2006. Fundeb comprised 27 funds (26 for each state and its municipalities, and one for the country's capital, Distrito Federal (DF)), financed by 15% of major state's taxes and grants and of the local Municipalities' Participation Fund (FPM). These resources were then redistributed, within the scope of each state, according to the number of students of each jurisdiction (including state and local governments) and weighted by the location (urban or rural) and the level of study (early childhood, primary and secondary education). It was also established that a central government complementation would be provided to the state funds that did not achieve a minimum per capita value (measured as the value of the state funds' revenues divided by the number of students in the state). The complementation is set as the value that closes the

gap between the per capita value of the state fund and the national minimum. However, since the federal budget for this complementation was significantly limited, not all state funds below this minimum received those resources. Besides, the complementation was destined primarily to the state funds with the lowest per capita revenues, not to the local governments with smallest fiscal capacity. Under this criterion, poor municipalities from states that achieved the minimum were not contemplated, while rich cities from states in which the funds were below the national standard would benefit from federal resources.

With the end of Fundef in 2006, the constitutional amendment n. 53/2006 transformed it into the Fund for the Development of Basic Education to last until 2020. The main improvements in relation to the previous fund were: (i) strengthening the fund by adding other revenues and increasing its share to 20%; (ii) setting the federal complementation to 10% of the fund's resources; (iii) broadening the coverage to early childhood and secondary education; and (iv) setting a minimum salary for teachers.

In 2020, a new constitutional amendment (n. 108/2020) turned the Fundeb into a permanent fund, increased the federal complementation progressively to 23% until 2026, and changed the distribution criteria to improve the redistributive impact. The new Fundeb sets new resources exclusively to municipalities that do not achieve the minimum values per capita after the federal complementation to state funds mentioned above.

The three constitutional amendments of Fundef/Fundeb, in 1996, 2006, and 2020, are good examples of the political economy of territorial redistribution of fiscal resources in Brazil. The reduction of territorial inequalities was an important objective of these reforms and was achieved through the distribution of additional resources to poor municipalities. The federal complementation also played a role in reducing inter-regional disparities and has been recently improved to increase its redistributive impact. On the other hand, the disaggregation of 27 funds that mainly obtain resources within the borders of each state and redistribute them accordingly to this territorial arrangement is evidence of the political challenges to promote more substantial inter-regional redistribution. This again shows the importance of territorial inequalities in the design of the transfer fund and highlights the key role of the central government in promoting a more equitable distribution of resources.

In sum, major transfer funds and subnational taxes include important elements that refer explicitly to territorial inequalities and, therefore,

that the Brazilian fiscal federalism has tried to accommodate them. In the Tax on the Circulation of Goods and Services (ICMS), the rate for interstate transactions was differentiated to increase tax collection in poor regions. State legislatures were permitted to autonomously set the distribution criteria for 25% of the local governments' quota, which allowed the introduction of socioeconomic criteria in some states. In the Municipalities' Participation Fund, initial attempts to reduce inequalities focused on the differentiation of urban and rural areas, and small and large cities. To reduce these distortions, national legislators set apart a percentage of the funds to state capitals (10%) and another one to large cities (3.6%) based on a more equalizing criteria that also considered the inverse of the average per capita income of each state. In the States' Participation Fund, the original distribution criteria considered were population and the inverse of the per capita income, and in the late 1980s, a significant share was set exclusively to the states of the North, Northeast, and Midwest. In the Fund for the Development of Basic Education, the redistribution is made by demand criteria, i.e., by formulas guided directly by social needs in the territory (the number of students, in this case), and was intended to reduce territorial inequalities linked to historical economic and institutional legacies. The central government complementation to the fund has more inter-regional equalization purposes and, although it is only 10% of the fund, national legislation approved recently will increase its share to 23% and its redistributive impact by implementing marginal but important improvements in the distribution criteria.

To What Extent Does the Transfer System Reduce Intergovernmental Revenue Inequalities?

After exploring, in detail, the mechanisms created in the fiscal constitution to accommodate territorial inequalities, we now turn our efforts to examine to what extent these rules were successful in reducing horizontal gaps. Brazil has a broad set of taxes and transfers with different objectives, some aim to reduce vertical gaps and others focus on horizontal equalization. Previous studies show the importance of fiscal transfers to reduce inequalities, particularly those originated from shared federal taxes (Arretche, 2010, 2016). In this section, we aim to develop this assessment further on in three ways. First, the effects that transfer revenue have on tackling horizontal inequality in aggregate terms for states and municipalities in the fiscal year of 2021 are discussed. Second, the resulting spatial

patterns of revenue distribution are presented through maps and showing the distribution of per capita revenues according to the level of income and socioeconomic development of the jurisdictions to understand their progressive or regressive character. Finally, the analysis of the main sources of transfers is disaggregated, to investigate their heterogeneity and their role in the distribution of fiscal resources.

Previous findings that the aggregate intergovernmental transfer system does reduce disparities are confirmed. By disaggregating the main revenue items, it is possible to add that the redistributive impact of each type of transfer is significantly different and that although the total effect is expressive, it is significantly limited due to: (i) inefficient distribution criteria of equalization funds that favor small states and municipalities; and (ii) the existence of high own tax collection disparities and relevant inequality inducing devolutive transfers, that share part of the upper level tax revenue with the territory where its economic basis occurred.

In 2021, on average, most state resources consisted of own tax. For municipalities, the scenario is reversed, and transfer revenues account for most of their total revenue. This indicates that in relative terms, municipalities depend more on transfers (especially the ICMS share and FPM) for public provision than states. It also means that the impact of transfers on the final distribution of per capita revenues is higher in the case of local governments than at the state level.

Measuring the inequality of per capita revenues by source, higher levels of Gini coefficient are perceived among states (0.224) and municipalities (0.504) considering only their own tax revenues. When we add transfers, there is a decrease in the Gini coefficient reaching the values of 0.175 and 0.237 for states and municipalities, respectively. This is the same Gini coefficient for the total per capita revenues of states and municipalities, meaning transfer revenues have a fundamental role in tackling inequality of resources in aggregated terms, especially among municipalities.

The highest per capita own revenues are concentrated in the South, Southeast, and Midwest regions. This matches with the data from Fig. 5, which shows these regions as the richest ones in terms of per capita income. In contrast, transfers to states are lower in the Center-South than in the North-Northeast, which indicates that there is not only an aggregate but also a regional/spatial reduction of inequalities. However, it is also clear by Fig. 6 that three states in the North region, Acre, Roraima, and Amapá, receive significantly higher per capita transfers than other

poor states. This result is clear in the total revenue map, which also highlights that the states from the Midwest and small states from the North present the highest per capita fiscal capacity. In the first case, high own revenue adds to the fact that they receive similar per capita transfers than poorer states from the Northeast; in the second case, it shows that states in the North previously mentioned receive such high per capita transfers, which leaves them among the highest per capita total revenues.

This is a direct consequence of two main features of the States' Participation Fund distribution criteria: (i) privileged states from the North, Northeast, and Midwest (the three poorer regions at the time) with 85%

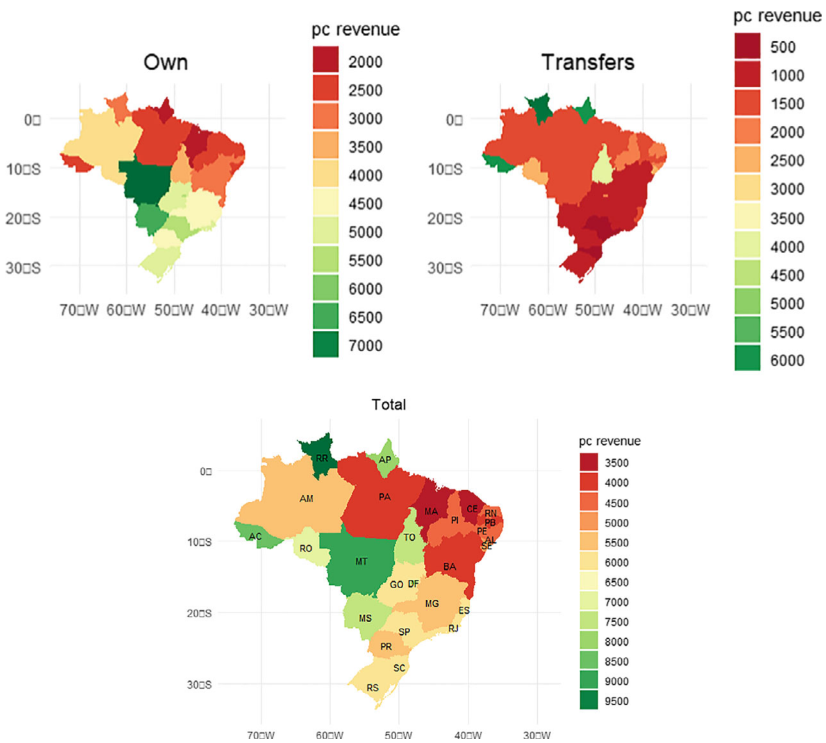

Fig. 6 Map of states per capita revenue by source, 2021 (*Source* Elaborated by the authors with data from STN (National Treasury Secretariat). Per capita revenue in current R$)

of the funds; and (ii) established minimum shares that benefited sparsely populated states. Evidence indicates that transfers to states are benefiting disproportionately some poor and less populated states and are not sufficient to tackle regional inequalities in the historically more populated and poorer states of the Northeast. The graphs below present the relation between per capita FPE revenues and the level of territorial development (using proxies such as per capita GDP and the Human Development Index). The dots dimensions are proportional to each state population, which is evidence that the negative relation that indicates progressivity is also characterized by benefiting disproportionately less populated states (Fig. 7).

As mentioned before, transfers represent a more significant percentage of municipalities' total revenues in comparison to states'.[6] They also play an important role in diminishing inequality as measured by the Gini coefficient: it goes from 0.504 to 0.237, which means that it decreases by half. When own tax revenues and total revenues are territorially distributed, the cleavage between North-Northeast and the Center-South can also be observed (presented in Fig. 8). On the other hand, it is interesting to notice that transfers are mainly benefiting municipalities in the Midwest, a region that previously was part of the poor but currently has the highest per capita income and own tax collection levels.

The distribution of per capita revenues according to the jurisdictions' per capita GDP and HDI shows a positive correlation between these variables instead of a negative one that would be expected in an inequality-reducing scenario. There are obvious limitations with the use of a simple linear regression to assess the progressivity degree of transfers to local governments. However, the dispersion plots clearly highlight that there is not a negative relation and that municipalities with similar levels of GDP and HDI receive significantly different amounts of transfers per citizen (Figs. 9 and 10).

It is important to bear in mind that some transfers are designed to diminish vertical fiscal gaps and others are more focused on horizontal equalization. In the following map, transfers are differentiated between the share of the Tax on the Circulation of Goods and Services (ICMS) and the Municipalities' Participation Fund (FPM), which respectively fit into

[6] In 2021, transfers represented 25.3% of all states' revenues and 72.3% at the local level.

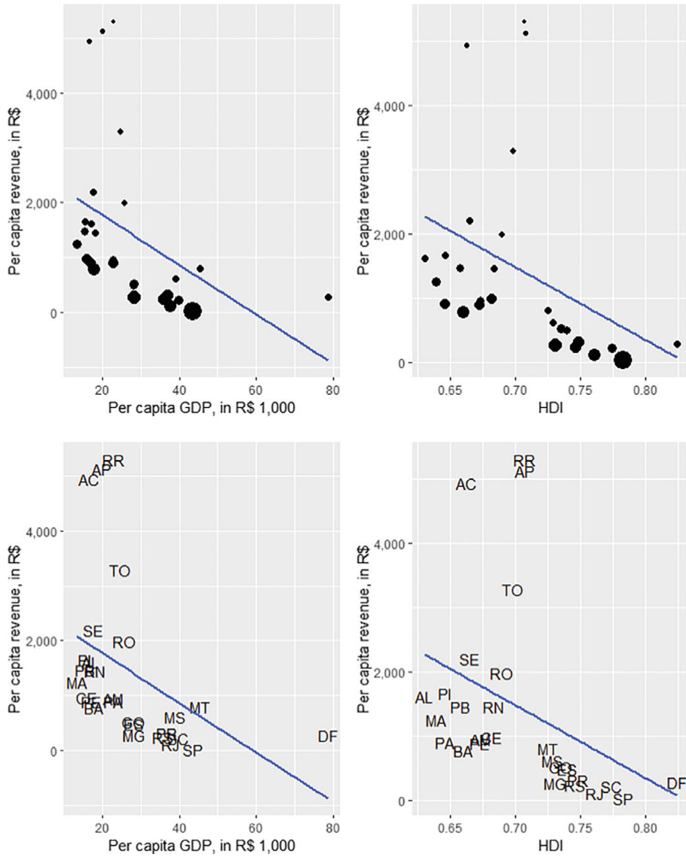

Fig. 7 States per capita FPE revenue according to per capita GDP and HDI, 2021 (*Source* Elaborated by the authors with data from STN)

these two classifications, and are the most important sources of municipalities' total revenues. Figure 11 shows that the cities with the highest per capita ICMS share concentrate in the Midwest, South, and Southeast regions, but also include municipalities from the North. The Northeast remains the net loser of this group of transfers. The FPM does not show a clear spatial pattern of distribution but highlights a less territorially concentrated scenario and some cities from the Northeast with higher revenues, in a sharp contrast with the ICMS share map. Besides, it can

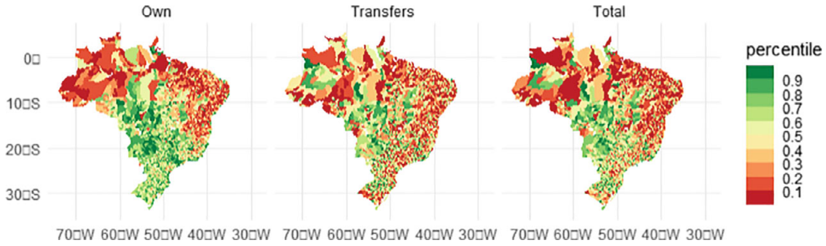

Fig. 8 Map of municipalities per capita revenue, 2021 (*Source* Elaborated by the authors with data from STN)

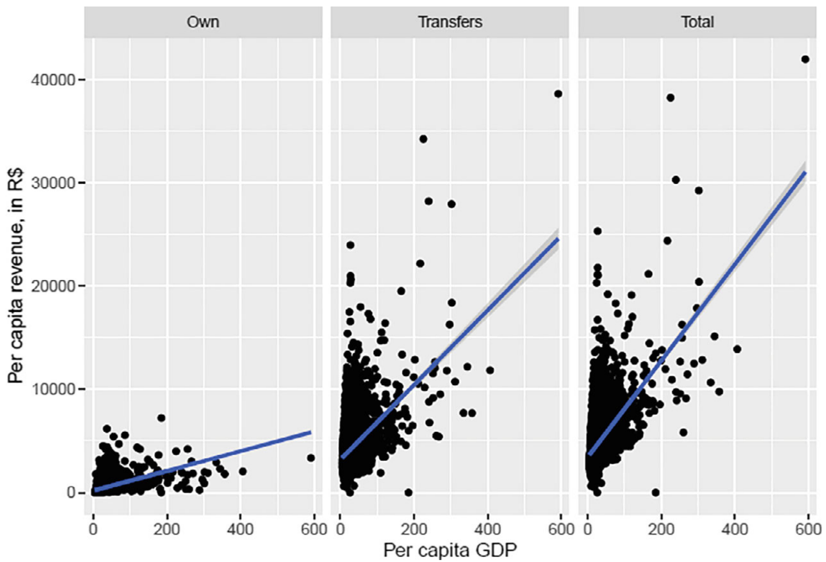

Fig. 9 Municipalities per capita revenue according to per capita GDP, 2021 (*Source* Elaborated by the authors with data from STN and IBGE)

be noticed that a large number of municipalities from the South and the Midwest regions are in green in both maps, which means they are among the top 50% in terms of per capita revenue in the two major local revenues.

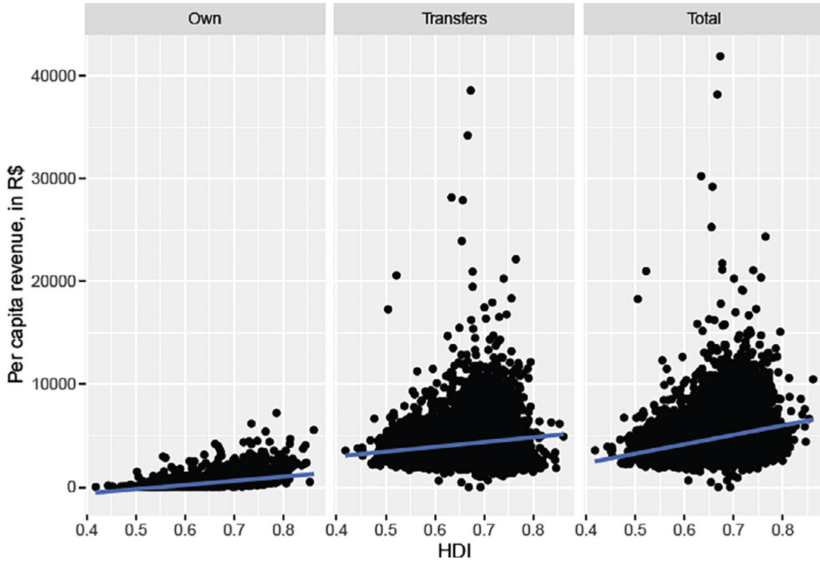

Fig. 10 Municipalities per capita revenue according to HDI, 2021 (*Source* Elaborated by the authors with data from STN and PNUD)

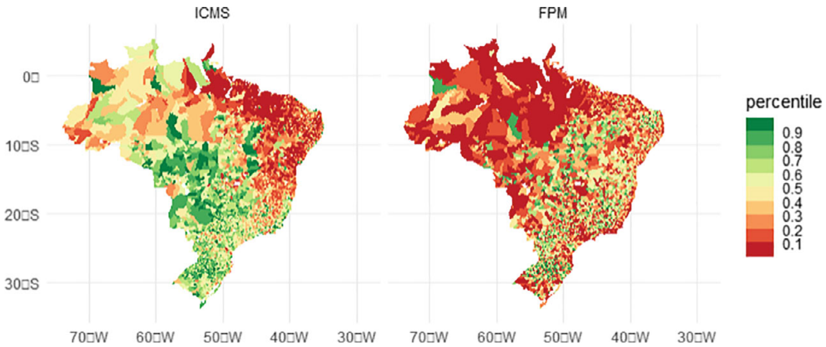

Fig. 11 Map of municipalities per capita transfers, 2021 (*Source* Elaborated by the authors with data from STN)

The dispersion plots presented below help to evaluate the impact of these transfers in accommodating socioeconomic inequalities. Besides the expected positive relation between the per capita value of the share of the Tax on the Circulation of Goods and Services (ICMS) and both GDP and HDI (Fig. 12), the graphs present evidence of a significant inefficiency in the equalization impact of the Municipalities' Participation Fund (FPM). Although the regression line indicates only a slight positive relation, the most striking result is in the FPM graph (Fig. 13), which shows the existence of major revenue inequalities between territories with the same level of development.

Education transfers are mainly composed of the Fund for the Development of Basic Education, which collects and distributes resources within each state and its municipalities. The data displayed in the following graphs (Figs. 14 and 15) indicate that municipalities with low per capita income and from poor regions benefit relatively more from these transfers. The negative relation between net per capita education transfers and income or development index indicates a higher level of progressiveness than other presented. In fact, the boxplots present the highest values for municipalities from the poorest state of Brazil, Maranhão,

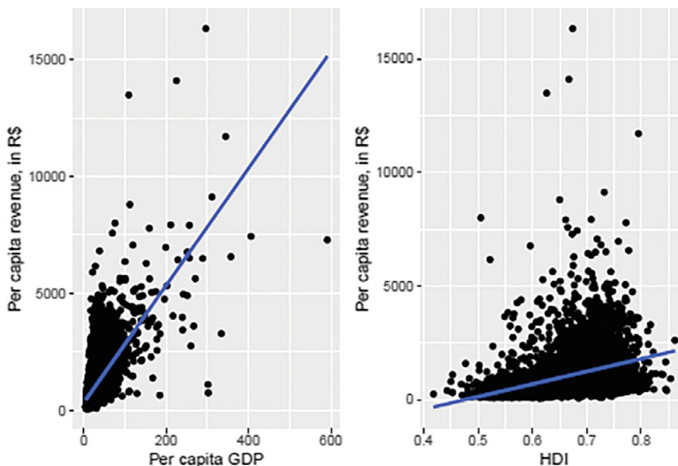

Fig. 12 Municipalities per capita ICMS share transfers according to per capita GDP and HDI, 2021 (*Source* Elaborated by the authors with data from STN, IBGE, and PNUD)

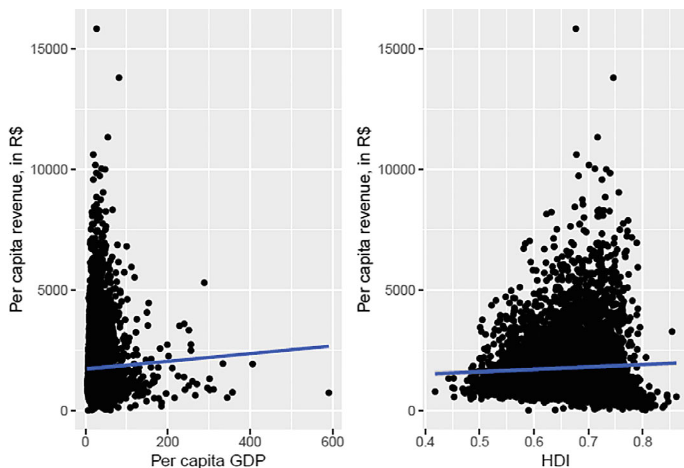

Fig. 13 Municipalities per capita FPM transfers according to per capita GDP and HDI, 2021 (*Source* Elaborated by the authors with data from STN, IBGE, and PNUD)

and show almost all states from the Northeast and North with higher per capita transfers than rich states' local governments. However, it is important to stress that this is not a result of inter-regional redistribution, since it is fundamentally a fund shared within each state and its municipalities. The regional pattern displayed in the boxplot graphs reflects the historical patterns of division of responsibilities between subnational levels of government in education described in the previous section. In poor regions, municipalities had to assume more responsibilities and had less fiscal capacity. Therefore, the distribution criteria guided by demand indicators (number of students in each jurisdiction, predominantly) contributed to accommodate this historical territorial diversity and significantly reduce territorial inequalities in basic education financing. The central government complements (with 10% of the funds' annual flow) the resources for those state funds that do not achieve the minimum value per student and therefore plays a residual but important inter-regional redistributive role.

In short, looking at the territorial distribution of revenues, one can conclude that transfers were capable of accommodating inequalities in fiscal capacity to provide public goods and services. In general terms, the

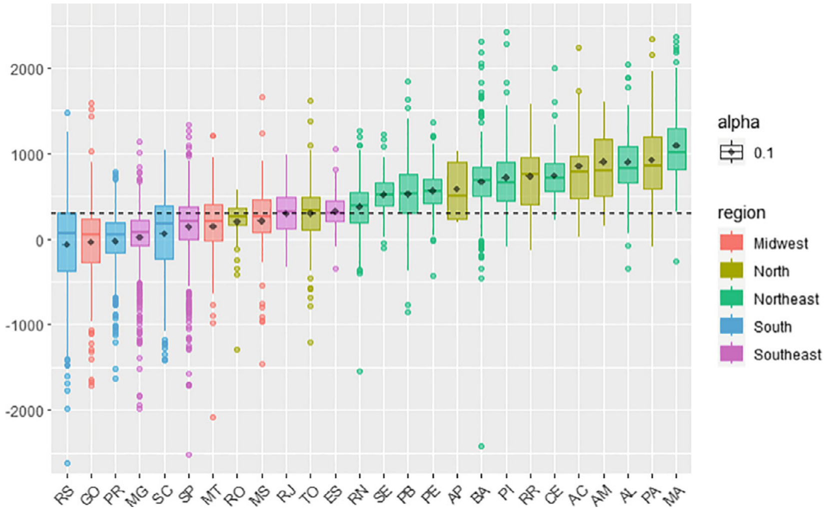

Fig. 14 Boxplots of per capita education transfers to municipalities grouped by states (*Source* Elaborated by the authors with data from STN)

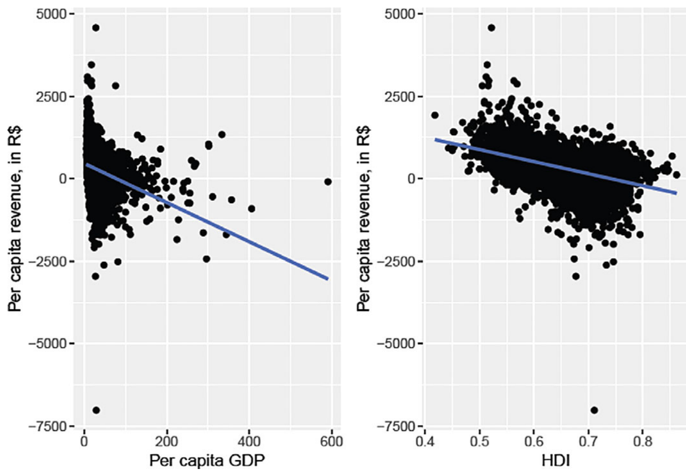

Fig. 15 Municipalities per capita education transfers according to per capita GDP and HDI, 2021 (*Source* Elaborated by the authors with data from STN, IBGE, and PNUD)

transfer system does reduce intergovernmental fiscal inequalities. This is especially true in the case of municipalities, in which inequality originates by own revenue and is reduced by half when measured by the Gini index. On the other hand, going beyond the aggregate analysis, it is possible to realize the limitations of this redistributive impact, considering that (i) own revenue promotes high territorial inequality; (ii) some important transfers do not have redistributive objectives; and (iii) there are inefficiencies in the equalization funds' distribution criteria. As a result, transfers tend to favor small states and municipalities regardless of their socioeconomic development level. Among state governments, revenues from the Tax on the Circulation of Goods and Services (ICMS) tend to replicate the inequality cleavage between poor and rich jurisdictions, while the States' Participation Fund seems to benefit mostly less populated states from the North. The Municipalities' Participation Fund (FPM), in turn, reduces inequalities but does not clearly benefit the poorest cities or regions. Education transfers, namely the Fundeb, show more progressivity and have a remarkable influence in the accommodation of historical territorial inequalities that are not only a result of economic inequalities but also of diverse regional institutional legacies. On the other hand, the inter-regional redistribution impact of Fundeb is limited to the central government complement, since Fundeb operates with 27 separate funds for each state and its municipalities, as mentioned in Sect. 2.

Concluding Remarks: Obstacles for the Advancement of an Equalization Agenda

Socioeconomic regional inequalities are the main diversities to be accommodated in the Brazilian federation. They have shaped the design of main subnational sources of revenues and altogether assured a significant and steady number of resources to subnational governments. Fiscal institutions show clear evidence of the attempt to accommodate diversities in fiscal capacities and they do reduce overall inequalities from own tax revenues. Grants are mandatory and regulated by the national Constitution as well as by laws that establish stable sharing criteria based on formulas or fixed coefficients. Therefore, they are protected from short-term political bargaining. On the other hand, some important transfers do not have redistributive objectives and increase inequalities further on.

Also, there are important inefficiencies in the equalization funds' distribution criteria that favor small states and municipalities regardless of their socioeconomic development level.

The reforms that could help to improve fiscal equalization showed little advance in Congress, especially since democratization. The State's Participation Fund had only marginal changes with a long transition time frame. In the Fund for the Development of Basic Education, the recently adopted reform has been restricted to a gradual and marginal improvement in the distribution criteria of the increased central government complementation to the fund. In the case of the Municipalities' Participation Fund, the only change was the increase of 3% in its share of federal taxes since the 1988 Constitution and later through constitutional amendments,[7] but the distribution criteria remain intact. In the Tax on the Circulation of Goods and Services (ICMS), several reform attempts were unsuccessful and resulted in the accumulation of economic and federative distortions.

It is important to highlight the case of the ICMS due to its relevance not only to subnational finance, as this is the main source of own revenue for states, but also to economic efficiency. Since the democratization process, three different proposals aimed to reform the tax: (i) during the constitutional assembly of 1987; (ii) in the first year of the Fernando Henrique Cardoso government, in 1995; (iii) in the second Lula government, in 2008. The main goals were to harmonize and simplify taxation on goods and services. The major changes were the unification of several taxes into one single VAT under national legislation (transferring states' and municipalities' autonomy to the central government or a multilevel agency) and the change of the place of collection to the destination of transactions. They were all unsuccessful mainly due to the difficulties of forming coalitions in an issue where benefits are complex and diffused and costs are tangible or, at least, there are strong expectations of losses (Arretche & Gobetti, 2023). Also, an important obstacle to reform is the multidimensionality of the conflicts involved, which overlap disputes between rich and poor states, and among different sectors of the economy (Junqueira, 2015; Orair & Gobetti, 2019; Prado, 2020).

Currently there are two proposals being discussed in Congress. Both try to change the tax incidence to the destination of transactions. As

[7] Constitutional amendments n.55/2007, n.84/2014 and n.112/2021.

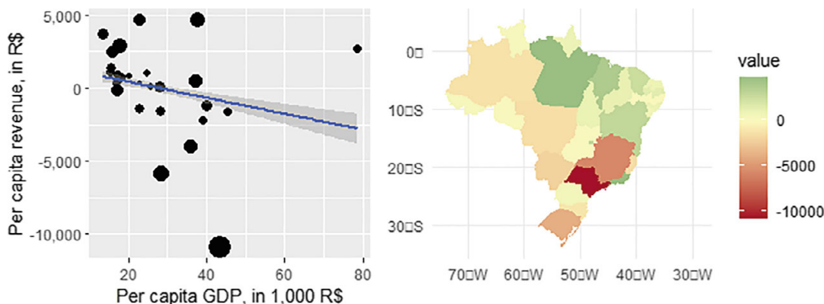

Fig. 16 Estimated reform impact by state (including state and local governments) (in million reais) (*Source* Elaborated by the authors with data from Orair and Gobetti (2019) and IBGE)

shown in Fig. 16, the reform impact is negatively related to income, that is, losses are concentrated in rich states and gains in poor ones. The map, in turn, shows the territorial character of this conflict, which mainly benefits states from the Northeast and penalizes states that concentrate production in the South and the Southeast.

The strong effort of the central government to approve this reform and the public willingness of state finance secretaries and congressmen show that this time may be different. Nevertheless, even if this reform is approved and achieves significant inter-regional redistribution, there is still evidence of the relevance of the territorial conflicts in the difficulty to advance this agenda. The decades of failures, the importance of a gradual change mechanism lasting 40 years, and the need for compensation funds to achieve the minimum consensus are strong indications of the political economy obstacles to further fiscal redistribution.

These institutions that consolidated the distribution of subnational revenues were forged through conflicts between rich industrial states in the Southeast and South regions and poor rural states in the North and Northeast. The tax and transfer system has also created interests over the appropriation of resources that influence current states' preferences to changes in the status quo. It is difficult to imagine states of the North engaging in a coalition to implement a structural reform in the State's FPE without knowing the result of the negotiation process, for example, if they already receive a higher per capita revenue under the current criteria. The Midwest is also a complex case because it was part of the

poor states in the past and treated as such by the FPE. However, the region's economic growth situated its states at the top of the average own revenue distribution. Now, they benefit from the tax and transfer system as the Midwest region became much less underdeveloped than the past or than the Northeast and North.

The formation of winning coalitions seems to be harder in these cases mainly due to the heterogeneity of territorial interests. The political preferences are complex and are influenced by institutional legacies and economic dynamics that determine the position of each state in the distribution of subnational revenues. Institutions such as a strong Senate, super majorities and, sometimes, the Supreme Court, as well as rules like disproportional representation, create potential further obstacles to territorial fiscal redistribution. The interaction of these intricate interests and intergovernmental relations in a context of political federal institutions designed to prevent the tyranny of the majority reduce the likelihood of successful inter-regional redistributive coalitions in current days.

In sum, these historical political processes have managed to produce a system that accommodates diverse fiscal capacities by significantly reducing inequalities arising from own revenues. On the other hand, its efficiency can be questioned and, since democratization, the few and marginal advances in this redistributive federative agenda highlight how difficult it is to articulate territorial interests in one broad coalition that can approve more effective redistributive fiscal reforms.

Annex

See Table 1.

Table 1 State ranking—Population, GDP, own tax revenue, and transfer revenue (per capita)

States	*Region*	*GDP pc*	*Rank*	*Population*	*Rank*	*Own tax revenue pc*	*Transfer revenue pc*
Acre (AC)	North	16,542.2	23	894,470	25	2324.3	5674.3
Alagoas (AL)	Northeast	17,049.3	22	3,351,543	16	2489.5	1213.4
Amazonas (AM)	North	22,805.9	15	4,207,714	13	3937.4	1375.2
Amapá (AP)	North	19,972.9	17	861,773	26	1688.5	5321.7
Bahia (BA)	Northeast	17,964.9	19	14,930,634	4	2535.0	984.9
Ceará (CE)	Northeast	15,909.1	24	9,187,103	8	2097.6	1085.5
Distrito Federal (DF)	Midwest	78,680.6	1	3,055,149	20	5157.7	1849.6
Espírito Santo (ES)	Southeast	28,262.5	9	4,064,052	14	4249.6	246.7
Goiás (GO)	Midwest	28,091.9	11	7,113,540	12	4541.5	–163.0
Maranhão (MA)	Northeast	13,300.6	27	7,114,598	11	1581.6	960.5
Minas Gerais (MG)	Southeast	28,229.6	10	21,292,666	2	4037.5	627.9
Mato Grosso do Sul (MS)	Midwest	39,117.9	5	2,809,394	21	6201.2	–379.5
Mato Grosso (MT)	Midwest	45,263.4	2	3,526,220	18	6983.4	–117.9
Pará (PA)	North	22,772.9	16	8,690,745	9	2390.2	1227.5
Paraíba (PB)	Northeast	15,465.2	25	4,039,277	15	2191.3	998.4
Pernambuco (PE)	Northeast	17,133.8	21	9,616,621	7	2665.7	1139.4
Piauí (PI)	Northeast	15,415.7	26	3,281,480	19	2005.9	1371.2
Paraná (PR)	South	37,021.4	7	11,516,840	5	4212.3	–312.4
Rio de Janeiro (RJ)	Southeast	37,666.9	6	17,366,189	3	4673.0	–7.3
Rio Grande do Norte (RN)	Northeast	18,057.0	18	3,534,165	17	2284.5	1201.3
Rondônia (RO)	North	25,738.5	12	1,796,460	23	3951.9	1493.7
Roraima (RR)	North	23,011.2	14	631,181	27	2957.4	5586.6

(continued)

Table 1 (continued)

States	*Region*	*GDP pc*	*Rank*	*Population*	*Rank*	*Own tax revenue pc*	*Transfer revenue pc*
Rio Grande do Sul (RS)	South	35,892.7	8	11,422,973	6	4949.1	–710.4
Santa Catarina (SC)	South	39,887.6	4	7,252,502	10	4935.5	–737.2
Sergipe (SE)	Northeast	17,546.8	20	2,318,822	22	2258.9	1947.6
São Paulo (SP)	Southeast	43,527.3	3	46,289,333	1	5120.8	470.1
Tocantins (TO)	North	24,844.5	13	1,590,248	24	3205.6	2951.3

Sources IBGE (Brazilian Institute for Geography and Statistics), STN (National Treasury Secretariat)

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(Dis)Empowerment and Self-Rule: Fiscal Federalism and Minority Nations in Canada

Jennifer Wallner

Introduction

Federalism is often advanced as a means enabling the coexistence of diverse peoples beneath a common umbrella of a shared state apparatus. Scholars have long considered how the division of powers and the allocation of jurisdictional capacities among multiple orders of government may empower and foster the autonomy of internal national minority communities. By tracking developments in such domains as social policy, education, health care, child care, family policy, language policy, and economic development, researchers have unpacked the ways in which such minority communities may leverage their autonomy and create distinctive packages and programs free from the intervention of the central state (Béland & Lecours, 2006; Cardinal, 2011; De Rynck, 2005; Keating, 2011; Maioni, 2011). Until recently, however, the political significance of the fiscal arrangements at work within a federation has remained largely unexplored. This, as Béland and Lecours (2014) argue, is surprising, given the fact that fiscal policies "are at the centre of the operations of the modern

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state" and "have the potential to shape the accommodation of nationalist movements that develop in multi-ethnic, multinational, or even strongly regionalized federal contexts" (pp. 337–338).

The objective of this chapter is to identify the concrete features of fiscal federalism that may contribute to—or detract from—the empowerment of internal minority national communities. Empowerment, in this context, is directly related to the principles of self-determination and self-rule. These principles call our attention to the abilities and capacities of a given polity to make decisions independently, without the excessive or undue influence of external actors. To be sure, all polities must work with one another in order to advance common objectives or resolve certain challenges. Self-determination and self-rule, in other words, are neither absolute nor predicated on the complete isolation of polities from one another. However, in a federation, the rules and practices should enable degrees of self-determination and self-rule for the constituent units of that system.

The Canadian federation provides an ideal case for identifying the potentially salient features of fiscal federalism as they pertain to empowerment. Canada is a multinational federation with a variety of internal minority national communities working to coexist within a shared framework. While operating within an overarching federal framework, as it will be detailed below, the specific fiscal arrangements at work for these internal national communities vary significantly. Drawing from Canadian experiences, it appears that three features of a fiscal architecture are directly related to the realization of minority national empowerment: (1) representation and participation in the management of the fiscal arrangements between the central government and the constituent units; (2) the relative independence of the revenue base that is available to the internal communities; and (3) the substantive nature of the fiscal transfers to the internal communities, specifically the conditions and time horizons that are associated with the funds.

The chapter opens with a discussion of fiscal federalism in plurinational federations. The purpose here is to underscore the greater salience of fiscal arrangements in such federations due to the potential drive for minority national empowerment. The second section provides a basic primer on key features of the Canadian case, focusing on the complex configurations of internal minority national communities in the federation and the four main models of fiscal federalism at work within it. Using this material, the three key features of fiscal arrangements are subsequently identified

as they pertain to empowerment, exposing the ways in which fiscal federalism has contributed to the achievement of self-rule for some internal minority communities while continuing to disempower others.

Fiscal Federalism in Plurinational Federations

Fiscal federalism is arguably one of the most expansive and challenging topics a federalism scholar may face. The great Donald V. Smiley (1987) himself wrote: "I have nothing to say about fiscal federalism – a subject which I once tried to comprehend but which, I am now convinced, is so complicated that one should either cultivate it as a full-time speciality or leave it alone entirely" (p. xi). Conceptually, the term refers to all fiscal arrangements at work within any political system that serve to decentralize financial matters. These include the power to raise revenues through taxation; the allocation of grants to implement and oversee programs; and the conditions and access rules applied to such grants. Consequently, the concept of "fiscal federalism" may be applied to all political systems—whether formally federal or not—that decentralize fiscal authority to multiple governing bodies (Oates, 1999).

While applicable to any political system, the subject of fiscal federalism takes on different meanings in formally federal states. According to Boadway and Shah (2009), "What distinguishes federal nations from unitary nations is that the decentralization involves giving significant legislative authority to lower levels of government, as opposed to simply administrative authority" (p. 61). Drawing from Elazar's undisputed definition of federalism as a combination of shared rule and self-rule, Jewkes (2015) further declares, "Self-rule is typically considered to be the central, and perhaps even unique definitional requirement of federalism … it allows a sub-state governmental agent to make and execute laws independently of the influence, and interference, of the central state apparatus" (p. 15). The exercise of real jurisdictional autonomy, however, is practically impossible without some accompanying fiscal autonomy (Simeon & Murray, 2001). Consequently, the design of a federation's fiscal architecture is a critical component in the realization of self-rule.

Many researchers have approached the subject of fiscal federalism as a set of rules, principles, and practices aimed at increasing economic efficiency. Efficiency is said to be achieved through such measures as limiting the opportunistic behavior of certain agents, bringing decision-making closer to the people, facilitating the creation of economies of scale, or

fostering constructive competition among jurisdictions (Boadway & Shah, 2009; Breton & Scott, 1978; Oates, 1999; Rodden, 2003; Weingast, 1995). Fiscal federalism has thus long been considered under largely economic, "rationalist," and prescriptive terms. Consequently, investigations into the *political* implications of fiscal federalism have remained somewhat sidelined.

In a series of articles, Daniel Béland and André Lecours (2014) carved a new path ushering the political implications of fiscal federalism to center stage. One thread of their research confronts the issue of equalization and why some federations—like Canada—experience significant conflict over the program, while others—like Australia—undergo less (Lecours & Béland, 2013). A second thread, particularly salient here, considers fiscal federalism's influence on minority nationalism (Béland & Lecours, 2014). Focusing on the Canadian case, the authors reveal the ways in which "equalization presents accommodation potential for nationalist movements in a federal system and how it can also generate some resentment towards the minority national community" (p. 341). Herein, we begin to see the even greater practical and normative implications of the fiscal arrangements at work in plurinational federations.

Plurinational federations are those with multiple self-identified political communities attempting to coexist within a shared institutional framework. According to some scholars and political leaders, for normative and pragmatic reasons, the design of a federation should enable the empowerment of the diverse collectivities that may live within the shared state (Basta, 2015; Gagnon, 2014; Rocher, 2009, 84). Such empowerment manifests through the principles of self-determination and self-rule, where polities can make decisions to pursue their own pathways free from the influence of other external actors. Former Quebec premier Daniel Johnson clearly articulated Quebec's position when he denounced the unilateral imposition of shared-cost programs by the federal government:

> Generally, the system of shared-cost programmes is incompatible with the pursuit by the French-Canadian nation of its essential objectives, since these impose priorities on it likely to displace those which it would otherwise establish, and reduce its true budgetary autonomy.
>
> Québec hopes that once and for all it will be understood that for socio-cultural reasons, Québec unreservedly insists that its constitutional jurisdiction be respected, and that it will brook no federal interference with this jurisdiction, whether that interference be direct or indirect. (Johnson, 1966, p. 50)

Pragmatically speaking, fiscal arrangements enable a meaningful realization of the division of powers, and thus concomitantly the achievement of self-rule for internal minority national communities in practice. These fiscal arrangements can be described as "a family of relationships that work to ensure that all the governments within a given political community have the fiscal ability to match their legal autonomy and expenditure responsibilities" (Bakvis et al., 2009, p. 137). As Noël (2009) writes, "In principle, then, the division of financial resources should correspond to the division of powers, to preserve the autonomy of the two orders of government" (p. 276). In practice, however, such a balance has proven notoriously difficult to achieve. Long-standing conflicts visible across multiple federations reveal the ways in which fiscal imbalances among the orders of government can compromise the achievement of self-rule.

It is not the case that the fiscal architecture of any given federal system is comprised of a single, comprehensive, monolithic structure. Rather, there are a multitude of arrangements emerging from different relationships set out between the central government and the various jurisdictions or communities that coexist within a federation. The fiscal architecture is thus constituted by an array of strategies layered over time with practices being set aside, replaced, or adapted to create the complex sedimentation of these fiscal arrangements (Streek & Thelen, 2005; Turgeon, 2014). Consequently, the design and management of fiscal federalism is neither straightforward nor simple; instead, it involves intense bargaining and negotiation, with concrete implications for the achievement of self-determination and self-rule for the constituent members.

Plurinational Canada and Four Models of Fiscal Federalism

As Peter Russell's book *Canada's Odessy* (2017) eloquently details, Canada's population is built upon three pillars: Indigenous Canada, French Canada, and English-speaking Canada. Within each of these pillars, moreover, there is significant diversity. Indigenous Canada, which in total constitutes approximately 4% of the Canadian population, consists of three distinct peoples with unique histories, languages, cultural practices, and spiritual beliefs: First Nations, the Inuit, and the Métis. At the time of Confederation, Indigenous peoples did not share power with the other polities who gained legislative power and constitutional jurisdiction

through the division of powers between the provincial and federal governments. Instead, as Russell (2017) notes, the only official reference to the original inhabitants of North America was the designation of "Indians, and Lands reserved for Indians" as an exclusive jurisdiction of the federal government.

As some of the descendants of the earliest migrants to North America, First Nations historically comprised between sixty and eighty nations whose collective territories stretched across the continent. As the inhabitants of lands that were of considerable interest to the settler colonialists, First Nations fell under the immediate and direct purview of the federal government. They were subjected to domination and assimilation, facilitated by the legal regime set up by the *Indian Act, 1876*, one of Canada's oldest pieces of legislation. "Status Indians," as they were referred to for generations, are affiliated with 633 Indian bands and reside on more than 2000 reserves across Canada. The Inuit are the Indigenous peoples of the Arctic and live in fifty-three communities across four regions: Inuvialuit (Northwest Territories and Yukon), Nunavik (northern Quebec), Nunatsiavut (Labrador), and Nunavut. Finally, the Métis are descendants of mixed relations forged between Indigenous peoples and early settlers prior to the establishment of contemporary Canada, mainly in the Prairie provinces and in northwestern Ontario, and themselves "make the distinction between two types of Métis, namely, the descendants of Red River who had basically adapted to the new settlement society and alternatively, the 'nomadic' Métis who essentially lived a traditional hunting and trapping lifestyle" (Voyageur & Calliou, 2000/2001, p. 112). All three of these peoples are now recognized as "Aboriginal peoples of Canada" within the meaning of section 35(2) of the *Constitution Act*, *1982*. With communities and populations spread across the country, Indigenous peoples rarely constitute the majority group within a specific jurisdiction. The exception to this is in the northern territory of Nunavut, where the Inuit constitute more than eighty-five per cent of the population.

The configuration of French Canada is appreciably more straightforward, though not without its own complexities. Today, French-speaking Canadians account for approximately thirty-three per cent of the total population of Canada. The majority of French Canadians is concentrated in the province of Quebec, where French-speakers constitute close to eighty percent of the population. Since the 1960s, the terms "Québécois" or "Québécoise" (rather than "French Canadian") have

been used to express a distinct cultural and national identity for those within that province. According to the 2011 census, outside of Quebec, over three-quarters of those who speak French at home live in New Brunswick or Ontario (Statistics Canada, 2011). Those living in the Maritimes, known as the "Acadiens," are often included among the French-Canadian linguistic group, but are in fact culturally separate due to their distinct history, which predates the admission of the Maritime provinces to Confederation in 1867. Ultimately, there are smaller French-speaking communities dispersed throughout the rest of the majority English-speaking provinces and territories.

Finally, English-speaking Canadians—while far from a homogeneous entity (McRoberts, 2003, p. 85)—form the dominant majority in the rest of Canada. Representatives from the historic British colonies held a privileged position in the negotiations that led to the *Constitution Act, 1867*. In contrast with the dispersed arrangements for many Indigenous peoples and French Canadians, those who identify themselves as part of English-speaking Canada, outside of Quebec, find themselves in the majority, and thus represented in both provincial and federal legislatures.

There is not a single, uniform model of fiscal federalism at work in Canada. Taking a bird's-eye view of the landscape, we can identity four broad models of fiscal federalism that influence the self-determination and self-rule achieved by internal minority national communities. The most prominent model is that between the federal government and the provinces. The second is that between the federal government and the territories. The third model pertains to the relationship between the federal government and the First Nations communities who still remain under the jurisdiction of the *Indian Act*. Finally, as land claims and self-government agreements are increasingly ratified, there are the newly emerging framework(s) between the federal government and Indigenous peoples, some of which are also beginning to forge formal tripartite relationships among the federal, provincial/territorial, and Indigenous governments.

Model 1

The first model, which is the most familiar to Canadians and observers of Canadian federalism, covers the fiscal arrangements at work between the federal government and the provinces. Under the terms of the *Constitution Act, 1867*, a division of powers was formalized and set

out the respective powers of the two entrenched orders of government. Under this division of powers, which also evolved over time, the provinces secured significant independent regulatory and spending authority (Turgeon & Wallner, 2013). While the federal government can spend in areas of provincial jurisdiction, "that spending cannot be interpreted as an attempt to regulate in a field of provincial jurisdiction" (Bakvis et al., 2009, p. 136). The federal government has access to both direct and indirect taxes, and the provinces have control over sources of direct taxation in their jurisdictions. Provincial governments can therefore set income, corporate, and sale taxes within their borders, further elevating their fiscal autonomy from the federal government. Provinces, moreover, have access to natural resource revenues, including mineral royalties, oil and gas taxes, stumpage fees, and other specific taxes. Put together, these arrangements have assured Canadian provinces considerably more control over autonomous revenue sources when compared to their subnational counterparts in most other federations (Turgeon & Wallner, 2013).

Like any federation, there are vertical and horizontal imbalances in the relative fiscal capacities and expenditure responsibilities of the central government and the constituent units (Bakvis et al., 2009). In the Canadian context, specific transfers, categorized in broad terms and with limited conditions, such as the Canada Health Transfer and the Canada Social Transfer, help address the vertical fiscal imbalance between the federal government and the provinces while also enabling the federal government to influence the policy choices of provincial decision-makers in key sectors through certain conditions in exchange for the funds. In addition to these relatively durable transfer programs, the federal government will often secure more targeted funding through agreements with provincial governments to further particular agenda items. For example, through the Investing in Canada Plan, the Government of Canada is partnering with provincial governments to invest more than $180 billion over twelve years in five main infrastructure priorities (Government of Canada, 2017a). When compared to the limited conditionality associated with the major transfers, the reporting requirements and conditions associated with the targeted initiatives are often critiqued by representatives from the provincial governments as illegitimate encroachments in areas of their jurisdiction. To quote a 2017 statement issued by the premiers through the Council of the Federation in regard to the infrastructure investment plan, "Agreement administration

and reporting requirements should be streamlined, reasonable and appropriately resourced. Those requirements should recognize provinces and territories' existing reporting mechanisms" (Council of the Federation, 2017, p. 3).

Finally, since 1957, the federal government has operated an equalization program to address horizontal inequalities among the provinces in terms of revenue-raising capacities. Entrenched in article 36(1) of the *Constitution Act, 1982*, the specific provision reads, "Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." These payments are completely unconditional, meaning that receiving provinces can spend the funds according to their own priorities. Reflecting on this first model of fiscal federalism in Canada, Kevin Milligan (2017) describes it as establishing a "radical" form of fiscal federalism, whereby 78% of spending in Canada happens at the subnational levels of government. In other words, this model of fiscal federalism affords considerable self-rule for the ten jurisdictions falling under this specific framework.

Model 2

Officially, Yukon, the Northwest Territories (NWT) and Nunavut, does not enjoy the same constitutional status as provinces. Through processes of devolution from the federal government, however, these three territorial governments have taken on greater power and authority, rendering them *de facto* orders of government somewhat resembling provincial governments.[1] Like provinces, territorial governments can set their own

[1] A brief description of these processes is warranted. Despite having an elected territorial council in 1908, it was not until 1979 that the federal government completed the process of transferring all executive authorities to the Yukon government (Alcantara et al., 2012, p. 330). It was this process that compelled the federally appointed commissioner to relinquish his powers, thereby enabling the territorial government to exercise its authority according to the principles of representative and responsible government. In the meantime, starting in the 1960s, the federal government began relaxing its control over the Northwest Territories with the idea of creating a legislative assembly and a new territorial government. One of the first steps toward this goal was the creation of a consolidated revenue fund in 1966, which provided stabilized funding to the NWT (Alcantara, 2013). And, by 1969, the Government of the Northwest Territories "had assumed nearly all the responsibilities that its provincial counterparts enjoyed" (Alcantara, 2013, p. 168). Finally,

personal and corporate tax rates. Under Territorial Formula Financing, which is an unconditional transfer from the federal government, territories are empowered "to provide a range of public programs and services to their residents that are comparable to those offered by provincial governments at comparable levels of taxation" (Department of Finance Canada, 2016, para. 1). Unlike provinces, however, the overwhelming majority of territorial revenues come from the federal government. For example, in 2017, federal transfers to Prince Edward Island—one of the highest-receiving provinces in the federation—totaled $3958 per capita. Per capita transfers to the territories, in the meantime, ranged from $25,299 per capita to the Yukon; $29,044 per capita to the Northwest Territories (NWT); and $41,745 per capita to Nunavut. This funding is nevertheless stable and predictable, with comparable reporting requirements as those that are set for the provinces.

A further distinction from the provinces is visible in the matter of natural resources. Control over natural resource revenue remains unresolved and the arrangements vary across the three territories. The Canada–Yukon Oil and Gas Accord, signed in 1993, allowed for the administrative and legislative control over oil and gas resources, including the collection of natural resource revenues derived from them. Then, in 2001, the Yukon Northern Affairs Program Devolution Transfer Agreement was signed. It "provided for the transfer of responsibilities for lands, water, forestry and mineral resources from the Government of Canada to the Government of Yukon" (Indigenous and Northern Affairs Canada, n.d., para 1). With these agreements, Yukon obtained a degree of resource-management power and responsibility that is similar to those enjoyed by the provinces.

In 2014, under the terms of the *Northwest Territories Devolution Act*, control over some land and resources was transferred to the Government of the Northwest Territories (GNWT). Under the agreement, the NWT "just like the provinces and Yukon – will receive a share of the royalties from resource development." (Northwest Territories, Department of Executive, n.d,). This agreement also included a further provision,

in 1993, after decades of lobbying and negotiation, the Nunavut Land Claims Agreement was reached between the Inuit of Nunavut and the Government of Canada. Then, in 1999, the territory of Nunavut was established under a public government, as opposed to an Inuit self-government with the "exclusionary elements of the self-government regimes emerging elsewhere in the country" (Hicks & White, 2014, p. 43).

whereby the GNWT committed to sharing up to 25% of its resource revenues with Aboriginal governments. Whereas Yukon's agreement "did not foresee the sharing of management responsibilities with the territory's Indigenous peoples or provide a mechanism for sharing resource revenues" (Sabin, 2017, p. 8), the one secured by the NWT government has laid the foundation for a new tripartite fiscal framework in the Canadian federation.

To date, the Government of Nunavut does not control, manage, or receive the benefits from Crown lands and resources. Representatives from the Government of Nunavut, Nunavut Tunngavik Incorporated (the representatives of the Inuit), and the federal government are engaged in an ongoing process of negotiating a devolution agreement, with the goal of securing an arrangement similar to that achieved with the NWT. Consequently, Nunavut likely faces greater barriers to the realization of self-rule when compared to its other territorial counterparts.

Model 3

Whereas the British somewhat worked to develop reasonable relations with the descendants of French settlers, recognizing and protecting their religion, language, and legal institutions, the situation was markedly different for First Nations (Papillon, 2011, p. 111). First Nations were subjugated under the "protection" of the British Crown, and federal policies were oriented toward the eventual assimilation of these minority nations into the majority polity. The cornerstone of this regime was the *Indian Act* of 1876, overseen by the Department of Indian Affairs. Devised and amended without the consent or participation of First Nations, its approach was simple: to "place Indian people temporarily on reserved lands – convert them to Christianity, dress them in European clothes, and teach them to become self-sustaining British citizens by becoming productive farmers" (Leslie, 2002, p. 24). The *Act* also "ensured the fiscal weakness of Aboriginal governments and communities, creating tiny communities fragmented across the land. Aboriginal-Canadian fiscal federalism, if it can be called that, operated under the highly intrusive and extremely paternalistic and hierarchical framework of this legislation" (Prince & Abele, 2003, p. 243).

In 1983, a major inquiry was conducted into the state of First Nations communities across Canada. Known as the Penner Report, the inquiry revealed an image of the subordination and dependence of First Nations

under federal control. If First Nations, the report declared, are to govern their own affairs, a financial underpinning that is in harmony with and reinforces this objective must exist. Present funding arrangements effectively deny Indian band councils and tribal councils control of the programs they administer; they exclude Indian people from policymaking; they place impossible accountability burdens on band councils that have assumed responsibility for administering programs; and they generate an excessive federal administrative and monitoring superstructure. In short, they inhibit the development of Indian self-government (Penner, 1983, p. 81). Indeed, according to one representative from the Grand Council of Treaty No. 3, the fiscal arrangements were "demeaning, irrelevant, and counter-productive in terms of nurturing mutual respect" (Penner, 1983, p. 87).

The report further contended that the Government of Canada was using fiscal transfers as political weapons. Aboriginal organizations and First Nations communities that embraced federal priorities and initiatives were rewarded financially, while those that rejected, criticized, or resisted such practices were punished (Penner, 1983). Finally, communities were required to return any surpluses that were saved from their annual funds. Representatives from the Christian Island Reserve summarized the pathology of this practice succinctly: "If a band were to practise a very conservative program for the year and create a surplus, the Department would merely move that resource to the following years, keeping that particular program static, thus eliminating the incentive for the band to save money for the other program" (Penner, 1983, p. 85).

Since the Penner Report, some adjustments were made to the *Indian Act* to address some of these problematic dimensions. The first occurred in 1988, when the *Indian Act* was amended to give First Nations the power to levy property tax, sales tax, certain provincial-type commodity taxes, and to tax non-Aboriginal interests on reserve lands. Subsequently, the first Aboriginal-controlled financial institution was created—the Indian Taxation and Advisory Board. According to Prince and Abele (2000, p. 340), by 1997–1998, 78 First Nations in seven provinces had taxation laws generating independent revenues. Another major change happened in 2005, when the federal government introduced the *First Nations Fiscal Management Act*. The *Act* provides "for real property taxation powers to first nations, to create a First Nations Tax Commission, First Nations Financial Management Board, and First Nations Finance Authority." One goal of this legislation was to increase the respective

capacities of First Nations communities to participate in the economy more extensively than before.

However, despite these adjustments, almost thirty years later, conditions have changed only slightly. The 2011 Auditor General's Report acknowledged that First Nations communities under the *Indian Act* lack appropriate funding mechanisms. Core services are supported through agreements that must be renewed yearly and which are subjected to onerous reporting requirements, with funds often arriving after significant delays. Fiscal surpluses must still be returned to the federal government. What is more, from 1996 until 2016, the federal government imposed a two percent funding cap on all funding for First Nations communities. While provinces gradually witnessed the reduction of the tight hierarchical conditionality historically associated with transfers, conditionality and accountability mechanisms intensified for First Nations over the past two decades. And, despite the aforementioned adjustments, the stability and conditionality of First Nations funding remains a persistent problem (Report of the Standing Committee on Indigenous and Northern Affairs, 2022).

Model 4

Of the various models at work in the Canadian federation, this last one is the most embryonic, and it is arguably the most complicated to describe. The complexity emerges not only from the novelty of these arrangements but also by virtue of the markedly different conditions for each of the Indigenous communities that have managed to secure the beginnings of a renewed fiscal relationship within the Canadian federation. Rather than characterizing this new model as simply an evolution of or an adjustment to the regime that had previously been imposed on Indigenous peoples, it is important that we acknowledge the transformational impulses, underpinnings, and objectives of such kinds of arrangements as they potentially contribute to a complete reshaping of relations between settlers and Indigenous peoples in the federation.

As detailed by Prince and Abele (2003), "self-government agreements, comprehensive land-claim agreements, and other recent developments [...] are increasingly resulting in a sharing of tax room between provincial and Aboriginal governments" (p. 251). Modern treaties signed since the 1970s with the Cree and Inuit in northern Quebec, the Inuvialuit in the Mackenzie Delta area, the Inuit of Nunavut, the seventeen Yukon

First Nations, the Tłı̨chǫ in the NWT, and others in British Columbia, are transforming the structure of the Canadian federation as Indigenous nations are re-establishing jurisdiction and control over their land and resources bases. As of 2014, fourteen self-governing Aboriginal groups had enacted personal income tax laws and concluded related tax administration agreements with Canada. What is more,

> some provincial and territorial governments share a portion of their personal income tax room with Aboriginal governments, either by providing a tax abatement which creates tax room for the imposition of an aboriginal tax, similar to Canada's approach, or by directly sharing a portion of tax revenues. (Indigenous and Northern Affairs Canada, 2014, para. 9)

In contrast with the arrangements at work for First Nations under the *Indian Act*, moreover, such agreements are negotiated and implemented by the Department of Finance and administered by the Canada Revenue Agency, as opposed to Indigenous and Northern Affairs Canada.

The Nisga'a Accord in British Columbia, for example, is particularly noteworthy for two reasons. First, it includes taxation provisions for self-government. Second, it provides for a variant of equalization known as the Fiscal Financing Agreements (FFA). This tripartite arrangement will be negotiated by the three parties every five years; will have a dedicated annual transfer to support the delivery of programs and services across a range of fields; and will have the expressed purpose of "enable[ing] the provision of agreed-upon public services and programs to Nisga'a citizens and, where applicable, non-Nisga'a occupants of Nisga'a Lands, at levels reasonably comparable to those prevailing in Northwest British Columbia" (Prince & Abele, 2000, p. 358).

Finally, in July 2015, the Government of Canada released a new policy framework for fiscal arrangements with self-governing Indigenous groups (Indigenous and Northern Affairs Canada, 2016). To date, bilateral fiscal arrangements have been concluded with more than twenty-five Indigenous governments as part of the self-government process. Working with leaders from self-governing Indigenous groups, representatives from the Government of Canada initiated a collaborative fiscal policy development process in 2016. In pursuing renewed relations, the government

> has identified the need to improve its approach to these self-government fiscal arrangements, and will work collaboratively with self-governing Indigenous groups to develop an improved fiscal policy framework that will strengthen self-governing Indigenous groups and their relations with the Government of Canada. (Indigenous and Northern Affairs Canada 2016, para. 4)

As this is a recent development, it remains to be seen what the concrete impacts of this new framework will be for the empowerment of these internal minority national communities.

(Dis)Empowerment Through Fiscal Federalism

Through this examination of the four models of fiscal federalism at work in Canada, it becomes possible to distill three critical features that influence the (dis)empowerment of internal minority national communities: (1) representation and participation in the development and ongoing management of fiscal relations; (2) the relative independence of the revenue base that a minority nation controls; and (3) the nature of the conditions and time horizons associated with transfers.

Representation and Participation

As members of the constitutionally recognized orders of government in Canada, elected and bureaucratic representatives from provincial governments have long been engaged in the processes that pertain to the negotiation of fiscal arrangements in the federation. What is more, since devolution, representatives from the territories are full members of these intergovernmental meetings. To be sure, the management of fiscal federalism is largely informal and all of the formal decision-making power rests in the hands of the federal government (Vats, 2010). While this is an imperfect process, the provinces—and increasingly the territories through conventional practices—nevertheless are able to participate in the negotiation and renewal of fiscal agreements, which provides a concrete form of empowerment for those enjoying a seat at the table. While the federal government retains greater power during these proceedings, the regular meetings of the ministers of finance offer clear opportunities for provincial and territorial leaders to influence, or at least weigh in on, key agenda items.

In June 2017, for example, the agenda for the finance ministers' meeting included such issues as the global economy and Canadian monetary policy, Canada–U.S. relations, cannabis taxation, tax integrity, corporate and beneficial ownership transparency, and the Canada Pension Plan (Department of Finance Canada, 2017). On the matter of cannabis taxation, the federal government initially offered a 50/50 revenue split with the provinces—a position that the provinces and territories vigorously opposed. Then, in December 2017, the federal-provincial-territorial ministers of finance met in Ottawa, where they reached a deal in which provinces and territories will receive 75% of the cannabis tax revenues, with the remaining 25% retained by Ottawa to a maximum of $100 million a year (Blatchford, 2017). It seems that representatives from the provinces and territories were successful in promoting the interests of their respective populations and determining their own course of action. Through these meetings, as represented by the Governments of Quebec and Nunavut, the Québécois and the Inuit thus maintained more self-rule than other members of internal nations without comparable standing in the federation.

The importance of representation was underscored by the authors of the Penner Report themselves when they explicitly acknowledged that there were no "Indian Members of Parliament" who could sit on the committee tasked with authoring that very report (Penner, 1983, p. 4). The members, therefore, asked the Assembly of First Nations to designate a representative to work as an *ex officio* member with all rights save for voting. In fact, while some slight progress is being made, direct representation of Indigenous people throughout the country—not just the Inuit in Nunavut—as equal members of the Canadian federation empowered to influence fiscal arrangements still remains out of reach. Without representation and participation in the design and management of the country's fiscal architecture, these internal minority nations are hindered in their abilities to determine their own destinies.

Independence of Revenue Base

Under the arrangements that have evolved in the first model of fiscal federalism in Canada, the provinces maintain several revenue sources with a high degree of independence from the federal government. While the specific balance varies across the provinces, on average, the provinces raise over 80% of their own revenues, with the remaining 20% coming from

federal transfers (OECD, 2016). As reported by the Organisation for Economic Co-operation and Development (OECD),

> Provinces have wide-ranging tax autonomy. Their tax revenues include Personal Income Tax and Corporate Income Tax, sale tax and payroll tax, tax on gaming profits, property tax, etc … They adhere to the federal tax base but maintain discretion over the tax rates. (OECD, 2016, p. 2)

Provinces, and therefore the Québécois, maintain the greatest amount of autonomy, thanks to the provisions of this model. In fact, further evidence of the greater autonomy exercised by Quebec is visible in the fact that the province is the lone outlier from the general income-tax-collection agreements maintained by the other provinces with the Government of Canada. To maintain its own autonomy, Quebec has retained its own independent tax-collection agency separate from the federal government.

As for the territories, despite some progress resulting from the processes of devolution, the overwhelming majority of revenues come directly from the federal government. On November 1, 2017, NWT premier Bob McLeod issued the following statement:

> The promise of the North is fading and the dreams of Northerners are dying as we see a re-emergence of colonialism. For too long now policies have been imposed on us from Ottawa and southern Canada that, despite good intentions sometimes, and ignorance other times, are threatening our economic potential and the decades long work that we as a government have taken. (Government of Northwest Territories 2017, para. 2)

It is important to underscore the fact that the federal government retains significant control over the fiscal arrangements and development of natural resources in the territories. For example, in December 2016, Prime Minister Justin Trudeau announced a five-year ban on offshore oil and gas activity in the Arctic (CBC News, 2016). This was done without consulting the territorial governments, and led to complaints from the territorial premiers. The limited independence of the revenue sources available to the territories thus curbs those jurisdictions' autonomy. More significant for the present discussion, such restrictions on the territories' fiscal autonomy diminish the empowerment of the Inuit of Nunavut relative to other national minorities such as the Québécois.

Control over funding for First Nations enshrined within the *Indian Act*, moreover, has perpetuated the subjugation of these peoples within the Canadian federation. Such subjugation is readily apparent in the chronic underfunding of these communities; as one Assembly of First Nations analysis found,

> in 2009 First Nations received roughly $8,400 per capita in programs and funding from the federal government [...] In comparison, all three levels of government spent an average of $18,178 on each Canadian citizen – more than twice as much as was spent on a First Nations citizen. (Assembly of First Nations, 2011)

Reconfiguring these fiscal arrangements will be a critical task in furthering the empowerment of First Nations communities in Canada.

Conditionality and Time Horizons

Though provinces and territories gradually witnessed a reduction of the tight hierarchical conditionality that was historically associated with federal transfers, conditionality and accountability mechanisms intensified for First Nations over the past two decades. Reliability of federal funds, moreover, continues to be a major concern as most grants to First Nations communities still under the *Indian Act* are issued on an annual basis through discretionary program funding run through Indigenous Services Canada (or what was formerly Indigenous and Northern Affairs Canada) and which are not guarded by legal protections. According to Brunet-Jailly (2008), "whereas Canadian fiscal intergovernmental relations in general are based on principles that are flexible and decentralize power among different government levels that are considered equal partners, in contrast, Canadian-Aboriginal relations are based on a rigid top-down system of government" (p. 20). Stringent rules have manifested in open conflict between the federal government and First Nations communities; in 2014, for example, Aboriginal Affairs Minister Bernard Valcourt withheld non-essential funding from almost 50 First Nations that failed to meet a government-imposed deadline under a new transparency law, while simultaneously asking the Federal Court to force six First Nations to publish audited financial statements and release the salaries of band council members and chiefs (Canadian Press, 2014).

July 12, 2016, the Government of Canada announced a memorandum of understanding establishing a new fiscal relationship with the Assembly of First Nations. The memorandum committed the federal government to lifting the 2% funding cap imposed in 1996 and to working toward the establishment of a "new fiscal relationship that gives First Nations communities sufficient, predictable and sustained funding to ensure the overall well-being of First Nations" (Assembly of First Nations, 2016). Furthermore, in December 2017, the Government of Canada issued a report on a new fiscal relationship with First Nations. Developed in collaboration with First Nations communities and the Assembly of First Nations, a key element of the program includes providing "sufficient, predictable, and sustained funding for First Nation communities." The release continues with the following declaration: "to support effective and independent long-term planning, the Government of Canada is proposing to work with First Nations Financial Institutions and the Assembly of First Nations on the creation of ten-year grants for communities that are determined by First Nations institutions to be ready to move to such a system" (Government of Canada, 2017b, para. 4). If successful, this work could perhaps lead to a fundamental reconfiguration of fiscal relations that would encourage the self-rule of Indigenous communities in the federation.

Conclusion

The fiscal architecture of a federation carries considerable implications for the achievement of self-determination and self-rule for the various communities that are working to coexist within a shared framework. Focusing on the Canadian case, this chapter detailed the key features of four models of fiscal federalism at work within the federation. This discussion revealed the significance of three features of fiscal arrangement as they pertain to the empowerment of internal national minorities: (1) representation and participation in the management of the fiscal architecture; (2) the independence of the revenue base; and (3) the conditionality and time horizons associated with grants and transfers between the sender and the recipients. Based on this study, the following observations can be made.

First, minority nations that maintain standing in the negotiating processes that establish and manage the fiscal architecture, achieve greater empowerment than those that do not. Representation and participation

mean that such internal nations have some capacity to influence the configuration of fiscal affairs and, concomitantly, the capacity to exercise jurisdictional autonomy. Second, as perhaps best evidenced by the Québécois, internal minority nations who have access to a significant base of independent revenues separate from the central government enjoy greater self-determination and self-rule than those that do not. Third, and finally, the conditions and time horizons associated with grants can either enable or stifle self-rule. Captured by the regime at work for First Nations peoples under the *Indian Act*, federal control over fiscal affairs has maintained the pervasive disempowerment of First Nations in the country. By systematically exploring the alternative methods of fiscal federalism at work in Canada, and by putting the varying political implications of these alternatives front and center, one can better understand the ways in which fiscal federalism plays a leading role in the achievement of the key federal principle of self-rule for internal minority national communities.

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Conditional Concessions and Cessation of Secession: What Role for Fiscal Federalism?—Insights from India

Chanchal Kumar Sharma

Introduction

Federal governments—striving to promote unity in diversity—often struggle to balance the principles of autonomy and equalization while preserving ethnic-cultural diversity and mitigating economic disparities. Although policies and legislation explicitly targeting social inclusion, equal opportunities, and anti-discrimination are instrumental in addressing the imperative of diversity accommodation, fiscal policy can also facilitate accommodation by judiciously allocating resources to initiatives that support economically disadvantaged regions and bolster underrepresented groups. Consequently, fiscal constitutions, typically concerned with fostering budgetary stability and economic growth, can be strategically employed in multi-level systems to cultivate perceptions of economic justice among ethnic minorities and territorial communities.

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Fiscal constitutions can shape perceptions through two policy instruments: fiscal autonomy and fiscal equalization. Both of these policy measures are perceived as instrumental in conflict resolution. However, there is no consensus among the academic community regarding these policies' exact function and impact in the context of secessionist conflict. For instance, fiscal equalization, which can potentially resolve regional imbalances (Ter-Minassian, 1997) and pacify subnational grievances through financial compensation (Sorens, 2016), has been found to be promoting political instability by making prosperous regions subsidize their less well-off counterparts (Lecours & Béland, 2010). In addition, fiscal equalization may also encourage inefficiency by softening budget constraints (Rodden et al., 2003). Likewise, fiscal autonomy, known to reduce the net payoff from secession in some cases (Bibbee, 2007; Garcia-Milà & McGuire, 2007), has been shown to be actually increasing incentives to secede in some studies (Rode et al., 2018), besides widening regional inequalities (Boadway & Shah, 2009).

The existing literature on territorial accommodation of subnational identities remains inconclusive as scholars approach the subject from diverse perspectives. Some scholars connect secessionist conflicts to economic inequality between distinct identity groups (Bookman, 1993; Hechter, 1971; Madiès et al., 2018; Muller & Seligson, 1987), while others emphasize the significance of political exclusion from state power (Boyle & Englebert, 2006; Cederman et al., 2010). Interestingly, some researchers have identified a lack of correlation between conflict and inequality, be it in the context of political exclusion (Fearon & Laitin, 2003) or economic deprivation of ethnic groups (Collier & Hoeffler, 2004). The inconclusive results from the large-N literature (Bakke & Wibbels, 2006; Sorens, 2016) highlight the need for comparative case study work that systematically examines the interplay between economic disparities, fiscal constitutions, party politics, socio-cultural divisions, and policy regimes across varying contexts.

This study advances the understanding of the role of fiscal federalism in secessionist movements by conducting a comparative analysis of three distinct secessionist movements in Indian states, delving into their unique origins, the federal fiscal approaches employed to manage them, and the resulting consequences. In order to shed light on the complex dynamics of these movements, it delves into the diverse blend of fiscal and financial measures, policy instruments, and military tactics employed by governments to deal with secessionist crises.

In this chapter, I emphasize the importance of the intersection between regional economic development and the nationalities question, which is relevant for comprehending secessionist and autonomy movements in India. Accordingly, I present a generalizable finding called *Ethno-Economic Overlap Thesis* or simply the *Overlap Thesis*—postulating a necessary relationship between nationality issues and economic justice. This thesis posits that in order to resolve the complexities of secessionist and autonomy movements, it is essential to recognize and address the intersection between economic justice and ethnic minority rights. It emphasizes that addressing economic disparities between ethnic groups is crucial in promoting stability and cooperation in societies facing secessionist and autonomy movements.

The overlapping relationship between ethnic separatism and equitable economic treatment is complex. In some cases, wealthy regions dominated by national minorities may argue that a centralist state requires them to make excessive fiscal transfers to poorer regions. Consequently, they may advocate for autonomy because that would grant them greater control over their own resources (Bird et al., 2003). Conversely, wealthy regions inhabited by majority nationalists may perceive benefits from a centralist state due to their political and financially dominant positions and ability to influence the political center (Bardhan & Mookherjee, 2000). Similarly, poor regions may have mixed opinions on financial decentralization depending on their nationality status, with national majority regions preferring more equalization rather than having to rely on their own fiscal capacity and minority regions believing that greater autonomy would empower them to address their underdevelopment more effectively (Rodden, 2002; Rodríguez-Pose & Ezcurra, 2010).

Applying the Overlap Thesis as an analytical tool in the Indian context, I find that although regional disparities may be an extension of the broader issues—a combination of socioeconomic, historical, geographical, and political factors—states with comparable income levels may perceive their relative wealth or deprivation differently, depending upon their nationality status within the country. For example, the economic grievances of states with high or low-income levels may be similar, but secessionist conflicts emerge only when these concerns coincide with the nationalities question.

The evidence presented in this study suggests that policies of the Indian Government do not seem to promote fiscal autonomy for

regions dominated by minority populations, particularly those with secessionist movements such as Assam, Punjab, and Kashmir. These policies seem to maintain these regions' relative financial dependence on the central government, irrespective of their income levels, thereby inhibiting their journey toward financial self-reliance. Analogous patterns can be discerned internationally, such as in regions like Catalonia in Spain and Scotland in the United Kingdom (Keating, 2004).

This analysis, within the context of India, is substantiated by a paired comparative analysis of the economic trajectories of two affluent states, one non-secessionist (Haryana) and one secessionist (Punjab), alongside two impoverished states, one secessionist (Assam) and one non-secessionist (Bihar). Additionally, I juxtapose Jammu and Kashmir with Himachal Pradesh, two neighboring northern states situated in the Himalayas, both characterized by similar geographical attributes, with the former dealing with secessionist tensions in the Kashmir region and the latter remaining non-secessionist.

A closer look at the sequence of events from the origin of grievances to the outbreak of the secessionist crisis in Punjab, Assam, and Kashmir, reveals that in all three cases, a *perception of cultural domination* prevailed—a sense of apprehension arising from the actions of the national majority, which dominated national institutions and the policies of the central government. Nonetheless, the *perception of economic injustice* frequently serves as the "first catalyst" that politicizes and galvanizes suspicious or insecure ethnic minorities, impelling them to seek institutional avenues for articulating their dissent and grievances. However, it is only when state institutions and political processes fail to provide institutional channels for expressing discontent that ethnic or religious minorities mobilize to pursue their interests through violent means. This insight is unequivocally evident in cases where conflict has been averted (Tamils), managed, and even transformed (Assam and Mizoram) and where secessionist conflict has remained entirely intractable (such as the conflict in Kashmir). Consequently, *institutional decay* constitutes the "second catalyst" in the overarching dynamics of secessionist conflict.

Thus, the second generalizable finding pertains to two sequential triggers in conflict escalation—initially, the manifestation of grievance (an apprehensive minority cognizant of economic inequity) and, subsequently, the absence or ineffectiveness of institutional channels to redress grievances. For succinctness, I designate this finding as the *Twin Catalyst*

Thesis. This thesis, which serves as a framework for understanding secessionist movements, posits that secessionist conflicts arise from two main factors: (a) an ethnically and economically marginalized minority group and (b) the inability of state institutions to address grievances effectively. When these factors coexist, they prompt ethnic or religious minorities, who already experience fear of cultural domination, to resort to violence in pursuit of secession from the country.

A synthesis of these two theses shows the path towards resolving secessionist conflicts. While the Overlap Thesis underscores the role of economic justice and financial equalization in diversity accommodation, the Twin Catalyst Thesis emphasizes that economic development or any financial accommodation of symbolic significance (for example, resource allocation to uphold minorities' cultural identities) will work only to the extent there are robust institutional channels for expressing grievances and alleviating perceptions of cultural subjugation.

Finally, this study explores the role of counterinsurgency: When militant separatist insurgencies receive limited external support and only moderate internal backing, counterinsurgency often succeeds. In such a scenario, two potential outcomes exist. First, if the militants surrender, renounce their demand for independence, and accept concessions, these concessions are granted, as evidenced by the situation in Assam. Conversely, if militants insist on independence—an action deemed illegal and unconstitutional in India—their movement is ruthlessly suppressed, and no concessions are extended. This latter scenario was witnessed in Punjab. However, military action often becomes protracted when militant separatist insurgencies receive substantial internal or external support. In such instances, due to its inability to quell the rebellion through a combination of military action and financial concessions, the central government employs more stringent policy measures to dampen the potential of the restive minority resisting the central government. An example of this would be the removal of Jammu and Kashmir's statehood, its conversion into a Union Territory, and the abrogation of Article 370.

Forging Frameworks for National Integration: From Accommodating Diversity to Combating Secessionism through Concessionary and Non-Concessionary Approaches

Before examining India's approach to secessionist crises or fiscal accommodation of conflict, it is essential to acknowledge that India's dominant strategy to deal with secessionism is by using a mix of military suppression and conditional concessions. The Constitution does not include provisions for secession for any region or community. However, the constitutional framework ensures the accommodation of diverse communities within the scope of India's core values of unity and integrity (Adeney, 2002; Swenden, 2017).

India's method of diversity accommodation can be subsumed under the concept of "Concessionary Federalism".[1] In terms of fiscal federalism, this approach strategically designs financial concession packages—balancing equalization and autonomy—in such a way that it addresses the economic grievances of territorial minorities, yet, the degree of autonomy within the equalization-autonomy mix is not so pronounced as to fuel aspirations for independent statehood in secession-prone regions. The idea is to foster financial dependence in these vulnerable areas rather than fiscal autonomy.

If the approach premised on concessionary federalism fails and separatist militancy escalates, the government typically responds with military suppression. When separatists surrender—as witnessed in instances such as the Naga uprising and the insurgency by Assamese against India—India welcomes them back into the fold, and the "conditional" concessionary approach is revived. The central government then grants a range of political and financial concessions, conditional upon separatist leaders taking the notion of succession off the negotiating table.

In scenarios where the separatist leaders continue to demand independence, the counterinsurgency continues. This could go one of two

[1] Concessionary federalism embodies a paradigm of reciprocal concessions aiming to reach a joint agreement between the Centre and the states. It is an illustrative framework of federalism where the concessions offered by the central government reciprocate the concessions received from subnational governments in such a way that any loss of utility suffered by the latter in one dimension is at least partially offset by a gain in some other dimension (For complete mechanism, see: C. K. Sharma, 2021, pp. 36–37).

ways: If counterinsurgency fully neutralizes the separatist movement, often due to diminished local support and foreign patronage, the government withholds concessions, as exemplified in the Punjab crisis. If the counterinsurgency campaign fails to quell the violent movement, the government plays its final hand and pulls back whatever autonomy was granted earlier. The idea is to shake the foundation of local support and foreign patronage. The situation in Jammu and Kashmir is a prime example of this tactic.

The Constitutional and Legal Framework

In India, secessionist advocacy is deemed unconstitutional and illegal. The Indian Government has consistently demonstrated resolute opposition to secessionist movements, as exemplified by legislative measures such as the *Sixteenth Constitutional Amendment Act 1963*—informally referred to as the Anti-Secession Bill—which amended Article 19(2) of the Constitution, incorporating the phrase "the sovereignty and integrity of India." This amendment curtailed the efforts of legislators and parliamentarians who sought to employ constitutional means to achieve separatist objectives, obligating them to take an oath of office pledging to "uphold the sovereignty and integrity of India." Moreover, to underscore its unwavering commitment to preserving national unity, the *42nd Amendment Act 1976* incorporated the term "integrity" into the preamble to affirm India's resistance to any challenges to its territorial integrity. Sedition charges, as stipulated in Section 124A of the Indian Penal Code, apply to individuals who "attempt to excite disaffection towards the Government." Additionally, organizations advocating for secessionism can be proscribed under the *Unlawful Activities (Prevention) Act* (UAPA) of 1967, classifying secessionism as an unlawful activity.

Concessionary Federalism in Action: Persuading Princely States to Choose Accession Over Independence—An Archetype for Integration and Accommodation

The fundamental tenets of concessionary federalism (C. K. Sharma, 2021), provide a vital theoretical lens to understand how India first integrated princely states after independence and then "held them together." Post the Indian Independence Act of 1947, a political landscape emerged where 565 princely states found themselves at a crossroads—accession

to either India or Pakistan, or a pursuit of sovereignty. Faced with this quandary, India astutely drafted the "Instruments of Accession," a document infused with substantial concessions, effectively enticing princely states to exchange their autonomy for these inducements (Guha, 2008). While the Indian Government could have, and in a handful of instances indeed did, resort to coercive measures to achieve the accession of the Princely States—the cases of Hyderabad and Junagadh being prime examples—it was primarily the carrot of the concessionary approach that swayed the majority of the princely states towards acceding to the Indian Union. The asymmetric provisions extended to the North-Eastern states and Jammu and Kashmir (until the revocation of Articles 370 & 35(A) in 2019) further illustrate the workings of concessionary federalism.

Neutralizing Naga's Separatism: The Dual Strategy of Military Suppression and Conditional Concessions—An Archetype for Secessionist Crises

The country's stance on violent separatist movements can be traced back to its early reactions to the Naga struggle for independence, which began in 1929 and has been referred to as the "mother of all insurgencies" in India (Bhaumik, 2009). During India's transition to independence, the princely states of Hyderabad and Travancore sought to secede, while other groups, such as Assamese, Mizos, and Tamils, entertained separatist ideas (Griffiths, 2016). Following India's partition, the Constituent Assembly (established to draft the Constitution of India) faced concerns regarding the issue of separatism. The majority of Constituent Assembly members favoured a federal structure with a strong central government to preserve India's unity while accomodating regional diversity.

Nevertheless, the Naga community proclaimed independence on August 14, 1947, the day before India's declaration. Subsequently, the Nagaland Baptist Church held a plebiscite in May 1951, with the overwhelming majority voting for independence. While Gandhi supported the Naga people's right to self-determination, Nehru opposed it, fearing it would establish a precedent capable of dismantling the newly formed Indian state (Chophy, 2019). Thus, when an armed Naga rebellion against India emerged in 1956, the Indian Government employed its military, air force, paramilitary, and local police to suppress the uprising decisively. *The Armed Forces (Special Powers) Act* was enacted in 1958,

granting extraordinary authority to the Indian Armed Forces in "disturbed areas." Eventually, a ceasefire was negotiated, resulting in the creation of a new state in India. Thus, with significant fiscal, legislative, and judicial autonomy, Nagaland was established on December 1, 1963 (Hausing, 2022).

This approach to the Naga insurgency set the stage for India's strategy to deal with secessionist movements. The chosen method combined a forceful military response to secessionist violence with offers of concessions if movement leaders refrained from demanding complete separation during the negotiations.

India's Fiscal Federal Balancing Act: Empowering the Laggards and Rewarding the Fiscally Prudent

This section provides a brief overview of India's Fiscal Constitution, which is vital for understanding its role in diversity accommodation. According to the Constitutional Assignments of revenue-raising powers and spending responsibilities, the central government in India has access to the most broad-based, productive, buoyant, and elastic sources of revenue. These sources include income tax, corporate tax, and customs duties. However, subnational governments provide most financial and social services, leading to a "vertical fiscal asymmetry" (C. K. Sharma, 2012). Furthermore, the states have wide economic disparities, with per capita income ranging from INR 43,605 in Bihar to INR 431,351 in Goa (Government of India, 2023, p. 33). To address vertical and horizontal fiscal asymmetries, the Constitution of India provides for a comprehensive system of intergovernmental transfers (Fig. 1). Therefore, states in general and low-income states, in particular, rely on the central government for a significant share of their revenue in order to fulfill their expenditure obligations. Figures 2 and 3 explain the extent of fiscal autonomy and fiscal dependency of Indian states. The states with lower income levels and reduced fiscal autonomy tend to rely substantially on the central government's devolution and transfers.

The Finance Commission, established under Article 280 of the Constitution, is appointed every five years to address the "Vertical Fiscal

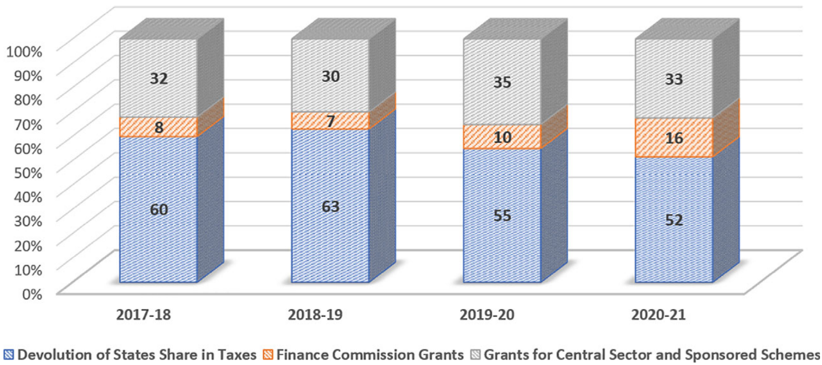

Fig. 1 Devolution and transfer of resources from centre to states (2017–2021) (*Source* Reserve Bank of India, various years)

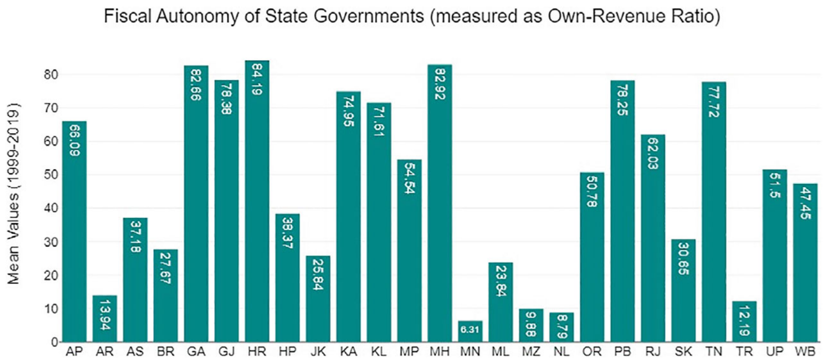

Fig. 2 Fiscal autonomy of state governments (measured as Own-Revenue Ratio) (*Note* Fiscal autonomy has been calculated as Own-Revenue Ratio ORR = [(SOTR + SONTR)/TSR] × 100, where TSR = CTS + CT + SOTR + SONTR. CTS: Tax Share (based on the Finance Commission recommendations); CT: Central Transfers (through Planning Commission & Central Ministries); SOTR: State's Own Tax Revenue; SONTR: State's Own Non-Tax Revenue. *Source* Reserve Bank of India, various years. State Finances: A Study of Budgets)

Fig. 3 Dependency of state governments on central government transfers (1999–2019) (*Note* The Financial Dependency Ratio (FDR) has been calculated using the following formula: FDR (%) = (CTS + CT)/TSR * 100 where TSR = CTS + CT + SOTR + SONTR, CTS: Tax Share (based on the Finance Commission recommendations); CT: Central Transfers (through Planning Commission & Central Ministries), SOTR: State's Own Tax Revenue; SONTR: State's Own Non-Tax Revenue. *Source* Reserve Bank of India, various years. State Finances: A Study of Budgets.)

Gap" (VFG)—that arises from uneven revenue and expenditure assignments (known as Vertical Fiscal Asymmetry, or VFA).[2] The Commission achieves this through a well-designed transfer system that involves a combination of recommendations for devolving a share of Union tax revenue to states and grants-in-aid to cover any deficits they may have post-devolution. The 15th Finance Commission, for example, recommended the devolution of 41% of the divisible pool of taxes to states for the period 2020–2021 to 2025–2026 (15th Finance Commission, 2020). The aim of revenue sharing, or unconditional transfers recommended by the Finance Commission, is to enable all the states to provide comparable levels of public services at comparable tax rates (Table 1).

Previously, the Planning Commission provided formula-based assistance to states (Table 2) for implementing development plans until

[2] The Vertical Fiscal Gap (VFG) is the desirable portion of vertical fiscal asymmetry (VFA) in a federal system, requiring closure through federal transfers to achieve fiscal equilibrium. Vertical Fiscal Imbalance (VFI) is the undesirable portion, necessitating a reallocation of revenue-raising authority and/or expenditure responsibilities (See C. K. Sharma, 2012, pp. 113–114).

Table 1 Equalization formulae used by finance commissions for resource distribution

Criteria	*FC-XI (2000–2005)*	*F-XII (2005–2010)*	*FC-XIII (2010–2015)*	*FC-XIV (2015–2020)*	*FC-XV (2020–2026)*
Population (1971)	10.0	25.0	25.0	17.5	–
Population (2011)	–	–	–	10.0	15.0
Income Distance	62.5	50.0	–	50.0	45.0
Fiscal Capacity Distance	–	–	47.5	–	–
Fiscal Discipline	7.5	7.5	17.5	–	–
Tax Effort	5.0	7.5	–	–	2.5
Infrastructure Index	7.5	–	–	–	–
Area	7.5	10.0	10.0	15.0	15.0
Forest Cover	–	–	–	7.5	–
Forest and Ecology	–	–	–	–	10.0
Demographic Performance	–	–	–	–	12.5
Total	100	100	100	100	100

Note The 15th Finance Commission was tasked with submitting two reports—the first for the financial year 2020–2021 and the second covering the 2021–2026 period
Source Various Reports of the Finance Commissions of India (XI to XV)

its abolition in 2015. Since then, the Finance Commissions have been required to recommend transfers to cover the state's entire expenditure requirements. In addition, central ministries provide financial assistance for central welfare schemes at the state level, some of which are fully funded and called central sector schemes. In contrast, others are jointly funded by the Centre and the states, called centrally sponsored schemes. These seek to ensure equalization of the expenditure levels of the states in respect of specified services. Finally, the Centre also provides various forms of ad-hoc assistance to the states through grants and loans (C. K. Sharma, 2017).

Aside from these explicit sources of transfers, there are implicit sources of transfers, such as food, fuel, and fertilizer subsidies, subsidization of

Table 2 Equalization formulae used by the planning commission (until the Twelfth Five-Year Plan)

Criteria	*1969*	*1980*	*1992*
Population (as on October 1, 1966)	60	60	60
Per capita income (Deviation method)	10	20	20
Per capita income (Distance method)	0	0	5
Tax effort	10	10	7.5
Irrigation and power projects	10	0	0
Special problems of individual states	10	10	7.5
Total	100	100	100

Note The formula used by the Planning Commission was to be applied after determining the proportion of the total central assistance allocated for meeting certain states' requirements. In 1969, this included Assam, Jammu and Kashmir, and Nagaland. By 1980, the list was expanded to include eight "Special Category States," namely Assam, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Tripura, and Sikkim
Source Government as India, Planning Commission (Five-Year Plan documents), New Delhi

public sector enterprises in the states, and highly subsidized borrowings of the state governments from the banking sector, the financial institutions, and the central government itself (Rao & Singh, 2006).

Regional disparities in India can be partially attributed to varying fiscal capacities across states, as evidenced by the differing own-tax revenue as a percentage of GSDP across states (Fig. 4). Consequently, India's fiscal federal system aims at fiscal equalization. This design results in the central government collecting excess revenue, thus creating Vertical Fiscal Asymmetry (VFA). A portion of this VFA is desirable as it allows the central government to address Horizontal Fiscal Imbalances (HFI), offer need based grants to specific regions, and finance programmes of national significance (C. K. Sharma, 2012).

However, beyond a limit, this horizontal equalization process can generate discontent among high-income states, especially those with secessionist tendencies. As illustrated by Punjab, a high-income state, grievances arose during the industrial licensing regime (dismantled post-1991 under the New Economic Policies of the Manmohan Singh India National Congress government). Punjab, already resentful of fiscal equalization policy, criticized the policy of diverting public sector units toward low-income states while depriving Punjab of industrial development (P. Singh, 2008).

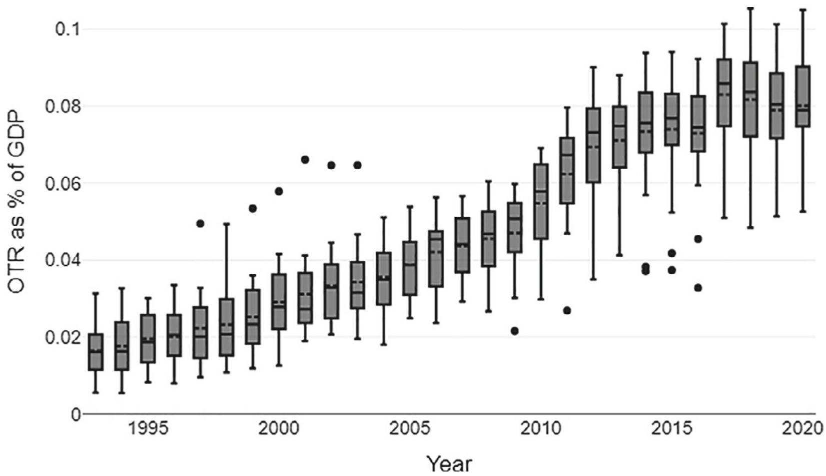

Fig. 4 Variation in Indian states' fiscal capacity (Own tax revenue as % of GSDP) (*Source* Reserve Bank of India, various years)

Thus, Indian policymakers consistently face the challenge of striking a balance to address the needs of high-income and low-income states. India's fiscal federal system strives to find an equilibrium between extreme fiscal equalization for low-income states and excessive compensation for high-income states' contributions to the national GDP. Therefore, the horizontal distribution formulae incorporate criteria desired by both wealthy and low-income states. Although combining various and often conflicting objectives in the equalization formula can dilute its redistributive impact, this is the only plausible approach in the Indian context (Tables 1 and 2).

The Finance Commissions' formulae for horizontal distribution of central tax proceeds and the Planning Commission's transfer formulae for state plans (discontinued after the 12th Five-Year Plan, 2012–2017) reveal the central government's consistent efforts to reconcile fiscal compensation for wealthy states with fiscal concessions for low-income states. The evaluation indicates that tax-revenue sharing does not excessively burden high per capita NSDP states, as they receive amounts commensurate with their contributions. At the same time, the horizontal distribution formulae give the highest weightage to income distance or deviation, appeasing low-income states (Tables 1 and 2). A standard critique

posed by Indian economists is that the Finance Commissions employ a "gap-filling" methodology, focusing on revenue equalization instead of addressing fiscal capacity disparities (Rao & Singh, 2006). Nevertheless, Fig. 3 shows that the fiscal capacity (OTR as % of GSDP) of all states is increasing, and the differences between states' fiscal capacities have decreased in recent years.

Thus, the overall transfer system is balanced, with low-income states receiving more per capita grants than they contribute and high-income states receiving reasonable amounts not significantly lower than their national revenue contributions. Although Fig. 5 reveals a growing trend in regional disparities, with box plot analysis indicating an expanding data distribution accompanied by increasing median and interquartile range values, the overall per capita NSDP of all states is also increasing, suggesting that poor states are also growing their economies, albeit at a slower rate than rich states. As the economy expands, rich states are better positioned to capitalize on opportunities, while poor states may struggle to attract businesses and investments. Numerous factors can influence regional disparities, and the relationship between fiscal equalization and disparities may not be straightforward.

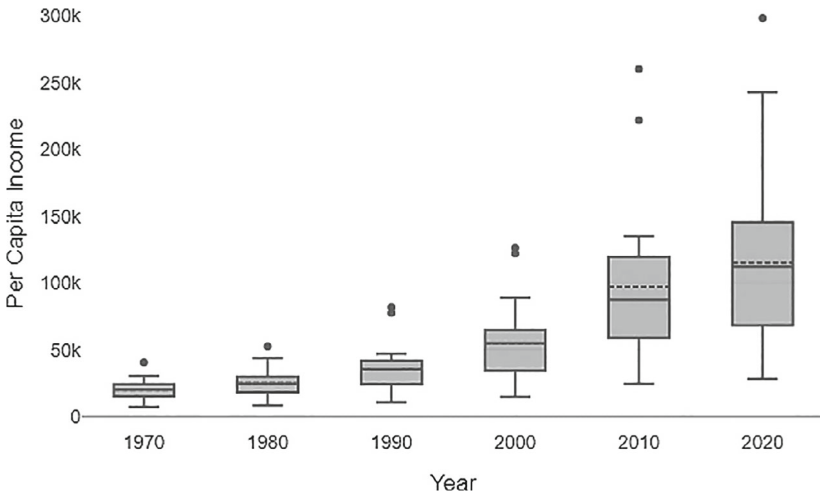

Fig. 5 Regional economic disparities in India (*Source* Reserve Bank of India, various years)

The Three Cases

Assam: The Ethno-Economic Divide, Conflict, Counterinsurgency, and Concessions

An intricate mosaic of diverse communities marks Assam's ethnocultural landscape. The Assamese Hindus and Muslims differentiate themselves from the Bengali-speaking "New Assamese" Hindus and Muslims and regard themselves as the region's original denizens. Identifying as Assamese speakers, both Assamese Hindus and Muslims distinguish themselves not only from the Bengali-speaking Assamese but also from tribes of the region who speak Bodo, Mising, Karbi, Garo, and Rabha (J. Sharma, 2011). Assam being primarily Hindu (Table 3) and sharing a religious identity with India's nationalist majority has implications for the approaches adopted by successive governments in handling secessionist movements within the region (Bhattacharya, 2023).

Assam, situated at the heart of Northeast India, has abundant natural resources, including fertile land, water resources, hydropower potential, and oil and natural gas reserves. It accounts for 40% of India's hydropower potential and 15% of India's crude output, which is 50% of its entire onshore production of oil and natural gas (Government of Assam, Mines and Minerals https://ahecl.in/portlets/assam-oil; also see Table 4).

Expansive fertile valleys support the cultivation of essential food grains and horticultural crops, while fertile hills are home to some of the world's

Table 3 Religious demographics—Distribution of population by religion in Assam

Assam	*2001*	*2011*	*2001*	*2011*
Hindu	17,296,455	19,180,759	64.89	61.47
Muslim	8,240,611	10,679,345	30.92	34.22
Christian	986,589	1,165,867	3.70	3.74
Sikh	22,519	20,672	0.08	0.07
Buddhist	51,029	54,993	0.19	0.18
Jain	23,957	25,949	0.09	0.08
Other*	22,999	27,118	0.09	0.09
Religion not stated	11,369	50,873	0.04	0.16
Population	26,655,528	31,205,576	100.00	100.00

Source Office of the Registrar General and Census Commissioner, India

Table 4 Selected state wise cumulative oil and gas production (2015–2021)

States	*Oil (in million metric ton)*	*Gas (in billion cubic meter)*
Arunachal Pradesh	0.32	0.23
Assam	**25.02**	**18.8**
Assam-Arunachal Pradesh	0	0
Assam-Mizoram	0	0
Assam-Nagaland	0	0
Manipur	0	0
Mizoram	0	0
Nagaland	0	0
Tripura	0.017	8.85
India	**25.36**	**27.88**

Source Lok Sabha Unstarred Question No. 2746, 17.03.2022

most prized teas. In general, the entire northeast region is resource-rich, with a vast untapped human capital, positioning it to become one of the most prosperous regions in the country. Paradoxically, the region remains economically, agriculturally, and industrially underdeveloped, characterized by low per capita income relative to the national average, inadequate infrastructure, and underutilization of its natural resources.

Abundant Resources and Economic Underdevelopment
The discrepancy between the region's development potential and the realization of that potential for the local population has been a source of discontent among the Assamese against the Indian state. The grievance is that the Indian state's approach is similar to that of the British, who exploited oil fields, coal mines, timber mills, and tea gardens in Assam for revenue generation without investing in the regional economy or local community welfare (D'Souza, 2012; Kikon, 2019). For instance, under the *Oil Fields (Regulation and Development) Act 1948*, Assam's royalty was fixed at a meager 10% of the crude oil price. When the government-owned Assam Oil Company discovered crude oil in upper Assam in 1956, the central government opted to build a massive oil refinery in Bihar using hundreds of kilometers of pipelines rather than constructing one in Assam, which would have saved millions of rupees and calmed local sentiment.

Under the Petroleum and Natural Gas Rules of 1959, the authority to determine crude oil prices was delegated to the central government

and oil companies, marking the first instance of Assam's economy being adversely affected. The central government established a fixed oil royalty of INR 72 per metric ton (MT) of crude oil. In 1962, Assam experienced a second economic setback when the central government, in collaboration with Burma Oil, Assam Oil, and Oil India, opted to determine the price of crude oil produced in Assam by factoring in the transportation costs from Kolkata to oil refineries. Consequently, the price of each MT of crude oil decreased from INR 72 to INR 48. The Assam government was left with a meager royalty of INR 4.80 per MT of crude oil, resulting in a revenue loss of INR 1.50 crore. Instead of raising the royalty rate to compensate for the revenue deficit, the central government resolved to increase crude oil production from 250,000 MT to 400,000 MT under the Third Five-Year Plan. The Assam government protested this decision, urging the central government to grant a 16% royalty as Oil India had reported a 50% profit in joint explorations with foreign companies. Furthermore, the Assam government highlighted that it had requested a 4% lower royalty rate than other crude oil-producing countries, which received a 20% royalty. Protests eventually led the central government to agree to establish a smaller refinery on the outskirts of Guwahati.

Figure 6 shows that Assam, similar to the other two secessionist cases examined in this study, experiences slower growth than other Indian states despite its abundant natural resources. However, the question of the state's underdevelopment, despite its wealth of resources and the central government's discriminatory policies undermining its economic and financial independence, did not become the root cause of the secessionist crisis in the state until the late 1970s when it converged with the issue that threatened their cultural identity—inclusion of illegal Bangladeshi migrants in the electoral rolls. The issue, as discussed in the following section, revolves around the inclusion of foreigners (illegal migrants from Bangladesh) in the voter list of Assam.

Ethno-Economic Intersectionality: Illegal Immigration, Cultural Domination, and Diminished Economic Opportunities

The large-scale influx of illegal immigrants from Bangladesh (formerly East Pakistan) in the 1970s threatened to overwhelm the indigenous population, undermine their identity, strain access to government services, erode local economic opportunities, and dominate markets, resources, and politics (Hazarika, 2000). It is important to note that after annexing the Ahom kingdom (Assam) in 1826, the British increasingly imported

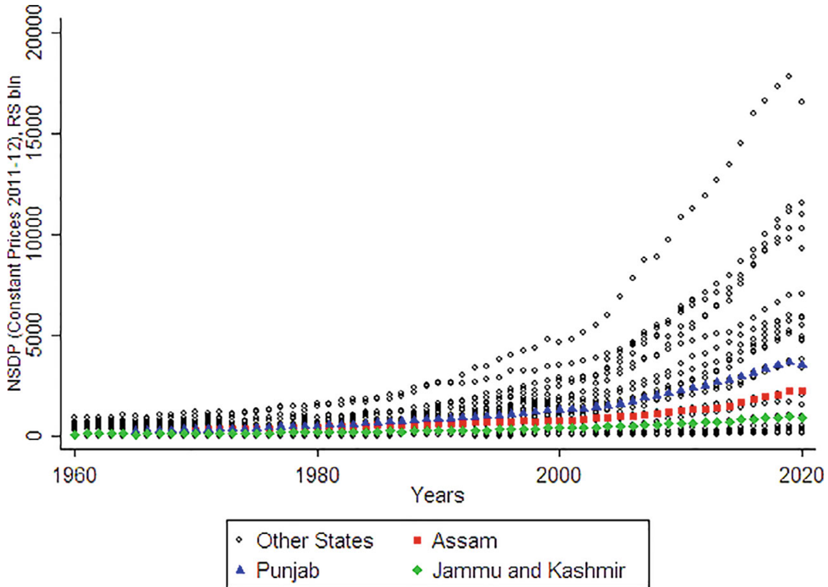

Fig. 6 Comparative economic growth of Indian states (1960–2020): Secessionist states in perspective (*Source* Reserve Bank of India, various years)

English-speaking and administratively competent Bengali officers to work in Assam. Bengalis quickly came to dominate state administration and modern professions in Assam, displacing the Assamese from positions of power and wealth (Baruah, 1999)—the Bengalis' treatment of the Assamese as culturally inferior fueled resentment towards Bengali domination in Assam. The Assamese attitude towards migrants grew increasingly hostile as migration from eastern Bengal continued even after its incorporation into Pakistan following the partition in 1947. At that time, although the Congress Chief Minister of Assam recognized the problem and opposed Bengali settlement, Prime Minister Nehru did not support the Chief Minister's stance. Instead of developing a mechanism to check borders, Nehru threatened to withhold development funds if the Bengali migrants were not settled (Nehru, 1989). As a result, the influx of Bengalis in Assam continued, peaking between 1970 and 1972 in the wake of the Bangladesh Liberation War in East Pakistan, ultimately leading to Bangladesh's independence in 1971.

The data analysis reveals that migration's influence on linguistic demographics in Assam has led to a notable decrease in the proportion of Assamese speakers (Table 5). Previously constituting a majority (exceeding 50%) of the population, they now represent a minority. This shift can be attributed to internal migration from different regions within India and unauthorized immigration from Bangladesh. However, the percentage distribution has stabilized since 2001.

Nevertheless, the issue of illegal immigration did not escalate into conflict because Prime Minister Indira Gandhi, on several occasions, acknowledged the problem of foreigners in Assam as a national concern and firmly promised to identify and deport them. However, when the Congress government fell in 1977 and a Janata coalition took power at the Centre, the dynamics between the Centre and state shifted. This

Table 5 Languages spoken in Assam

Language	*1971*	*1991*	*2001*	*2011*
Assamese	60.888	57.812	48.810	48.375
Bengali	19.706	21.667	27.549	28.919
Bodo	3.649	5.285	4.863	4.538
Dogri	0.000	0.000	0.008	0.005
Gujarati	0.004	0.024	0.026	0.025
Hindi	5.419	4.620	5.889	6.734
Kannada	0.001	0.003	0.008	0.008
Kashmiri	0.000	0.000	0.001	0.001
Konkani	0.001	0.003	0.001	0.001
Maithili	0.000	0.000	0.016	0.019
Malayalam	0.028	0.016	0.031	0.018
Manipuri	0.596	0.567	0.578	0.539
Marathi	0.009	0.007	0.024	0.037
Nepali	0.000	1.930	2.119	1.911
Odia	1.027	0.628	0.868	0.700
Punjabi	0.087	0.064	0.115	0.075
Sanskrit	0.000	0.000	0.000	0.000
Santali	0.589	0.606	0.911	0.683
Sindhi	0.002	0.004	0.003	0.063
Tamil	0.017	0.008	0.021	0.017
Telugu	0.137	0.102	0.103	0.085
Urdu	0.043	0.018	0.018	0.027
Other languages	7.783	6.629	8.031	8.443

Source Office of the Registrar General and Census Commissioner, India

change was primarily due to Jan Sangh,[3] a significant coalition partner, only wanting to deport Muslim migrants and not Hindus among them. This development angered the Assamese but did not yet lead to an uprising.

Sequential Triggers in Conflict Escalation: Economic Injustice and Institutional Failure

Inability to Prevent Illegal Migrants from Entering Voter Lists

The tipping point came in April 1979 when a court inquiry revealed that forty-five thousand illegal migrants were included in the voter list for the Mangaldai parliamentary constituency. The news immediately ignited anti-foreigner agitation in Mangaldai, rapidly spreading throughout the state. The All Assam Students' Union (AASU), which had been actively championing the Assamese cause since its establishment on August 8, 1967, initiated a state-wide strike to eliminate illegal migrants in June 1979. The All Assam Gana Sangram Parishad (AAGSP) was established in this year to demand the use of the 1951 National Register of Citizens as the baseline for identifying legal inhabitants and illegal migrants in Assam. AASU) joined AAGSP in launching the Anti-Foreigners Agitation, a movement characterized by protests, civil disobedience, and violent clashes against Bengali immigrants (Kimura, 2013).

Failure of the Assam Accord

In 1985, following the rise of Rajiv Gandhi to power, the central government sought to negotiate with AASU and AAGSP to end the ongoing agitation. Consequently, the Assam Accord was signed on August 15, 1985, effectively bringing the Assam movement to a close (Pisharoty, 2019). According to the accord, January 1, 1966, was established as the base year for determining residents' citizenship status. Individuals who entered the state between January 1, 1966, and March 25, 1971, would be excluded from electoral rolls for a decade, while those who arrived after March 25, 1971 (the day when the Bangladesh liberation war

[3] In light of the resurgence of the Hindu Nationalist ideology since 2014, with the Bharatiya Janata Party (BJP) in power—formerly known as Jan Sangh and ideologically affiliated with the Rashtriya Swayamsevak Sangh (RSS)—the party intends to confer citizenship upon Bengali Hindu immigrants from Bangladesh post-March 25, 1971, while deporting only Muslims among them (See the *Citizenship (Amendment) Act 2019,* which nullifies the Assam Accord).

started) would face deportation. Subsequently, AASU President Prafulla Mahanta transitioned to mainstream politics by establishing the Assom Gana Parishad (AGP) political party, thereby transforming from a former rebel into a stakeholder (Mitra & Singh, 2018). The AGP secured a victory in the state elections in December 1985, with Mahanta assuming the position of Chief Minister of Assam. However, the AGP was unsuccessful in implementing the accord and deporting illegal immigrants. The party also struggled to control violence in the state and inadvertently created new insecurities among the Bodo minorities by emphasizing Assamese identity exclusively.

Bodo Resistance to Assamese Dominance and Assamese Struggle Against Perceived Indian Imperialism

The AGP's strong focus on Assamese identity created unease among minority ethnic groups in the state, such as the Bodos, who started advocating for a separate Bodoland State. The AGP showed a lack of sensitivity towards tribal identity movements that emerged in the 1980s in Assam, as well as toward other communities who had migrated from different Indian states. This turmoil led to internal strife, the emergence of autonomy movements like Bodoland, and general chaos during the AGP's rule (Baruah, 1999). Consequently, the AGP government was perceived as unsuccessful in maintaining the unity and integrity of Assam. This perception eroded the AGP's credibility, allowing the United Liberation Front of Asom (ULFA) to fill the void and tackle the state's complex issues.[4] Established by a group of AASU-affiliated students on April 7, 1979, the ULFA largely remained dormant until the mind 1980s. The ULFA's agenda focused on liberating Assam from what it perceived as Indian imperialism rather than the deportation of migrants. The militant outfit exhibited no concern for illegal immigrants in Assam and did not perceive Bangladeshi immigrants as adversaries. Instead, this insurgent group vilified Marwari and Bengali traders, Biharis, and other Indian settlers in Assam as exploitative colonizers.

[4] ULFA (United Liberation Front of Assam) is a separatist group born out of the Assam Movement, aiming for an independent Assam through armed struggle. Their methods and goals were more extreme than those of the AASU and AGP. AASU (All Assam Students' Union) is a student body that led the Assam Movement (1979–1985) against illegal immigrants. AGP (Asom Gana Parishad) is a political party formed by AASU leaders post the Assam Movement.

ULFA's proposed solution entailed abandoning Assamese chauvinism in favor of treating all Assam residents as equal and confronting the Indian state that had entrenched the British policy of extracting Assam's rich natural resources without adequate compensation to the region and without conferring benefits on the Assamese people (Gogoi, 2016). The AGP, tasked by the central government with managing ULFA (Butt, 2021), faced a complex challenge: on one hand, they were to deal with the secessionist tendencies of ULFA while on the other hand, they struggled to reconcile the AASU call for the expulsion of unauthorized immigrants with ULFA's vision of a "broader" Assamese nationalism.

The AASU) leaders criticized the AGP government[5] for deporting only a small percentage of illegal Bangladeshi migrants and demanded a more efficacious and concrete implementation of the 1985 Assam Accord. At the same time, they expressed a desire to develop new refinery projects capitalizing on the state's petroleum resources, thereby reducing the unemployment rate among the Assamese youth.

Although the AASU initiated the Assam movement in 1979 with a focus on oil, encapsulated by the slogan "Tej dim, tel nidi" (we will give blood, not oil), over time, the ULFA emerged as a prominent advocate for the people of Assam in asserting control over their land and resources (Baruah, 1999). Consequently, the group's leadership galvanized regionalist sentiments against the Indian state's extractive endeavors. By December 1989, ULFA had instituted parallel governance structures in numerous rural regions of Assam, further asserting its influence on natural resource control.

Military Suppression and Economic Concessions

In Assam, the central economic issue was the population's limited control over land and natural resources, leading to secessionist violence in the 1980s to establish an independent sovereign state. The perception of India's extractive interventions as a form of colonial rule, which failed to return a fair share of benefits from extracted resources, fueled the unrest (Baruah, 1999; Butt, 2021; Pisharoty, 2019).

[5] The AASU is an organization that was instrumental in the Assam Movement and in the creation of the AGP. When the AASU leaders criticized the AGP government for not effectively implementing the Assam Accord (1985), it represented the organization's dissatisfaction with the state government's actions.

In the late 1970s, the AASU, which claimed to represent a substantial proportion of the state's 1.3 million school and college students, demanded a thorough examination of the electoral rolls prepared by the Election Commission to expunge the illegal migrants before the 1979 parliamentary elections. As a consensus regarding the criteria for determining citizenship remained elusive, the AASU opposed the parliamentary elections held in late 1979 and engaged in acts of civil disobedience. Consequently, the Election Commission annulled the elections in 12 of Assam's 14 parliamentary constituencies (U. K. Singh & Roy, 2019).

The discord intensified in 1980 when the Assamese endeavored to impede Oil India Ltd., a public sector enterprise in Assam, from exporting oil beyond the state's borders. The ensuing civil disobedience severely hampered the economy and state governance, incited the torching of residences, and compelled numerous Bengalis to seek refuge elsewhere. This anti-foreigner movement subsequently permeated the neighboring states of Tripura and Manipur. In the initial months of 1983, the animosity towards Bengali immigrants culminated in the massacre of approximately 4000 individuals, the displacement of a quarter-million residents, and the mass exodus of countless others (Kimura, 2013).

In an effort to assuage mounting dissatisfaction, the central government, in conjunction with OIL and ONGC, resolved on November 27, 1983, to augment Assam's royalty rate from INR 4.80 to INR 61 per metric ton of crude oil (Kikon, 2019). To address the contentious issue of migrants, a formula was devised, which subsequently formed the basis of the Assam Accord (Pisharoty, 2019). However, the AGP administration failed to execute the accord, providing the militant organization ULFA with an opportunity to capitalize on the prevailing discontent and redirect the conflict from matters of identity to economic concerns, thus portraying India as an imperialist state with exploitative aspirations (Walter, 2022).

As ULFA's armed struggle for an independent sovereign nation-state escalated, the Government of India implemented a dual approach. Firstly, it declared Assam a Special Category State in 1991, making it eligible for development funds in the form of grants instead of loans. Secondly, it employed military force to suppress the armed conflict against India decisively, demonstrating a classic carrot-and-stick response.

The Government of India banned ULFA under the *Unlawful Activities (Prevention) Act* and launched military operations against it. During the

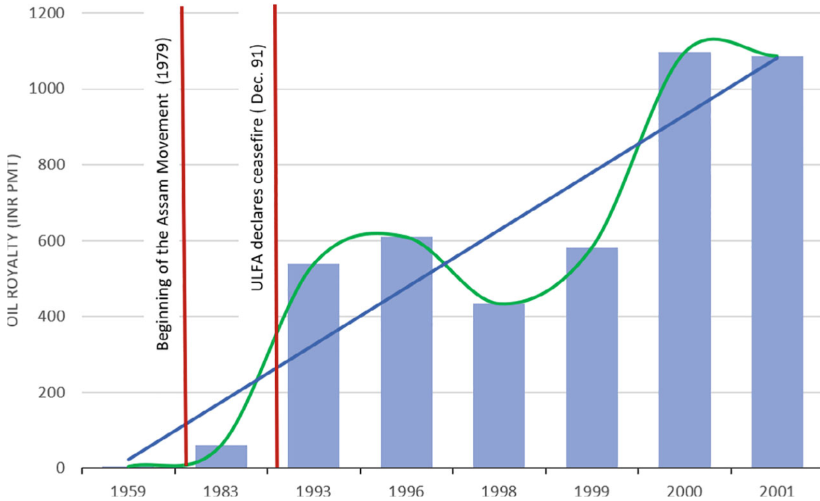

Fig. 7 Oil royalty rate (INR per metric ton) (*Source* Author's calculation based on Lok Sabha Starred Question No. 59, dated 3.3.2005)

Congress administration led by Chief Minister Hiteswar Saikia (1991–1996), counterinsurgency operations reached their zenith. "Operation Bajrang" in 1990 and "Operation Rhino" in 1991 crushed the movement and by January 1992, most of its members had surrendered and entered into negotiations with the Indian Government under the ULFA-S banner (R. Singh, 2010). In exchange, the Government pledged to modernize education in Assam, strengthen the state's economy, and allocate a larger share of royalties from oil, plywood, and tea to the state. The following concessions were offered to deter secessionist demands.

Increased State's Share in Royalties

The oil royalty rate was revised in 1993, escalating from INR 61 to INR 539.20. On April 1, 1996, the royalty per metric ton of crude oil was further augmented to INR 609.95, and it was determined that Assam would receive a 20% royalty on crude oil prices (Fig. 7).

Increased Grants for the Economic Development of Assam

Assam's share in financial transfers experienced a rapid increase following the conclusion of the conflict in 1991, which suggests that there was

an escalation in financial incentives to address the economic demands of secessionist forces. From the fiscal year 1991–1992 onward, Assam was granted special category status, leading to a significant shift in the grant-to-loan composition of its plan assistance from the previous 30:70 ratio to 90:10. Consequently, the proportion of grants allocated for state plans rose from 41.86% of total grants in 1990–1991 to 65.22% in 1991–1992. In other words, the designation of Assam as a special category state enabled it to secure a larger share of plan grants as well as schematic grants from the Planning Commission in subsequent years (Fig. 8).

Fiscal Autonomy or Dependency?

As hypothesized, the central government has attempted to promote the financial dependence of Assam (as a secessionist state) rather than encouraging its fiscal and financial autonomy. This is reflected in Assam's traditionally low tax-to-GDP ratio. A shift was seen post-mid-1980s, as local leaders from the Assam Movement assumed power, and further

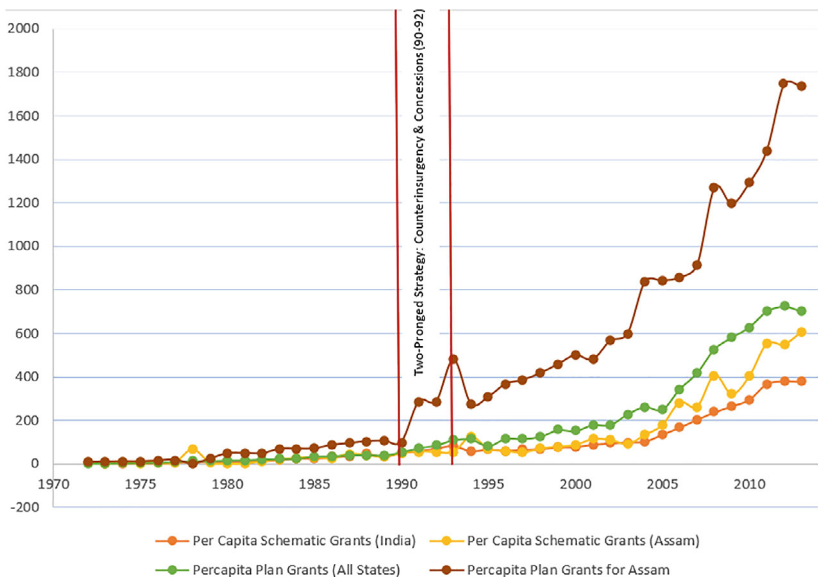

Fig. 8 Per capita state plan and central plan grants (Centre's welfare schemes) (*Source* Author's calculation based on RBI data)

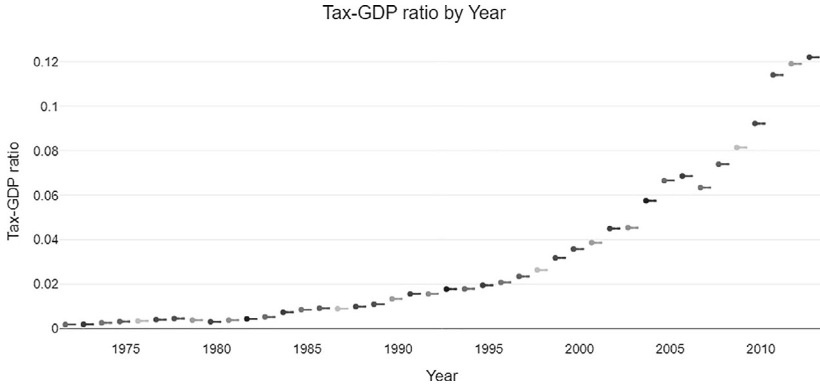

Fig. 9 Evolution of Assam's Tax-to-GDP ratio (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

when peace was restored following ULFA's surrender in 1991. This shift, illustrated in Fig. 9, signaled a move towards greater fiscal autonomy. However, Assam's autonomy ratio of 37% remains modest when compared to Haryana's 84%, the highest among all states (Fig. 2). Overall, Assam remains financially dependent on the central government, as indicated by its high dependency ratio of 38%. This ratio is just below the highest dependency ratio of 48% held by Manipur (Fig. 3). Although central transfers have decreased from over 70% during the conflict years to between 60 and 65% currently, Assam continues to depend significantly on these transfers for its revenue (Fig. 10).

Economic Discontent and Secession: A Non-Linear Correlation

In alignment with the Overlap Thesis proposed in this study, it is noteworthy that economic hardship alone does not provoke all low-income states to rebel against the Indian Government. Rather, the intersection of ethnic insecurities and economic deprivation sparks movements seeking recognition, identity, and political empowerment. This interplay becomes evident when comparing the states of Assam and Bihar. Both are economically disadvantaged, yet their responses differ significantly.

Despite Bihar having a lower per capita income than Assam, along with less fiscal autonomy (as illustrated in Fig. 2) and a higher degree of dependency (Fig. 3), the state exhibits no indications of secessionist sentiment. This case highlights that in isolation, economic deprivation

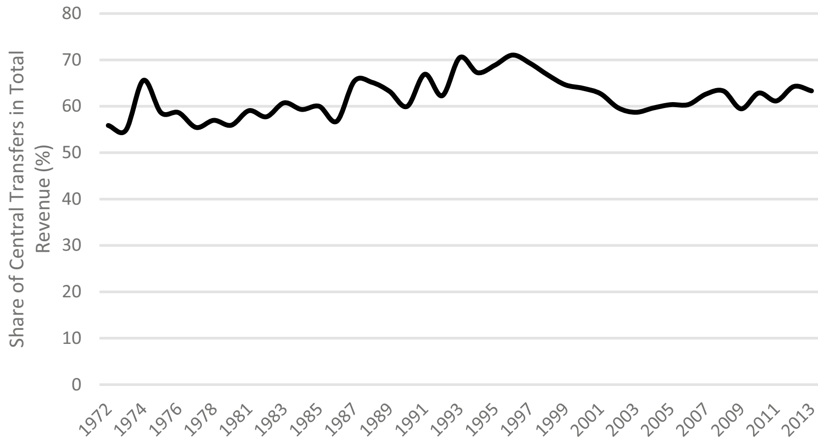

Fig. 10 Proportion of central transfers in Assam government's total revenue, illustrating fiscal dependency (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

and regional economic backwardness are not potent enough to incite secessionist movements. While Bihar, like any economically disadvantaged state, does harbor discontent, its demographic composition prevents the emergence of regional groups advocating secessionist movements. Biharis, belonging to the national majority community, have not felt the need to champion secession.

Punjab: Religious and Economic Grievances, Communal Unrest, Military Suppression, and the Absence of Concessions

The *Punjab Reorganization Act 1966* dissolved the erstwhile state of East Punjab, establishing the current state of Punjab and the new state of Haryana. Additionally, some territory was allocated to Himachal Pradesh, then a Union territory. Chandigarh was designated a temporary Union territory, functioning as the provisional capital for both Punjab and Haryana. This division resulted from the Punjabi Suba movement (1947–1966), spearheaded by the Akali Dal, which advocated for a Punjabi-speaking state (present-day Punjab). Concurrently, a

predominantly Hindi-speaking state, Haryana, emerged as India's 17th state.

Despite vigorous campaigns by Arya Samaj and other Hindu organizations urging individuals to register Hindi as their mother tongue instead of Punjabi before the 1951 and 1961 censuses, communal clashes or riots did not ensue. This is primarily attributed to the Sikh religion's secular foundations and Jan Sangh's support for the Punjabi language, although they opposed establishing a separate state based on linguistic or communal grounds. Post-1966 reorganization, disputes over the use of the Punjabi language persisted (Brass, 1994). However, electoral politics necessitated that the Akali Dal ally with the Jan Sangh, a Hindu organization that did not recognize Sikhs as distinct from Hindus, much to the former's chagrin. This was primarily due to the Akali Dal perceiving the Indian National Congress (INC) as a more significant adversary, having opposed their demands for over two decades after independence. Consequently, the Akali Dal formed coalitions with the Jan Sangh or BJP, despite the latter's Hindu majoritarian and supremacist inclinations (Bakke, 2015; Deol, 2003; Kaur et al., 2012; Kumar, 2019).

The INC's organizational presence across the state, combined with the absence of communal voting patterns among Sikhs, hindered the Akali Dal from achieving a majority on its own. The INC's strategy of fielding Sikh candidates and maintaining an electoral base among both Hindus and Sikhs further compounded this difficulty. As a result, political instability prevailed, with no assembly completing a full five-year term until 1992 when the militancy that originated in the 1980s came to an end (Table 6).

Table 6 Religious demographics—distribution of population by religion in Punjab

	1981	*1991*	*2001*	*2011*
Sikh	60.75	62.95	59.91	57.69
Hindu	36.93	34.46	36.94	38.49
Muslim	1	1.18	1.57	1.93
Christians	1.1	1.11	1.2	1.26
Others	0.22	0.3	0.38	0.63

Source Office of the Registrar General and Census Commissioner, India

Punjab in the 1980s: A Descent from Harmony and Affluence to Unrest, Insurgency, and Turmoil

In 1979, prior to the onset of violent terrorist activities in Punjab, India Today published a cover story titled "Island of Prosperity" (March 15, 1979), highlighting that during 1978–1979, Punjab contributed 6 million tons of food grains to the country's total production of 11 million tons, thus earning the epithet of the nation's breadbasket (Fig. 11). Figure 12 illustrates that Punjab ranks first among all states in per capita availability of food grain. In 1982, the same magazine published a special report titled "Harvest of Hatred" (May 31, 1982), stating that Punjab, previously a beacon of peace and prosperity, had been scarred by the bloodshed ensuing from communal violence.

To comprehend the Sikh resentment of the 1980s, it is crucial to recognize whom they credit for their prosperity. Various accounts and surveys reveal that Punjabis attribute their success to their own efforts and accuse the central government of hindering their progress (Bakke, 2015; Butt, 2021; P. Singh, 2008). While the land reforms of the Punjab government and the Indian Government's Green Revolution policies played a part, Punjabis credited their prosperity to their hard work, courage, skill, resilience, competitiveness, and a value system that regards farming as a noble profession.

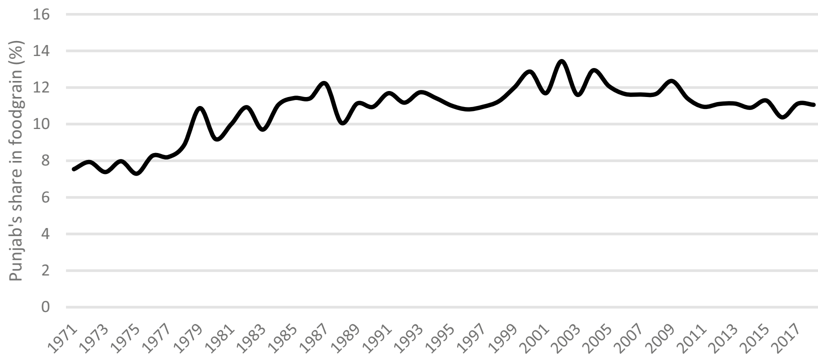

Fig. 11 Punjab's share in total foodgrain production in India (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

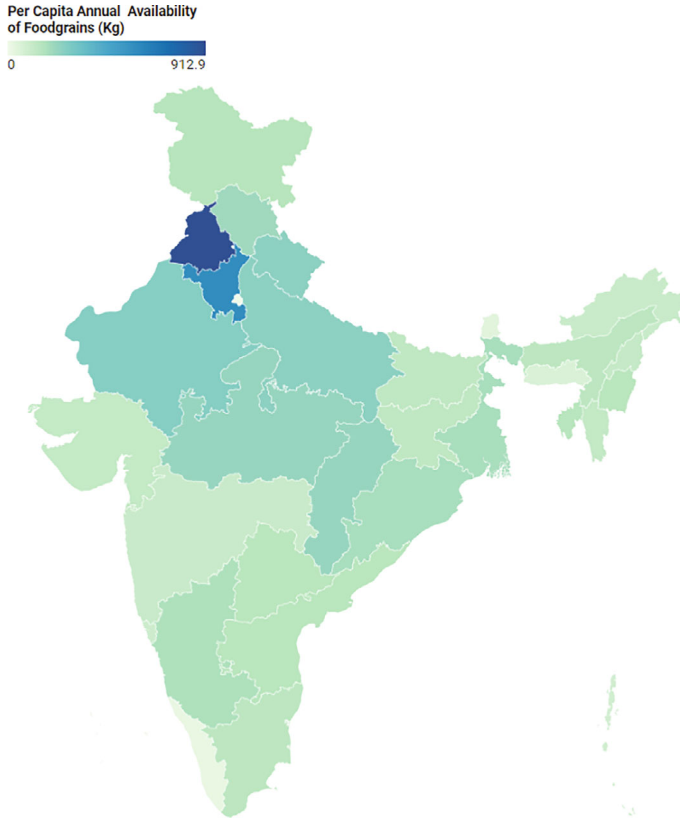

Fig. 12 State-wise per capita availability of foodgrain (*Source* Annual Report (1999–2000), Ministry of Consumer Affairs and Public Distribution, Government of India. Map created by Author using Datawrapper)

The Complex Convergence of Ethnic and Economic Grievances

Ethnically, the primary source of Sikh disquiet in independent India stemmed from the resurgence of organizations promoting the "Hindi, Hindu, Hindustan" slogan (Pandey, 2012). This movement posed a threat to the Sikhs' distinct religious identity. During the 1980s, the zealous campaigns by certain organizations advocating for Hindi and Sanskrit in Punjab were perceived by Sikhs as an affront to their linguistic and religious identity. As Sikh prosperity peaked in the 1980s, the

endeavors to deny independent Sikh identity and language tended to alienate the Sikhs, who were the primary beneficiaries of the Green Revolution.

From a socioeconomic perspective, the Green Revolution engendered polarization among Punjabis, as the policy disproportionately advantaged wealthier Jat farmers at the expense of lower castes and landless laborers (Frankel, 2015). The economically disadvantaged Sikhs harbored grievances not only against the Akali Dal, which was perceived as championing the cause of the affluent landowners rather than the rural poor but also against the central government, whom they viewed as indifferent and ignorant to the plight of Punjab's impoverished (Jeffrey, 2016).

The central government's approach to promoting "regional balance" resulted in the suspension of industrial projects in Punjab because of its high-income status (P. Singh, 2008). It was argued that allocating many industries to Punjab, which had benefited from the Green Revolution, would exacerbate regional disparities. This policy approach contributed to a scenario in which Punjab's industrial sector's share in its GDP remained low compared to Haryana and many other major Indian states (Fig. 13).

This sparked dissatisfaction in Punjab, particularly among economically vulnerable populations, such as small farmers and rural laborers, who had

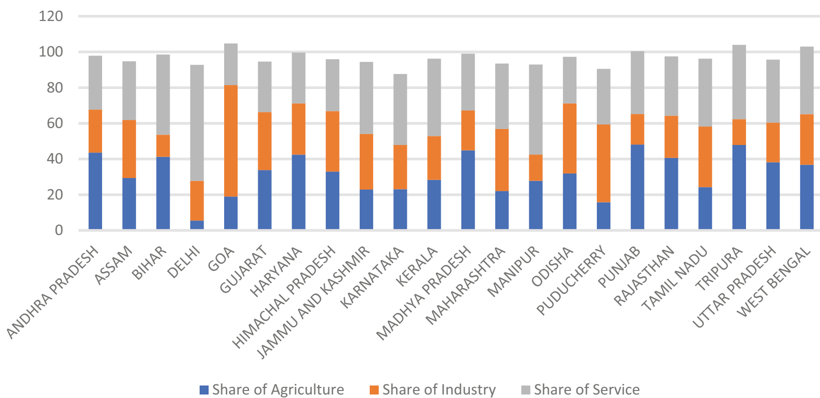

Fig. 13 Average percentage share of three sectors in states' net domestic product from 1970 to 2020 (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

not reaped the benefits of the Green Revolution. The dearth of industrialization stymied their prospects, potential, and productivity, rendering them increasingly susceptible to and ill-equipped for change. While inadequate subsidies for agricultural inputs depleted their income, the limited scope of Punjab's industrial sector precluded the possibility of alternative income sources.

Overall, the economic grievances of the Sikhs in Punjab in the 1980s can be outlined as follows:

- The central government controlled development policies and Industrial Policies.
- Local tax collection was transferred to the central government.
- The central government managed river water resources.
- The central government regulated agricultural prices, resulting in high input costs, insufficient subsidies, and low procurement prices set by the government.

From an economic standpoint, the primary cause of Punjab's grievance can be attributed to the perception of the central government penalizing the state for its high-income status and fiscal autonomy by denying it a share in central taxes proportional to its contribution and by hindering its industrial growth through the industrial licensing regime, which restricted public sector expansion. To verify the validity of the claims, I compare several economic indicators of Punjab and Haryana, both of which became new states after the *Punjab Reorganization Act 1966*. The empirical evidence suggests that although Haryana and Punjab initially showcased parity in income and industry, Haryana experienced a more rapid growth after 1980. During the 1980s, Haryana's industrial production expanded at a swifter pace than Punjab's, as depicted in Fig. 14. Furthermore, Haryana surpassed Punjab in terms of per capita income post-1990s, as illustrated by Fig. 15.

The comparative industrialization of Punjab and Haryana, assessed through the annual increase in the Gross Fixed Capital Ratio—which represents the total value of newly produced and acquired capital assets (Fig. 16)—and the gross output value, signifying overall production (Fig. 17), further substantiates and supports the claims concerning Punjab's lagging industrialization. Interestingly, despite Haryana outperforming Punjab in terms of revenue capacity (Fig. 18), Punjab has

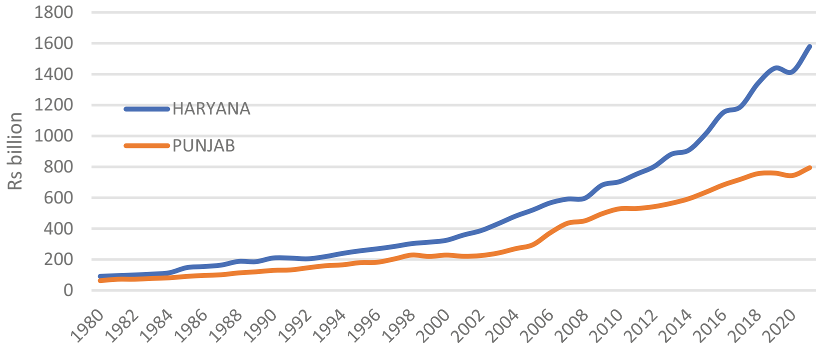

Fig. 14 Share of industry in GDP: Haryana and Punjab (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

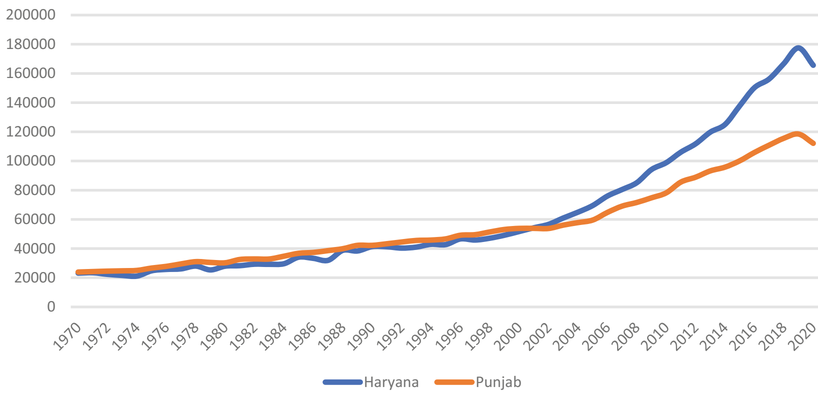

Fig. 15 Per capita income: Haryana and Punjab (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

consistently received a smaller share of central taxes and grants than Haryana (Fig. 19).

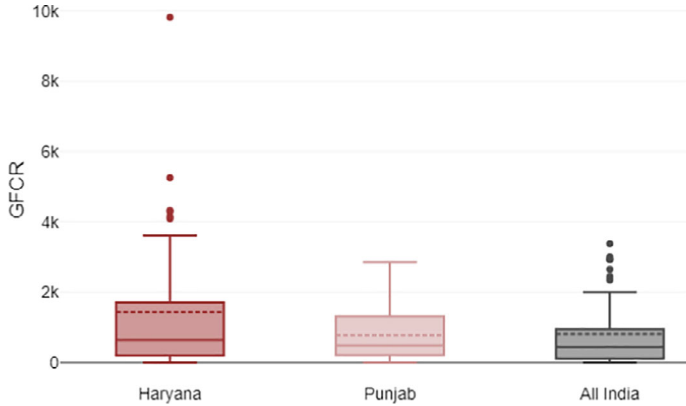

Fig. 16 Per capita gross fixed capital ratio (GFCR): Haryana, Punjab, all India (1970–2014) (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

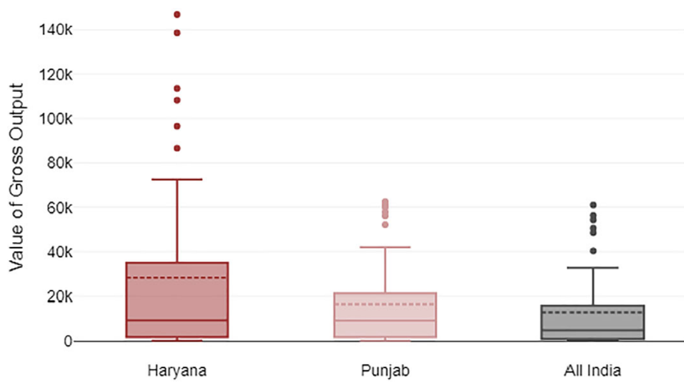

Fig. 17 Per capita value of gross output: Haryana, Punjab, all India (1970–2014) (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

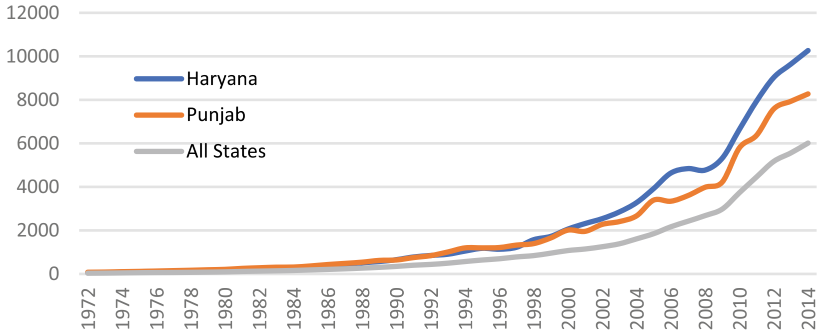

Fig. 18 Per capita own-source revenue: Haryana and Punjab (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

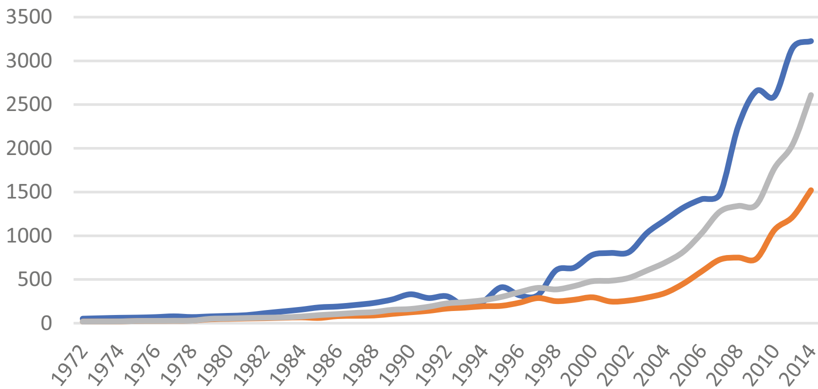

Fig. 19 Per capita share in central transfers: Haryana and Punjab (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

Cascading Conflicts: From Agitational Politics to Communal Unrest in the Turbulent 1980s

In September 1981, the Akali Dal presented a list of grievances comprising twenty-one economic, fourteen religious, eight political, and two social issues. However, negotiations with the central government fell

through as Prime Minister Indira Gandhi dismissed all demands. Consequently, the Akali Dal, which had previously favored negotiations over confrontation, shifted to agitational politics (Narang, 1983).

On April 24, 1982, the Akali Dal initiated a "Nehar Roko Morcha" (the struggle to halt the canal), aiming to impede the construction of the Sutlej-Yamuna Link canal, which would divert river water from Punjab to neighboring states. On July 26, 1982, the Akali Dal organized the All-World Sikh Convention and resolved to launch the "Dharam Yudh Morcha" (religious war front)—a civil disobedience movement under the guidance of Harchand Singh Longowal.

During this period, a fundamentalist and militant preacher named Bhindranwale criticized the politics of the Akali Dal, portraying it as a party of affluent Sikh landlords who neglected the rural, underprivileged Sikh communities (Jeffrey, 2016; K. Nayar & Singh, 1984). As this narrative aligned with the short-term interests of the Congress party in power at the Centre, they encouraged Bhindranwale to concentrate on discrediting their political rival in the state, the Akali Dal (B. R. Nayar, 2015). Nevertheless, Bhindranwale soon identified Hindus as the primary adversaries of Sikhs and began promoting violence and animosity towards both Hindus and the central government controlled by them. His leadership plunged Punjab into secessionist violence, characterized by the daily killings of Hindus throughout the 1980s.

Military Suppression of Militancy, Ineffective Concessions, and the Onset of the Second Wave

As terrorist violence escalated in Punjab, Prime Minister Indira Gandhi, in June 1984, ordered the army to storm the Golden Temple, the holiest Sikh shrine, to eliminate the Sikh militants who had taken refuge there. This action led to the brutal massacre of hundreds and thousands of Sikhs, including both secessionists and innocent civilians (R. I. Singh, 2022).

Following Operation Bluestar, the army launched Operation Woodrose, which continued to apprehend secessionists scattered across the Punjab countryside for three months. In retaliation, Prime Minister Indira Gandhi was assassinated by her Sikh bodyguards in October 1984. In the 1984–1985 national elections held after Gandhi's death, the Congress party emerged victorious, and Indira's son Rajiv Gandhi became the Prime Minister of India. He decided to grant significant concessions to Sikhs in all major areas of concern.

The Punjab Accord between Rajiv Gandhi and Harchand Singh Longowal, an Akali Sikh priest, also known as the Rajiv-Longowal Accord, was signed on July 24, 1985. This agreement garnered substantial goodwill within and outside Punjab. However, the extremist faction of the Sikh movement rejected the deal, as they sought an independent Khalistan (Chima, 2010). Consequently, religious militants assassinated Longowal, the Sikh signatory, within a month of the accord and labeled Akali Dal leaders as puppets of the central government. Thereafter, militancy in Punjab entered a second, deadlier phase. During this stage, Sikh extremists established a parallel government in specific areas of Punjab. However, their actions over time, which included punishing and even killing individuals for failing to comply with strict Sikh religious principles, ultimately served to alienate the very people they represented (Gill, 1997). In this situation, support for militants among Sikhs declined, although their resentment towards the central government remained strong.

Effective Suppression of Secessionism in Punjab Without Concessions

The Indian Government enacted and stringently applied the strict anti-terrorist laws, the *Terrorist and Disruptive Activities (Prevention) Act* (TADA) in 1985, and the *National Security Act (NSA) 1987*. The Indian army carried out numerous summary executions involving both civilians and suspected militants. Between 1986 and 1987, Punjab's Director-General of Police, Julio Ribeiro, led the police force in a vigorous crackdown on Sikh militants, adopting a "bullet for bullet" policy.

After 1987, K.P.S. Gill, Punjab's new Director-General of Police, implemented an even more stringent strategy—a relentless and efficacious police campaign marked by comprehensive search and cordon operations (Gill, 1997). These operations encompassed Black Thunder in May 1988 (aimed at the Golden Temple) and Operation Rakshak in November 1991, which followed a "catch and kill" policy for purported militants. Gill avoided engaging religious militants in theological discussions. Instead, he directly addressed their inherent survival instincts and presented a clear choice: they could either perish for their idea of God or live for themselves, with no third option. Consequently, human rights violations increased, but the secessionist movement was effectively subdued and dismantled.

No Financial Concessions: Redistribution or Retribution?
The central government's decisive victory over Sikh militants in Punjab diminished its incentive to honor the concessions sought in the Rajiv-Longowal accord, resulting in none of them being granted. Furthermore, instead of prioritizing Punjab's economic growth and development, the central government consciously refrained from providing financial support to the state after its economic downturn began in the mid-1980s and accelerated in the early 1990s, forcing Punjab to borrow to finance its committed expenditures. Figure 20 illustrates that Punjab's per capita tax shares and grants have consistently been lower than the average for all states, and even lower than Haryana, which boasts higher income and own-source revenue than Punjab. Figure 21 shows the extent to which the Punjab government relies on borrowed funds to cover its mandatory spending commitments.

The central government's approach to Punjab's financial situation during and after the conflict is contentious. Rather than offering grants to the state to combat the militancy, the central government supplied loans—a strategy that burdened the state with debt (Fig. 21). The central government did not consider writing off these loans, despite their purpose being to address a national issue of great significance.

This financial burden has left Punjab trapped in a vicious cycle of debt over the years, impacting its economic well-being. Although the 9th Finance Commission recommended a two-year moratorium on repayment of principal and interest for special loans granted to Punjab between 1984 and 1989, it proved insufficient. Despite the 12th Finance Commission classifying Punjab as a debt-stressed state and recommending a financial package, the state never received adequate support. The 13th Finance Commission devised a roadmap to tackle the issue, but the Punjab government deemed the relief measures insufficient. The 14th Finance Commission removed Punjab from the debt-stressed category, claiming that the agrarian state was becoming revenue-surplus and that granting debt relief to such states would penalize those with prudent fiscal management.

Punjab has persistently advocated for a relief package, either in the form of a complete debt waiver or rescheduling, as this debt was incurred during the period of militancy when the state was under direct central rule. However, such proposals have been consistently dismissed. In 2011, the finance ministry rejected requests for debt relief, arguing it would encourage fiscal mismanagement and set a poor precedent. In 2015,

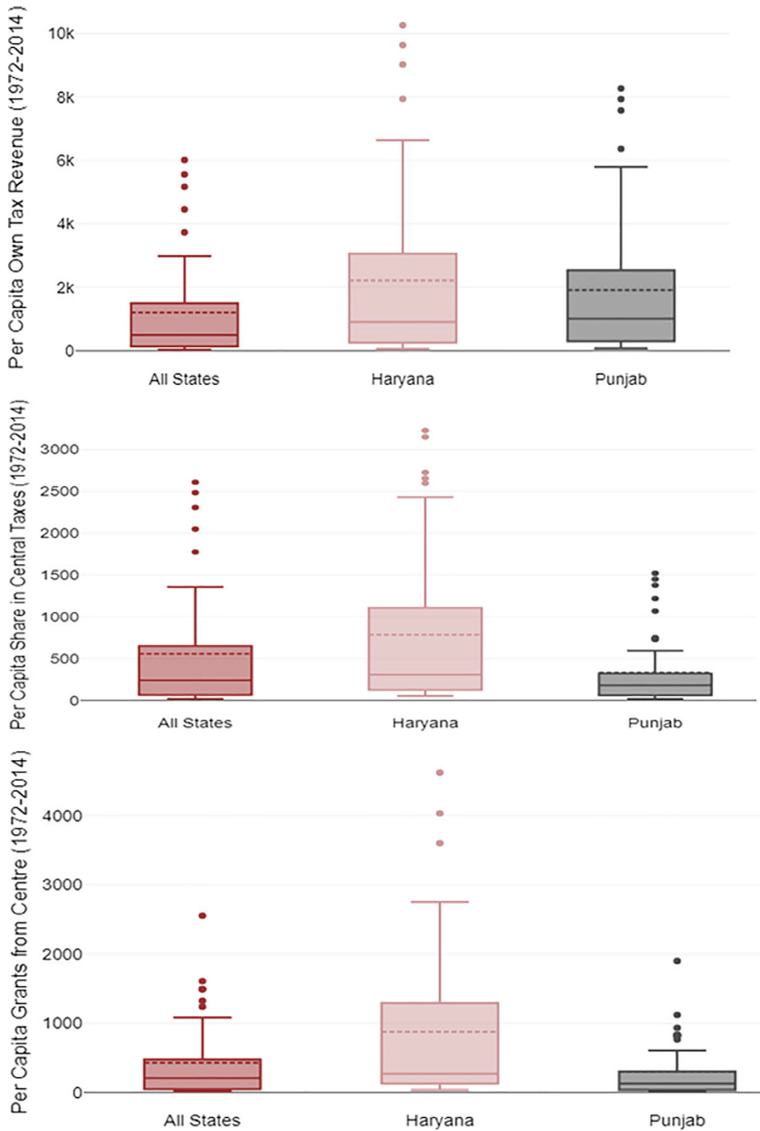

Fig. 20 Contrasting effects of high-income on central tax and grant allocations to Haryana and Punjab: Redistribution for national benefit or disadvantage for Punjab? (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

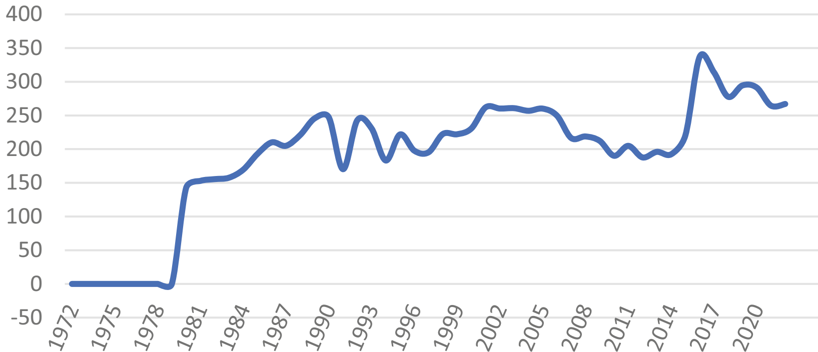

Fig. 21 Punjab's borrowings as % of committed expenditure (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets

the central government cited the state's provision of significant power subsidies to the farm sector as a reason for withholding assistance.

As Punjab's struggle with debt continues to hinder its growth and development, it is important to note that some of this issue can be attributed to the alleged corruption within the state's prominent political party, the Akali Dal. Mirroring the situation in Kashmir, the Akali Dal's governments have engaged in corruption and selectively provided business contracts and policy benefits to their own, rather than fostering market competition. The crucial difference, however, is that unlike in Kashmir, Punjab's ruling parties were not perceived as puppets of the central government.

The Puzzle of Peace Without Significant Concessions Since 1992: The Emergence of Coalition Politics, Fair Electoral Processes, and the Alternative Scheme of Devolution

Although there was no formal institutional accommodation of Sikh demands, and even the Rajiv-Longowal Accord, considered crucial for resolving the Punjab dispute, was never revived, the movement seemingly ended permanently. Concessions related to increased autonomy, river water sharing, and the transfer of Chandigarh to Punjab were not granted, making this a seemingly implausible outcome. However, the key

to a peaceful Punjab lies in the de facto shift in Centre-state relations during the 1990s.

The political and economic decentralization that occurred in the 1990s played a significant role in reshaping the perceptions. This period marked the transition from one-party dominance at the Centre to a multi-party coalition system and the termination of the industrial licensing regime. Elections in Punjab also became more competitive, with free and fair processes allowing Sikhs to contest and win elections, subsequently forming governments. Unlike in the case of Kashmir in 1988, there have been no allegations of election rigging by the central government or state parties.

Furthermore, the Tenth Finance Commission, which submitted its report on November 26, 1994, for the five years from 1995–1996 to 1999–2000 recommended that the fiscal framework be reformed and adjusted to accommodate state demands for increased shares in central taxes and the broadening of shareable tax categories. The Commission proposed an "Alternative Scheme of Devolution," which expanded the range of shareable taxes from only two central taxes to all central taxes. This removed the Centre's ability to deliberately distort the tax pattern by concentrating on collecting non-shareable taxes (e.g., corporation tax under clause IV of Article 270) at the expense of shareable taxes (e.g., income tax under Article 270, Union excise duties under Article 272, and tax sources under Article 269, such as estate duty on property, taxes on railway fares, transactions in stock exchanges, sale-purchase of newspapers, and interstate trade or commerce) to the detriment of the states. The Alternative Scheme of Devolution contributed to addressing certain financial grievances by including corporation tax in the divisible pool and ensuring that states could share the aggregate buoyancy in all central taxes during the period of fiscal consolidation. This allowed states like Punjab to have more access to central funds. Although Punjab's relative share from the divisible pool transfers remained low, the overall growth in the pie partially compensated the state for its low share in taxes, providing some degree of financial relief.

Kashmir: Elite Corruption, Communal Tensions, Political Decay, Militarization, and Enduring Separatism Amid Fiscal Equalization Policies

The former state of Jammu and Kashmir, which was dismantled in 2019, comprised three regions: Jammu, the Kashmir Valley, and Ladakh. Separatism originated in the Muslim-majority region of Kashmir (Behera, 2000). The Hindu-dominated Jammu region consistently contested the idea of autonomy for Jammu and Kashmir under Article 370 (repealed in 2019). From the very outset, the Jammu region sought greater autonomy within the state of J&K and called for the abrogation of Articles 370 and 35A (Puri, 1981, 1999).

The Ethnic-Economic Overlap Thesis is particularly applicable to the Kashmir scenario. Under the state's Muslim leadership, wealth has predominantly accumulated among those connected to the state ruling parties, fostering a widening gap between rich and poor. Therefore, the less privileged Muslim population, particularly in rural areas, felt marginalized, leading to increasing discontent (Hingorani, 2016). This mirrors the situation in Punjab, where the economically disadvantaged Jat Sikhs spearheaded rebellion, not the affluent Sikhs. Note that impressive economic growth and per capita income in J&K masks significant societal disparities (Drèze & Sen, 2013). In fact, the data, collected at the state level, inclusive of Jammu and Ladakh divisions, obfuscate the precise economic situation of Kashmir but still allow for some general conclusions. However, before delving into the economic data, it is crucial to understand the politics, context, origin, and evolution of the secessionist conflict in Kashmir.

The Beginnings of Conflict: Convergence of Communalism and Land Reforms

On October 26, 1947, Maharaja Hari Singh of Jammu and Kashmir signed the "Instrument of Accession" which provided the state with a special status within the Indian Union, where central authority was constrained to merely three domains: defense, external affairs, and communications. This distinctive provision was codified as Article 370 in Part XXI of the Indian Constitution, which took effect on November 17, 1952. Further augmenting this status, Article 35A endowed the region's

permanent residents with exclusive rights, ranging from property ownership to the entitlement of state-sponsored scholarships, while limiting the corporate sector's capacity to employ non-residents. In 1969, the National Development Council, while adopting the recommendations of the Fifth Finance Commission, awarded Jammu and Kashmir a Special Category Status (SCS). This status provided the state with central funding on preferential terms, tax reliefs, and the establishment of dedicated development boards. The objective was to bolster economic development in the state by catalyzing industrial growth and encouraging investment.

The first major reform under the leadership of Sheikh Mohammed Abdullah, the first Prime Minister of Jammu and Kashmir, was the radical redistribution of land which abolished landlordism and laid the groundwork for rural prosperity. On July 13, 1950, the state legislature passed *Big Landed Estates Abolition Act* transferring land to tillers without compensating former landlords. This act affected 9000 landowners and emancipated thousands of peasants from virtual slavery (Para, 2018). However, the Hindu community and Kashmiri Pandits perceived the land reform as anti-Hindu and pro-Muslim, believing it was designed to transfer Hindu land to Muslims (Tremblay & Bhatia, 2020). As the land reform controversy gained a communal aspect, Hindu right-wing groups in Jammu, organized under the Jammu Praja Parishad, launched an agitation in 1952–1953 demanding the abrogation of Article 370 and full integration of Kashmir with India.

Amid escalating mistrust between the central government and Sheikh Abdullah due to his suspected intentions, Abdullah was dismissed and imprisoned on charges of subversion on August 8, 1953. This led to violent protests in Kashmir, resulting in the deaths of hundreds. This event derailed land reform policies and scarred the psyche of Kashmiri Muslims, who began to perceive the central government as a threat to their physical security. From that point on, rallying the population around the demand for independence became more accessible (Habibullah, 2004; Santos, 2007). However, the extensive concessions and preferential treatment afforded to the state prevented this "communal consciousness" from escalating into a full-scale secessionist crisis. The precarious balance sustained over three decades until the ineffectiveness of institutions in addressing local grievances became strikingly evident. In the 1950s, 60s, and 70s, a series of corrupt state administrations gradually escalated the situation to a tipping point, which was conclusively reached with the rigged elections of 1987.

Elite Capture of Local Resources and Corruption by the Local Elite: 1953–1975

From 1953 to 1975, the states' Chief Ministers were viewed as power-hungry representatives of the central government (Bose, 2009; Ganguly, 1999; Wani, 2018). Throughout this period, pervasive corruption resulted in widespread alienation among Kashmiris. Although stability was attained under Bakshi Ghulam Mohammed (1953–1964), it came at the expense of establishing an unhealthy economic precedent. Contracts and licenses for various sectors were granted in exchange for money, exacerbating economic inequality in the region and fostering a sense of alienation and resentment among the poorer Kashmiri. Ghulam Mohammed Sadiq (1964–1971) and Syed Mir Qasim (1971–1975) continued these practices.

In 1975, Sheikh Abdullah returned to power after the Indira-Sheikh accord, promising self-rule through democratic elections. However, in April 1975, he changed his stance and began advocating for the merger of Jammu and Kashmir with Azad Kashmir, a region administered by Pakistan. This shift was driven by Sheikh Abdullah's long-held desire for a united, autonomous Kashmir. This change in position was not well received by the Indian Government and eventually led to the imposition of Governor's Rule in the state from March to July 1977.

The Decade of Misrule and Corruption (1977–1987)

Sheikh Abdullah won the state's first free and fair election in July 1977. However, his rule was marked by vindictiveness, dictatorship, rampant lawlessness, increased political corruption, and institutional decay in Kashmir. The administration, police, and civil liberties were undermined, with restrictions imposed on newspapers and other publications. Following Sheikh Abdullah's death in 1982, his son Farooq Abdullah succeeded him, exacerbating corruption and nepotism. The state bureaucracy proliferated, consuming a significant portion of non-plan expenditure population (Ganguly, 1999; Habibullah, 2004). In 1984, violence erupted in Kashmir, and his brother-in-law, Ghulam Mohammad Shah, ousted Farooq Abdullah.

G.M. Shah's rule from 1984 to 1986 was also marred by corruption, with allegations of financial assistance to his son's industries being the

most prominent. To regain support from local Muslims, he exploited religious sentiments, pushing Kashmir to the brink of disaster. Following communal riots in South Kashmir, G. M. Shah's government was dismissed in March 1986. In the wake of the Rajiv-Farooq accord, a new coalition government formed by the National Conference and Congress was subsequently sworn in.

1987: Rigging of Elections and the Rise of a Rebellion

The discontent among the rural Muslim populace did not immediately spark a rebellion. Instead, the disenchanted Kashmiri Muslims sought institutional mechanisms for change, such as participating in the 1987 elections (Behera, 2016; Bose, 2009; Ganguly, 1999; Hingorani, 2016; Widmalm, 2014). However, these elections were marred by allegations of fraud. The elections, allegedly rigged by then Chief Minister Farooq Abdullah, led to an unexpected reversal of electoral outcomes.

In the 1987 elections, the Kashmiri people predominantly supported the newly formed Muslim United Front (MUF) party instead of Farooq Abdullah's National Conference (NC), which had formed a pre-electoral alliance with Rajiv Gandhi's Congress (I) party. However, Kashmiris were shocked to see the rigged election results and the false accusations and imprisonment of MUF leaders. A tidal wave of protest engulfed the valley, leading to the radicalization of many young men who had guarded ballot boxes for the MUF. Two Islamist militant groups emerged: Hizbul Mujahideen, seeking to separate Kashmir from India and merge it with Pakistan, and the Jammu Kashmir Liberation Front, advocating for a secular, independent Kashmir. Pakistan capitalized on the situation, providing moral, financial, and military support to the terrorists (Schofield, 1996; Wirsing, 1998).

The rigged 1987 election was the catalyst, but the root of alienation lay in a combination of factors, including insecurity created by right-wing leaders in Jammu, the perceived physical threat from the central state, and years of misgovernance by regional parties seen as the central government's puppets. Successive governments failed to modernize agriculture, establish industries, or create jobs for local youth. Both the central and state governments were responsible for this unholy partnership.

This validates the Twin Catalyst Thesis, where the first catalyst is the economic deprivation of a religious minority that views the majority

community with skepticism. The second catalyst is the failure of political avenues and constitutional mechanisms to address their grievances.

Fiscal Federalism's Failure to Fracture the Foundations of Separatism in Kashmir

Jammu and Kashmir has seen substantial central funding, particularly following the escalation of conflict, as a measure to curb separatist sentiments (Figs. 22 and 23). However, due to a high degree of elite capture of state institutions, the policy benefits failed to permeate the rural, impoverished sections of the Kashmir valley. Amidst this economic discontent, Muslim radicalization continued to grow throughout the 1980s. By the late 80s, militancy in Kashmir had become self-sustaining, bolstered by both local and Pakistani support. Although in Assam and Punjab, military suppression proved effective when internal and external support for militancy waned, in Kashmir, the conflict has perpetuated primarily due to external support from Pakistan.

In fiscal terms, the Indian Government's strategy seems to sustain the region's dependence, denying fiscal autonomy and inhibiting financial self-sustainability. This is evident from the fact that the state transitioned from a high-income state to a low-middle-income state in the 1990s and its per capita own-source revenues, which had previously aligned with the all-India average until the late 1980s, have consistently fallen below the

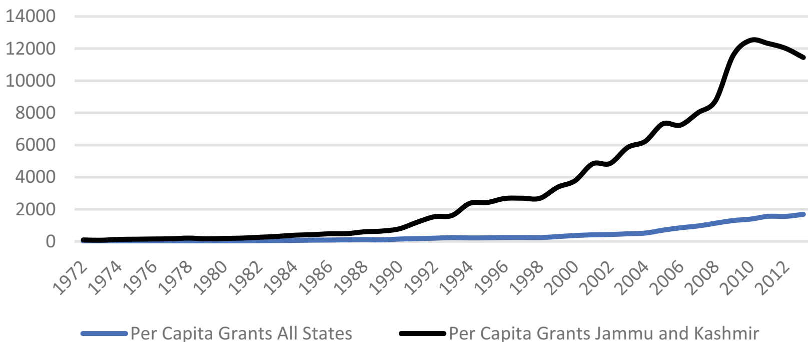

Fig. 22 Per capita grants: Jammu Kashmir versus all states (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

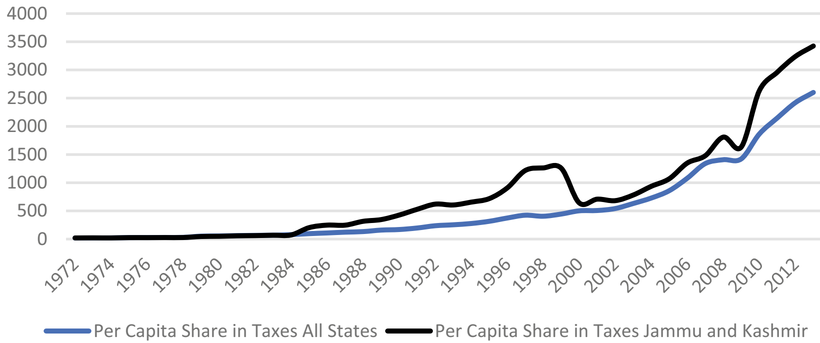

Fig. 23 Per capita share in taxes: Jammu Kashmir versus all states (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

all-India average since then (Fig. 24). Post-conflict, the state's economic growth plummeted (Fig. 25), and more industries have been established in neighboring Himachal Pradesh than in Kashmir (Figs. 26 and 27). While conflict might have contributed to some deindustrialization of Kashmir, it is notable that the share of industry in Kashmir's economy continued to decline even after terrorist violence began to decrease in the 2000s (Fig. 27). Moreover, the financial approach of the central government has left the state highly indebted (Fig. 28).

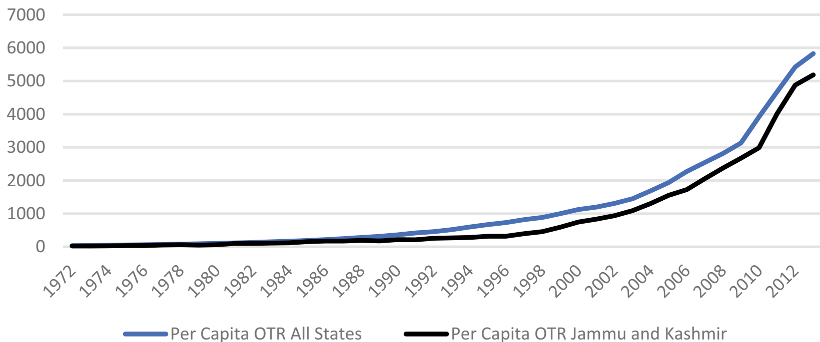

Fig. 24 Per capita own tax revenue: Jammu Kashmir versus all states (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

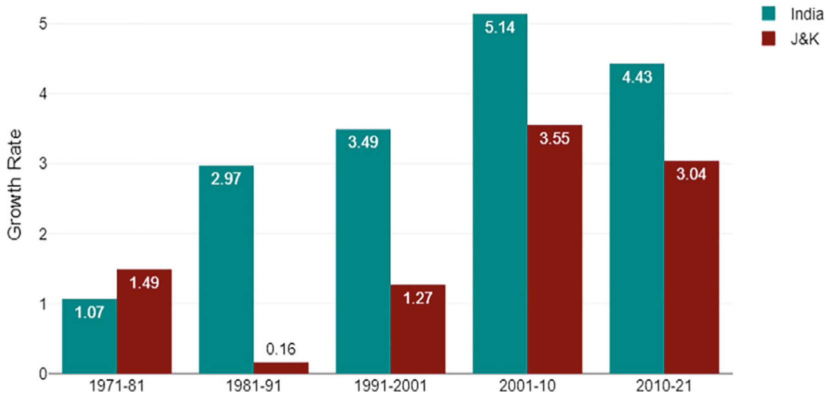

Fig. 25 Economic growth rate: All India vs. Jammu and Kashmir (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

Reversal of Symbolic and Substantive Concessions: A Shift from a concessionary to a non-concessionary approach

The concessions extended to Jammu and Kashmir after its accession to India served as a pacifying force, preventing separatism for decades. However, the disputed 1987 elections marked a turning point, triggering the outbreak of violent secessionism. Once this "genie was out of the bottle," it proved impossible to return to the previous status quo through concessions or even through force. As all attempts to normalize the situation proved largely futile, it became evident that a strategy was required to dismantle the local support for militancy and counter foreign patronage, particularly from Pakistan.

On August 5, 2019, India's policy towards Jammu and Kashmir, once a shining example of "concessionary federalism," took a dramatic turn. In an abrupt reversal, the Modi administration rescinded all concessions previously extended to the region and abrogated both Article 370 and Article 35A. Simultaneously, the government bifurcated the region into two separate Union Territories—Jammu and Kashmir, and Ladakh marking the end of Jammu and Kashmir's semi-autonomous status. The Government of India decisively asserts that the matter of Kashmir is now conclusively settled with the Union Territory of Jammu and Kashmir being the integral part of India (The Times of India, 2020).

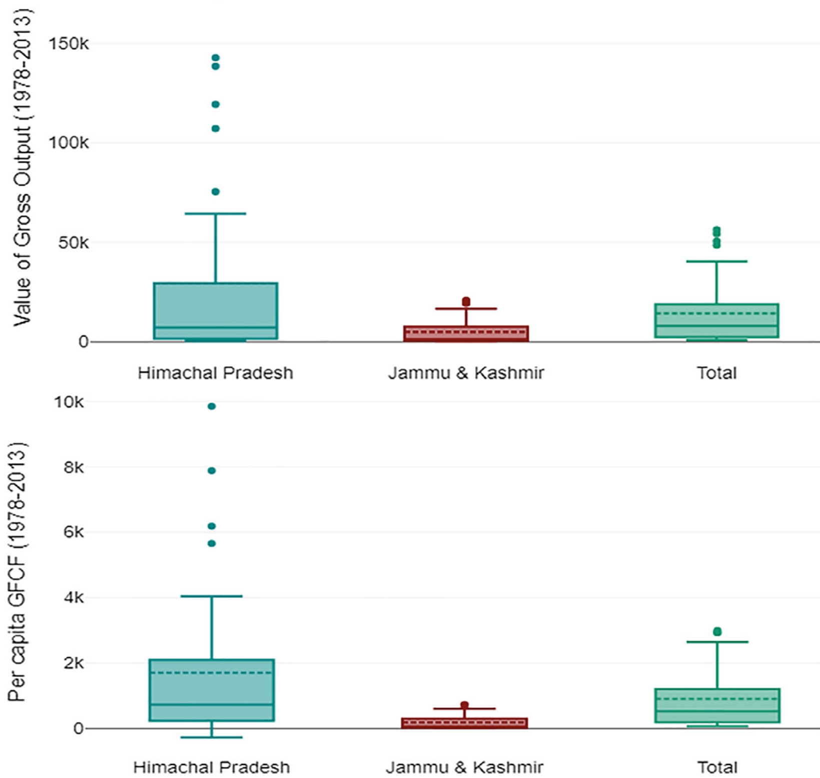

Fig. 26 Industrialization in Jammu and Kashmir, Himachal Pradesh, and all India average (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

Non-Escalation of Secessionist Crisis Following Reversal of Concessions
Contrary to expectations, the revocation of concessions to Jammu and Kashmir did not provoke a surge in separatist activity (Fig. 29). While it is not straightforward to assert a complete cessation of secession in Kashmir, the region currently enjoys relative stability, peace, and harmony. The Kashmir case, thus, calls into question the hypothesis that the withdrawal of symbolic concessions exacerbates secessionist crises (Basta, 2021).

Studies endorsing this hypothesis perhaps did not consider the unique context of a country like India, where the federal structure allows

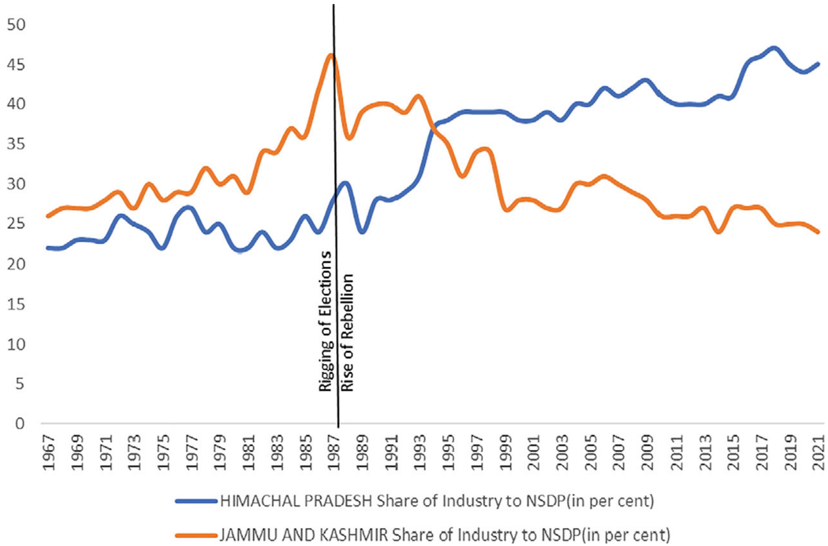

Fig. 27 Share of industry in economy: Himachal Pradesh vs. Jammu and Kashmir (*Source* Reserve Bank of India (Various years). State Finances: A Study of Budgets)

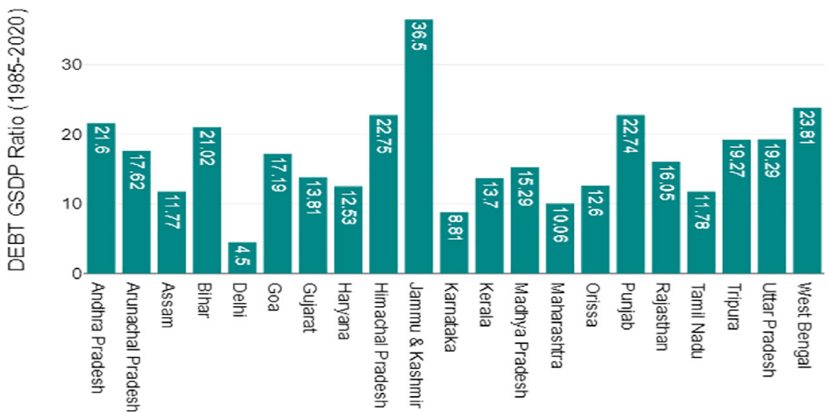

Fig. 28 Debt-GSDP Ratio: A comparative overview of the Indian states (*Note* Reserve Bank of India, various years)

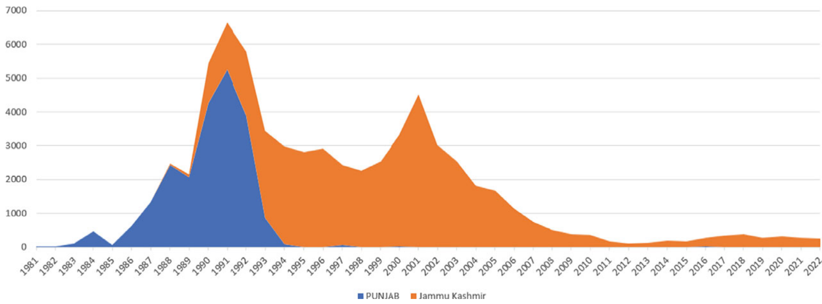

Fig. 29 Secessionist violence (total fatalities) in Punjab and Jammu and Kashmir (*Source* South Asia Terrorism Portal https://www.satp.org/)

for dynamic boundary changes and fluid state-to-Union-Territory status transformations. This underscores the need for context-specific analysis in studying separatist movements and the effectiveness of state responses. In the context of India, when concessions and counterinsurgency fall short in stifling separatism, the government can resort to more assertive punitive measures, including a fundamental reconfiguration of the state's territory and its identity to extinguish local support and foreign patronage to militants, thereby defusing the secessionist crisis.

Conclusion

In this concluding section, I synthesize a variety of insights gleaned from the intricate interplay between fiscal federalism and secessionist movements in India. This is done by focusing on the cases of Assam, Punjab, and Kashmir. First, this study has found support for the hypothesis that the central Government promotes financial dependence of secessionist regions rather than fostering their fiscal and financial autonomy. Second, as long as violent separatism, which necessitates counterinsurgency, is absent, a nuanced concessionary approach is typically employed by the central authorities when dealing with secessionist-prone areas. The Concessionary Federalism approach straddles a delicate balance—negotiating concessions sufficiently persuasive to dissuade these regions from pursuing secession, while cautiously ensuring not to kindle either aspirations for independent statehood or stir up resentment among the majority nationality over the perceived excessive concessions granted to these

regions. The central government aims to convey to secessionist regions that the rewards of secession are negligible, whereas the costs of disassociation are considerable and that the merits of maintaining allegiance to the union outweigh these costs.

The rest of the findings have been categorized into four distinct yet interconnected themes: the genesis of conflict, the escalation of conflict into violence, the approach of military suppression and conditional concessions, and the role and impact of military action.

The Genesis of Conflict: The "Overlap Thesis"

The Overlap Thesis highlights the origins of secessionist sentiments. This thesis argues that separatist tendencies are only ignited when economic and ethnic divisions intersect, thereby creating a dynamic interplay and mutual reinforcement.

In both Assam, a less affluent state, and Punjab, a wealthier state, economic grievances were the primary catalysts for conflict. In Assam, the central point of contention stemmed from the local population's lack of autonomy over their land and natural resources. Conversely, in Punjab, the central government's perceived control over resources, unfair income distribution, and economic policies were deemed problematic. In the Kashmir Valley, considered a middle-income region, pervasive resentment existed against the state governments' economic mismanagement, corruption, and nepotism. The successive state governments were widely perceived as puppets of the Indian Government. Consequently, these adverse conditions resulted in the exclusion of the majority Muslim population in the valley from receiving policy benefits.

However, perceptions of economic injustice within a minority community region merely create a potential for secessionist sentiment to escalate into violent secessionist conflict. The real tipping point emerges when state institutions and political processes fail to provide a platform for the expression of discontent. This brings us to the second thesis.

The Escalation of Conflict into Violence: The "Twin Catalysts Thesis"

The Twin Catalysts Thesis highlights the lethal synergy of economic injustice and political disempowerment in the escalation of conflict into secessionist violence (Fig. 30). While the perception of economic injustice often serves as the initial catalyst—which politicizes insecure

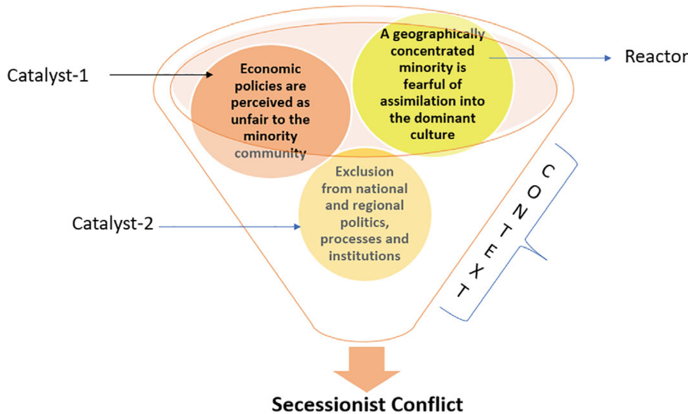

Fig. 30 The chemistry of conflict: Twin catalyst thesis

ethnic minorities and propels them to seek avenues for expressing their grievances—it is typically the failure of state institutions and political processes to provide legitimate channels for the expression of discontent that drives these groups to resort to violence to achieve their interests.

Military Suppression and Conditional Concessions: The "Dual Strategy"

India's experience with violent secessionist movements in Assam, Punjab, and Kashmir reveals a dual strategy adopted by the central government, amalgamating military suppression with conditional concessions. The central government commits to addressing the ethnic and economic demands of the secessionist region, contingent upon the movement leaders' renunciation of secession. When leaders accept the proposed concessions, military action is suspended. This typically results in the cessation of the movement, as observed in Assam. However, if secessionist leaders persist in their demands for independence, refusing concessions, military action continues, often intensifying, leading to a brutal conflict.

Concessions, No Concessions, or Withdrawal of Existing Concessions: The "Military Outcome-Dependent Approach"

Once military suppression commences, it often exacerbates the forces it seeks to subdue, plunging the secessionist crisis into a destructive cycle of reinforcement. The success or failure of military operations hinges the extent of local support and the level of foreign assistance provided to militants combating the central and state governments. As Fig. 31 shows, military forces prevail in the absence of internal or external support to militancy, effectively quelling the rebellion, as observed in Punjab. This significantly diminished the incentive for the central government to offer concessions. Therefore, following the cessation of militancy, Punjab was met not with financial or socio-political concessions, but with a distinct void of financial support. Even the promises encapsulated within the Rajiv-Longowal Accord remained unfulfilled relics of the past. However, the case of Punjab also demonstrates that maintaining the integrity of state-level electoral institutions plays a role in restoring local trust in political processes.

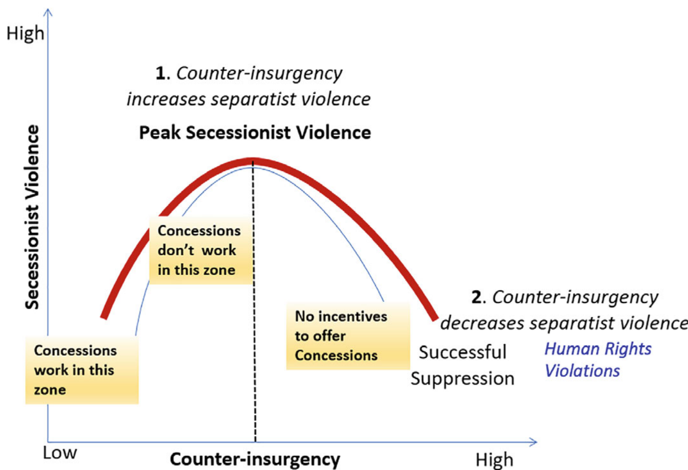

Fig. 31 Relationship between secessionist violence, counterinsurgency and concessions (*Note* Outcome 2 is achieved when the separatists' militant insurgency receives limited external support from foreign countries and modest internal support from their own populace)

Conversely, military action becomes protracted when either internal or external support persists. In such scenarios, the government often resorts to revoking previously granted concessions to the secessionist region, as seen in the case of Jammu and Kashmir. In 2019, the Indian Government withdrew Article 370, thus ending the region's special rights. With this decision, the Indian Constitution is now fully applicable in Jammu and Kashmir. Further, the central government changed the region's status from a state to a union territory, bringing it under direct central administration. Interestingly, the decision has not resulted in the escalation of secessionist crises. Instead, it has resulted in stabilization and, in some accounts, a modest improvement in the situation.[6] This thesis thereby emphasizes the interplay between the efficacy of military suppression and the adjustment of concessions, highlighting the conditional and reactive nature of government response to secessionist movements.

Finally, this study suggests that equalization policies can act as double edged swords. While an optimal level of fiscal equalization can resolve conflicts, the extremes of no equalization and full equalization can instigate anxieties, fears, and insecurities in low and high-income states respectively (Fig. 32). However, the emergence of secessionism in such economically aggrieved states is contingent upon the existence of an ethnic-economic overlap and a perceived sense of deprivation and disempowerment among ethnic minorities. These two conditions, essential for the rise of violent secessionism, are encapsulated by the Overlap Thesis and the Twin Catalyst Thesis.

The juxtaposition of Jammu and Kashmir with Assam, Bihar, Punjab, and Himachal Pradesh suggests that economic hardships or injustices alone are insufficient to ignite separatist sentiments. These hardships must intersect with a sense of identity and alienation (the Overlap Thesis), as well as political disempowerment or the inability to express grievances through established political institutions (the Twin Catalyst Thesis). The case of Punjab substantiates the viewpoint that the presence of political channels to express discontent, especially free and fair elections, is vital in fostering trust in legitimate constitutional channels among minorities. Post-conflict, state-level free and fair elections have kept anti-central sentiments from escalating beyond a certain point in Punjab.

[6] This phenomenon runs counter to the hypothesis that secessionist crises intensify when symbolic concessions to minority nations are withdrawn by the central government, often to placate majoritarian views (Basta, 2021).

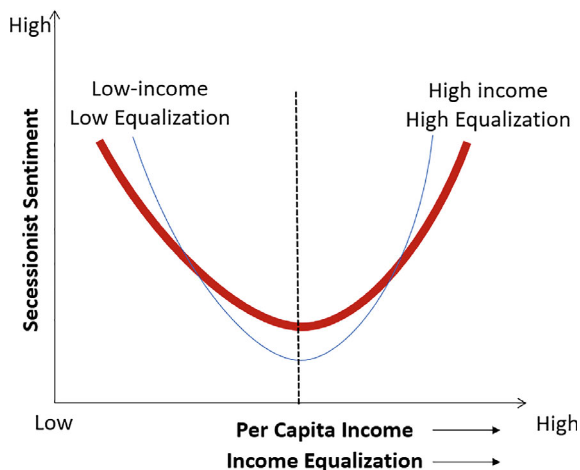

Fig. 32 Relationship between income status, equalization policies, and secessionist sentiments (*Note* These findings are subject to the existence of the ethnic-economic overlap (See Overlap Thesis) and the presence or perception of economic injustice and political disempowerment (See Twin Catalysts Thesis))

However, external support from foreign countries does play a role. Unlike Assam and Punjab, the persistent external support, primarily from Pakistan, has significantly contributed to the longevity and intensity of the conflict in Jammu and Kashmir (Fig. 29). The combination of identity elements, a sense of belonging to a marginalized national minority, economic deprivation, political disempowerment, and external support has sustained the separatist sentiment.

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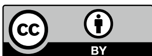

Unity and Diversity: A Turbulent Journey Through Italian Fiscal Federalism

Antonia Baraggia and Benedetta Vimercati

Italian Regionalism and Italian Fiscal Federalism: On the Unity and Diversity Seesaw

Today's Italian legal and political landscape is witnessing a renewed debate on the relationship between differentiation, autonomy, equality, and solidarity and this could trigger conflicts that must find a balance that might change over time (Bognetti, 1992). Although authentically secessionist

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Although this article was conceived together, Benedetta Vimercati wrote Sects. 1, 2, and 3 and Antonia Baraggia wrote Sects. 4 and 5.

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proposals have never materialized, as happened in other legal systems,[1] the difficult binomial of "unity and diversity" has returned to the center of the debate due to the attention placed on the so-called differentiated regionalism referred to in art. 116, 3 of the Italian Constitution (IC). This provision provides that additional special forms and conditions of autonomy, related to specific and enumerated legislative competences, may be attributed to other Regions by State law at the initiative of the Region concerned.

For a long time, with the exception of some failed efforts at implementing the differentiated regionalism procedure, the latter experienced a prolonged period of oblivion. Nonetheless, the sturdy demands for differentiation recently put forward by some Regions[2] have rekindled the discussion and turned the spotlight on the pros and cons of new forms of differentiation among the Italian Regions. This debate was further inflamed after the last election results, which delivered a right-wing majority in which some parties are strong supporters of differentiated regionalism.

However, it would perhaps be too simplistic to associate this rekindling of the debate solely with a change in the Government majority. Although certainly not indifferent, the political factor must be read in conjunction with the implications stemming from the economic crisis (2008) and the upheaval caused by the pandemic. Both these events had a huge impact not only on guaranteeing social rights but also for the institutional actors involved in providing such a guarantee and, consequently, on the vertical separation of powers in Italy. Moreover, this resurgent differentiation claim must also be read in light of the overall regionalist

[1] A lukewarm effort, frozen by the Italian Constitutional Court (ICC), was made by the Veneto Region; ICC decision no. 118/2015 on Veneto Region law no. 16/2014 calling for an advisory referendum with the following question: "Do you want Veneto to become an independent and sovereign Republic?" The ICC declared the law unconstitutional due to the violation of art. 5 IC. According to the judges, "pluralism and autonomy cannot be taken to extremes so as to result in the fragmentation of the legal order and cannot be invoked as justification for initiatives involving the consultation of the electorate – albeit only for consultative purposes – concerning prospective secession with a view to the creation of a new sovereign body".

[2] Some of these demands have been politically strengthened by a preventive positive outcome obtained with a regional advisory referendum (see Lombardy and Veneto).

design, of the reform movement that led several constitutional and non-constitutional reforms (sometimes pushed by the European level), and of the consequent constitutional case law.

Why open a chapter on Italian fiscal federalism with differentiated regionalism? Besides being the most recent stage of the complex, wavering, and still unfinished path of Italian regionalism, this differentiation process also entails a reassessment of the distribution of powers between the State and the Regions. One of the main prerequisites for the implementation of differentiated regionalism is represented by the implementation of some key elements that have driven the law on fiscal federalism (2009) , which has not yet been fully implemented at least partly due to the sovereign debt crisis. Faced with a worsening crisis, the focus has shifted to the urgent and pervasive measures adopted by the national level in order to contain public spending, paradoxically casting aside the implementation of fiscal federalism.[3]

The way financial power and taxing power are distributed is one of the factors that contributes to defining the degree of asymmetry in federal systems (Palermo, 2018). Moreover, it embodies the cornerstone of the entire polycentric structure: public power geography is determined by the financial relations between the State and subnational entities. In turn, this is crucial to understanding to what extent rights (and especially social rights) are guaranteed in a composite state (Mortati, 1976; Rivosecchi, 2019).

That is exactly why the debate on differentiated regionalism has inflamed the opposition and brought heated remarks on the issue of equality and differentiation. The latter is a classic theme in all composite states, as old as composite states are old because equality arises as a pivotal principle of institutional pluralism. This holds true for all the multiple articulations that equality assumes in a vertical separation of powers: on the one hand, in relation to the autonomous entities (meaning equality in the relationship between the territorial autonomies and the central power) and, on the other hand, with regard to individuals as equality of citizens within a region (interpersonal equality) and equality between citizens of different regions (interterritorial equality) (Gambino, 2021).

[3] According to Belletti (2022), the paradox is represented by the fact that a previous implementation of fiscal federalism would have made it possible to tackle the crisis with more solid tools, including mechanisms for allocating resources based on standard costs.

The equality issue, assumed in close connection with the very concept of citizenship (which in Italy is seen as unitary[4]), enlivens the most antithetical doctrinal positions on the opportunity to design a vertical separation of powers (Gamper, 2021). According to some authors who are disinclined to territorial power sharing, differentiation is at its very root irreconcilable with equality. On the contrary, others argue that:

> the uniformity of law does not in itself ensure the overcoming of gaps, nor the uniformity of treatment of subjective situations; and tendencies toward unification can even aggravate gaps and discrepancies and harm more (or for a greater number of citizens) the subjective situations constitutionally guaranteed. (Mangiameli, 2019, p. 1)

In summary, it could happen that uniform rules set in different contexts—especially in those where differentiation is profound and original—could accentuate disparities instead of nurturing unity (Palermo, 2018).

This tension between equality and unity, uniformity and differentiation, has been a constant of Italian decentralization since its origins.[5] Ever since its foundation, Italian regionalism has accepted a certain degree of differentiation and of equality (in the double meaning expressed before). The degree of differentiation was required due to the profound differences featuring the Italian Regions. Italy was marked by pronounced territorial variations encompassing not only cultural and historical distinctions but also demographic, geographic, linguistic, and socio-economic differences. Many of these distinctions continue to exist today, albeit in a less pronounced manner. Similar to the experience of other nations, in Italy as well, the complex nature of the nation-state is derived from the multiplicity and diversity of integrated territories, and consequently, from the variety and diversity inherent in the communities settled in the local territories involved in the process of national unification (Nevola, 2003).

[4] See, among the others, decision ICC no. 141/2015.

[5] This debate originated even more the entry into force of the IC. At the beginning of 1900, within a strongly centralized state that used to be familiar only with an administrative decentralization, a discussion started on the opportunity to differentiate the function of municipalities having regard for demographic criteria (Romano 1908).

Suffice to know that a special regime exists for certain Regions (the so-called Special Regions[6]) because of some of the aforementioned differences. And this special regime is based on a different distribution of legislative and executive powers, and on a specific fiscal regime agreed by each individual Special Region with the State and regulated in Special Statutes.

Nonetheless, in a legal system that aspires to maintain unity while enhancing territorial autonomy, the question remains as to which are the privileged tools for a vertical sharing of power that is capable of protecting and improving the specific features of territories[7] without, at the same time, sacrificing two fundamental cardinal values for Italian constitutionalism: the principle of equality and the complementing principle of solidarity (Arban, 2021; Ronchetti, 2021). Those principles are considered constitutive features of the Italian social state, unaltered and unalterable in the Italian Constitution as they are fundamental principles (art. 2 and 3 IC).

The cumbersome presence[8] of these fundamental principles has therefore driven the advancement of our federalism and our fiscal federalism, which are not competitive but aim to develop, at least in terms of intentions, through cooperation and solidarity.

Then one grasps that it would be incomplete and improper to explore Italian fiscal federalism only in the light of the main provision setting forth the principles of fiscal federalism, i.e., art. 119 IC, one of the more amended provisions of the IC.[9] This issue requires a broader scope of investigation, looking at the entire Title V of the IC (especially the provisions regulating the distribution of competences and the provision on state substitutive powers), at the provisions regulating the so-called

[6] The special Regions are five: Friuli-Venezia Giulia, Sardinia, Sicily, Trentino-Alto Adige, and Valle d'Aosta. The Trentino-Alto Adige Region is also composed of the autonomous provinces of Trento and Bolzano.

[7] Italian Regions are profoundly different in multiple aspects: cultural, demographic, social, geographic, and economic.

[8] In this context, the word cumbersome is meant without a negative connotation.

[9] The most important provision is art. 119 IC which has undergone several amendments over the years: a first revision in 2001, a second amendment in 2012, and a final amendment in 2022. The first two constitutional revisions are explored in greater depth below. The most recent revision introduced a section under which: "The Republic recognizes the peculiarities of the Islands and promotes the necessary measures to remove the disadvantages deriving from insularity".

fiscal constitution, and at the provisions on fundamental principles. In such an approach, one can appreciate the centrality of the principles of equality and solidarity in the definition of Italian regionalism and its fiscal federalism, also judging the outcomes.

According to this perspective, tools of solidarity have been foreseen in Italian regionalism precisely as a safety net to guarantee equality between the Regions and between their citizens, specifically to avoid a widening of the socio-economic divide that has always existed between the Northern and the Southern Regions. It is worth recalling here that the Gross Domestic Product (GDP) gap between a Southern and a Northern citizen was at 45% around the time of the COVID-19 pandemic (Banca d'Italia, 2022).[10]

This risk was specifically recalled to oppose the 2001 constitutional reform of Title V of the IC aimed at enhancing decentralization in the Italian regional system. The fear of further jeopardizing national social cohesion is nowadays an argument against adopting differentiated regionalism,[11] held up as a leverage for the transition from cooperative to competitive regionalism.

Otherwise, as the recognition of Special Regions demonstrates, there is no a priori incompatibility between differentiation and equality. In order not to create inherent incompatibility, it is important to take seriously the multiple specific situations that characterize the whole territory, and this may require a margin of differentiation. Over and above that, it is maybe even more relevant to define what kind of equality we strive for (Mangiameli, 2019).

In light of the above premises, answering some questions is crucial. How much inequality is acceptable? (Belser & Zünd, 2021). Is the measure of inequality that allows diversity but not disparity acceptable? Or is it better to raise the level of acceptable inequality?

Keeping these questions in mind, this chapter intends to reflect, in a diachronic perspective, on fiscal federalism in Italy, notably focusing on ordinary Regions. For this purpose, we will sketch out the various stages

[10] See also, "for over twenty years the GDP per capita in the South has been around 55-58% of the Centre-North; in 2021 GDP is around 18,000 euros (33,000 in the Centre-North). Southern Italy is below the national average" (Istat, 2023).

[11] Differentiated regionalism is blamed for attributing unjustified privileges and guarantees to the Northern Regions, worsening the current gap between Northern and Southern Regions (Villani, 2019).

that have marked the development of Italian regionalism and its fiscal federalism. Through this reconstruction we will bring out the issues and the attempts to answer the two previous questions, trying to understand how the Italian legal system has sought to build its own fiscal federalism by reconciling two naturally dynamic principles such as those of decentralization and equality (Friedrich, 1968). In this short exploration, the focus will not only be on the provisions in the Constitution, which moreover must be read in conjunction with ordinary legislation, but also on the case law and all the external or non-institutional factors that have contributed to shape Italian fiscal federalism.

Italian Fiscal Federalism: Mild "Fiscal Regionalism" for Mild Regionalism

The dawn of Italian regionalism is certainly not characterized by a strong vertical distribution of powers. Mild regionalism—or regionalism without a model (Luciani, 1994)[12]—emerged from the debate in the Constituent Assembly, marked by a distribution of competences that restored undisputed centrality in the Italian institutional structure to the central level, using the pattern of the Napoleonic model built around a peripheral administration (Patroni Griffi, 2010).

This mild regionalism, which remained in limbo for almost twenty years due to the lack of implementation caused by "majoritarian obstructionism", was very constrained both in terms of the attribution of functions and responsibilities, and of financial autonomy (Calamandrei, 1953, p. 129).

Financial intergovernmental relations between the State, the Regions, and the subnational entities settled in the original text of the IC could not be defined as fiscal federalism but more properly as "fiscal regionalism"—and in a sense this remains true today. Financial relations were based on a strongly centralized system in which the collection and distribution of revenues were hinged at the center.

In accordance with the principle of decentralization pursuant to art. 5 IC,[13] art. 119 IC recognized a margin of financial autonomy for the

[12] Other Authors talk about an administrative regionalism (De Siervo, 2016; Tarli Barbieri, 2021).

[13] Article 5: "The Republic is one and indivisible. It recognises and promotes local autonomies, and implements the fullest measure of administrative decentralisation in those

Regions but narrowed by the forms and limits established by the laws of the Republic. Regions were assigned their own taxes, shares of state taxes, and transfers in proportion to the expenditure needs of the Regions to fulfill their functions.

Although these provisions seemingly recognize a margin of territorial financial autonomy, on closer inspection and in conjunction with the distribution of competences,[14] they heavily confined regional financial autonomy (Bartole & Giangaspero, 2022). In the first place, art. 117 IC allocated the Regions few legislative powers and, in non-prominent sectors, they were also liable to be limited in the face of the national interest clause. This picture did not improve for administrative powers due to the so-called parallelism principle under which, apart from the possibility for the State to delegate others administrative competences to Regions, the IC established a correspondence between legislative and administrative functions. Regions exercise administrative powers for the same matters for which they have the power to enact laws.[15] As such, administrative powers are as restrained as legislative powers.

Secondly, the power of Regions to impose taxes could not be exercised in the absence of a prior state law and regional taxes were assigned to the Regions by the State. State transfers were moreover strictly tied to purposes, and hence not bound by the effective amount and quality of the allocated functions.

Notwithstanding the circumscribed financial autonomy, differentiation and equality found a balance in the IC, which empowered the State to assign, by law, a special contribution earmarked for financing specific needs and, in particular, for enhancing the most vulnerable areas of the country (i.e., the South and the Islands). The IC embraced, following Buchanan's teaching, the principle of equalization (Buchanan, 1950). In particular, the IC embraced a theory of interregional equalization based on the equalization of needs, so that whatever the tax revenues generated

services which depend on the State. The Republic adapts the principles and methods of its legislation to the requirements of autonomy and decentralization".

[14] The lack of attention to an overall view has probably helped in complicating the process of implementing fiscal federalism.

[15] The parallelism principle has been defined as "a second-level principle which combines the more general principle of legality with the delegation of state functions to the regions, requiring the (regional) administrative bodies to act, even when they exercise delegated functions, on the basis of a legislative framework" (Bin, 2002, p. 365).

in a subnational entity, the State is required to provide sufficient resources (Giarda, 2009).

The regulatory framework on the financial autonomy of peripheral units envisaged by the IC was therefore very meager, requiring mainly the intervention of the national legislator. This feature of the Italian financial architecture, grounded in general principles that need enforcement through ordinary laws subject to both changing majorities and contingent factors, was and remains one of the weaknesses of the development of fiscal federalism (Valdesalici, 2014).

Art. 119 IC remained unimplemented until the establishment of the ordinary Regions in the 1970s. Its implementation has been thereafter entrusted to some laws and governmental decrees such as the tax reform act, law 825/1971, and, notably for local entities, the Stammati decrees (DL 2/1977 and DL 946/1977). These regulations established a state-transfer-based system of regional and local financing that centered around a pronounced centralization of taxes. Subnational entities were financially supported with a system of transfers of state resources while regional and local taxes were almost irrelevant (Paladin, 1973). Moreover, the tax reform act provides for the replacement, starting from 1973, of all local taxes with state transfers tailored on the revenue from the suppressed taxes. This provision was supposed to be transitional, pending a new regulation of regional and local finance which, however, never happened until the Stammati decrees.

The latter further complicated the framework for strengthening centralization and outlined, for local administrators, a sort of irresponsibility that is nowadays one of the most critical aspects of Italian fiscal federalism. Notably, the second Stammati decree introduced the criterion of "historical expenditure"; thus, the transfer of resources by the State to local authorities took place based on the expenditure incurred during the previous year, increased by a fixed percentage, to a greater extent for Southern entities.[16]

The choice of financial unification with a single taxing body distributing the revenues was rooted in the belief that it would guarantee a more efficient system, avoid abuses, and contain the imbalances between the multiple entities involved. A state-transfer-based system should have

[16] However, this system could not guarantee a fair distribution of resources among the subnational entities, whose financial needs were covered in those years by around 80% with state transfers.

ensured adequate financing of the decentralized functions and greater homogeneity. But, at the same time, this system compressed legislative and administrative functions, which resulted in a compression of political autonomy (Gallo, 1979). Thus, this belief has been rebutted by reality, studded with absent accountability, and the inability to control debt,[17] both not outweighed by a reduction of unevenness.[18]

This situation failed to radically change even with the season of reforms inaugurated by the Bassanini laws (in particular law 57/1997),[19] which were characterized by substantial administrative decentralization with several administrative functions being transferred to the Regions. This reform as carried out with some major deficiencies, the lack of a constitutional amendment is the most notable one (Italian legal scholars talk about a reform with an unchanged Constitution) but also financial regulation is another important absentee. The transfer of functions was not accompanied by an organic revision of financial relations, with a few sporadic exceptions. Alongside the Bassanini reform, the Italian Government endorsed some measures aimed at revising the fiscal system, generally called the Visco reform.[20] In 1997, Legislative Decree no. 446 introduced a regional production tax (Irap), levied in all Italian Regions and paid in the region of production.[21] The revenue from the tax is assigned to the Regions, which use this funding source for their spending (chiefly healthcare). The decree also provided for the establishment of a surtax on personal income tax (Irpef) on behalf of the Regions as well as the provision of equalization tools to adjust territorial imbalances in fiscal capacity in relation to Irap and Irpef.

It was considered essential to supplement regional revenues with equalizing transfers which should have made it possible to bring the total

[17] So that "bail-outs of insolvent administrations remain worryingly commonplace" (Palermo and Wilson, 2013, p. 13.

[18] As Giarda affirmed this system was marked by a low value of regional revenues, meager possibilities for Regions of raising taxes, uncertainty about the amount of resources of state transfers, a sectorization of funding sources, inadequate increase of the amount of resources compared to the amount required to finance regional expenditure, and not stringent budget constraint (Giarda, 1995).

[19] The Bassanini reform also encompasses laws 127/1997, 191/1998 and 50/1999.

[20] Legislative delegations were bestowed from the Parliament to the Government through art. 3, par. 143–144, law no. 662/1996.

[21] In case the activity is located in more than one region, the tax is paid proportionally on the basis of the workers employed in each region.

resources available for each region to levels that ensured homogeneous per capita spending capacity. In order to increase regional autonomy, the Regions were given their own taxes and a degree of flexibility in setting the rates (Bosi & Guerra, 2003; Circolare Ministero delle Finanze, 1998).

These elements had to embody the at least threefold intention this fiscal reform was introduced for: to simplify and rationalize the tax system; to ensure greater financial autonomy for the Regions, boosting fiscal decentralization through stimulating a federal transformation project; and to guarantee the Regions a consistent flow of resources to fund their expenditures, increasing the accountability of regional and local administrators (Commissione Parlamentare Consultiva, 1996).

The above-mentioned goals were supposed to initially be implemented through Legislative Decree 56/2000, through which the national Government redesigned the financing of the healthcare system. The decree sought the abolition of state transfers and the financing of healthcare expenditure (the largest cost at regional level) through regional own taxes and surtaxes, where the repeal of state transfers and the potential resulting territorial imbalances[22] were softened by a national equalization fund based on multiple criteria, including needs, resident population, and fiscal capacity.

This first step toward more genuine fiscal federalism immediately suffered a setback. From the very beginning, state transfers were immediately reintroduced and the equalization fund was not actually implemented.

Toward an Envisaged but not Implemented Fiscal Federalism

In 2001, the legislator tried to remedy the lack of a constitutional framework that could genuinely support fiscal federalism by the significant constitutional reform of Title V of the IC. The constitutional legislator sought a federal reform, but not the establishment of a fully-fledged federal state (Groppi, 2015), which is feared as it is seen as an irreparable risk for "the unity of the state and the solidarity-based relationships that inform the Italian constitutional architecture" (Arban, 2021, p. 101).

[22] The imbalances could arise due to the different bearing of the sources of income on the whole national territory.

The spirit of the reform seemed to be embodied in art. 114 IC, which states that Municipalities, Provinces, Metropolitan Cities, and Regions are recognized as autonomous bodies with their own statutes, powers, and functions. The provision was hailed as the epiphany of placing the various spheres of autonomy (over time disowned) on the same level, including the financial one found in a revised art. 119 IC. Financial relationships appeared to be undergoing an overturning of perspective. Subnational entities were considered active protagonists of their own financial autonomy, called upon to find their own resources for the exercise of their functions, partly by exploiting their tax power, in a context marked by an overall enlargement of legislative and administrative powers.

With reference to legislative powers, art. 117 IC officially lists the subject-matters reserved to the State (Sect. 2) and those reserved to concurrent competence, according to which the State has the right to determine the fundamental principles and the Regions the detailed regulation (Sect. 3). Section 4 establishes the "residual clause" under which all subject-matters not listed in the previous sections are included in the powers of regional legislators (Panzeri, 2017, p. 159). In relation to administrative competences, the principle of subsidiarity was constitutionalized, destined to supplant the principle of parallelism. Therefore, the administrative functions had to be carried out by the institutions "closest to the citizens (i.e., the municipalities) unless they are attributed to the provinces, metropolitan cities and regions, or to the State, pursuant to the principles of subsidiarity, differentiation, and proportionality, to ensure their uniform implementation" (art. 118 IC).

This enhancement of subnational autonomy was also translated into art. 119 IC—thus, in a sense, stressing the tension between unitarian and autonomist demands (Carrozza, 2010). Setting forth revenue and expenditure autonomy, the amended provision ascribes subnational authorities with independent financial resources. They set and levy taxes and collect revenues of their own, but they also share in the tax revenues related to their respective territories.

The use of the adjective "own" to qualify regional taxes is not meant to remain linked to the allocation of the taxes in the sense that the recipients of the revenues are the Regions. The entitlement to the tax is dissimilarly connected to the entitlement of the taxing power. This seems to be additionally reinforced by the terminological choice adopted, that of juxtaposing and being the word "levy" preceded by the word "set", which suggests the possibility of making changes to structural components of the

tax, including the power to create a new tax. The underlying logic that stands out in art. 119 IC is that of moving from a state-transfer-based system of regional and local financing to a system of financial autonomy wherein spending power hinges on the ability to generate revenues.

However, in designing fiscal regionalism characterized by solidarity, the reform did not remain untouched by the search for a balance between unity and differentiation, including a mix of elements of autonomy and central control. Art. 119 IC requires the national legislator to produce an ordinary law for an equalization fund, without any allocation constraints, for the sake of those territories that have lower per capita taxable capacity. Thus, it is possible to highlight a change in the equalization theory. Equalization based on needs switches to the equalization of fiscal capacities so that the state is required to mitigate or eradicate the differences between per capita territorial revenues. But it is worth noting that:

> the new Constitution does not indicate the 'extent' of equalization, whether differences in per capita fiscal capacity are to be eliminated or only reduced. It would seem that in the presence of matters of purely regional interest, one should opt for reduction rather than for elimination. (Giarda, 2001, p. 8)

The revenues raised from the above-mentioned sources[23] will enable subnational entities to fully finance the public functions attributed to them under the new separation of legislative powers and the subsidiarity principle.[24] The latter is an inherently dynamic principle "capable of accentuating a given trend"—both a decentralizing and a centralizing trend—and, in a sense, it could make the distribution of powers less clear and stable (Steering Committee on Local and Regional Authorities, 1998, p. 23). This direct connection between expenditure and functions helps to mark the distance from an authentic federal system in which what is necessary for the functioning of the center would have been established as a priority, thus leaving the remainder to the peripheries, and not vice versa (Falcon, 2008).

[23] In sum, Regions and local entities can benefit from three kinds of resources: own-taxes, regional surtaxes on State taxes, and resources from the equalization fund.

[24] The justiciability of this correspondence is also highly challenging, as the burden falls on the region itself to prove with adequate documentation the absolute impossibility of carrying out the functions assigned to it by the Constitution due to the implementation of financial measures (Rivosecchi, 2019).

Remaining within the scope of equality and differentiation, along with the equalization fund, art. 119 IC provides for "specific-purpose-grants for extraordinary circumstances". In order to promote economic development, social cohesion, and solidarity, to reduce economic and social imbalances, to foster the exercise of individual rights, or to achieve goals other than those pursued in the ordinary implementation of their functions, the State is allowed to allocate supplementary resources and adopt special measures in favor of specific entities.[25] Given its purposes, it has been considered as a sort of "relief valve" for the system, inasmuch as it is a mechanism to compensate for the need for territorial financial resources, or to streamline measures of national relevance, whenever deemed essential by the national legislator (Astrid, 2003).

However, the mechanisms the constitutional legislator has introduced to protect unity and equality in the Regions and their citizens are not only those mentioned above. It is worth mentioning two other macro-categories of mechanisms: the first is the exclusive competence of the national legislator to define "the essential level of benefits relating to civil and social entitlements to be guaranteed throughout the national territory", which is further safeguarded by the substitutive powers of the national Government referred to in art. 120 IC; the second is represented by the reference contained in art. 119 IC by virtue of which the Regions can set and levy taxes and collect revenues of their own, but in compliance with the Constitution and according to the principles of coordination of State finances and the tax system.

With regard to the first macro-category, the State is called upon to determine the essential level that needs to be guaranteed across the country for the protection of social and civil rights. This definition is binding for the regional governments, which are required to guarantee these essential levels, including in economic terms.

It is inherently true that the rights and the rules on competences are complementary because constitutional rights, when it comes to the distribution of competences, establish the duties of the State and the Regions. However, this holds even truer, for the essential levels of protection for

[25] Art. 119 IC ends assuring subnational entities "their own properties, which are allocated to them pursuant to general principles laid down in State legislation. They may resort to indebtedness only as a means of funding investments. State guarantees on loans contracted for this purpose are not admissible".

social and civil rights. This complementarity can also be found in financial aspects. This is why the essential levels are strictly intertwined with regional and local financial autonomy, as their scope could affect their margin of autonomy.

Moreover, according to art. 120 IC, if the Regions are unable to guarantee essential levels, the national Government can exercise substitutive powers. This is one of the most enigmatic provisions amended by the 2001 reform. Indeed, the opaqueness of this notion gave rise to several interpretative doubts that even remained unresolved after the entry into force of the "La Loggia" law in 2003.[26] Nevertheless, substitutive powers have often been deployed, especially to preserve the right to health. Some Regions have been placed under receivership and repayment plans in order to redress regional deficits and restore regional imbalances in the protection of fundamental rights. The Regions under repayment plans, subscribed both by the State and by the Region, cannot implement measures that might prejudice the plan. Plans only allow the financing of the essential levels, but not of services falling outside of these levels.[27]

The exclusive competence of the State does have the merit of seeking to protect at least a minimum level of homogeneity across Italy in guaranteeing essential levels, but it has also been the subject of some criticism. First of all, the national Parliament and Government have not yet determined all the essential levels, neither have the determined levels been kept updated.[28] Secondly, also in the light of constitutional case law, the essential levels constitute "a Trojan horse for the centralization of competences" (Martinico, 2011, p. 36). The exclusive competence of the State to define them has been described by constitutional judges as a transversal competence. Due to the fact that the exercise of this competence can overlap with regional competences (both concurrent and residual), it can reduce the regional margin of legislative, administrative, and financial autonomy.

Moreover, the essential levels—even when defined—have not always been able to mitigate inequalities, as demonstrated by the ongoing

[26] Law 131/2003 is aimed at implementing some of the amended provisions of Title V IC.

[27] The ICC has viewed the repayment plans as interposed norms in the judgement of constitutional legitimacy.

[28] Except the updating of the essential level on health (LEA), laboriously reached in 2017, sixteen years later their definition by Dpcm November 29, 2001.

phenomenon of health mobility. One of the reasons for this is because they were not supported by fully implemented fiscal federalism and a consequent equalization mechanism.

Lastly, the legislative competence in defining minimum levels should be combined with monitoring based at the central level. Unfortunately, while the central level does carry out close monitoring of spending, alert, accurate monitoring of the quality of services is in short supply (Bin, 2021).[29]

The second category of mechanisms the constitutional legislator has introduced to protect unity and equality is no less relevant. The IC establishes the parameters within which Regions can set and levy taxes and collect revenues of their own. These parameters are in harmony with the Constitution and the principles of coordination of public finances and the tax system. Both of these evoke some of the most debated aspects of the financial autonomy of subnational entities.

Coordination between multiple tiers of governance is a crucial profile in outlining any decentralized system, especially financial coordination; the way it is conceived and how stringent it is shape the spheres of autonomy of regional and local entities. In the Italian system, financial coordination is designed to ensure two cornerstones, one internal and one external: the curbing of disproportionate disparities, and compliance with European financial targets and constraints.

It is also worth pointing out that, pursuant to art. 23 IC, "No obligation of a personal or financial nature may be imposed on any person except by law". This provision must be linked to the division of competences between the State and the Regions (Brancasi, 2006; Gallo, 2002). In terms of aspects that are exclusive to national competences, art. 117 IC indicates the legislative power for state taxation and accounting systems, and the equalization of financial resources. From the residual clause, it is also possible to infer that Regions have residual competence for regional tax systems. But it is here that the coordination issue resurfaces. Art. 117 IC establishes that the coordination of the public finances and the tax system is a concurrent competence, so that the taxing powers of the

[29] Within healthcare system, legislative decree 56/2000 and the following Ministerial decree on December 12, 2001, provided for a monitoring system. More recently, DM March 12, 2019 has launched a revised monitoring system aimed at measuring the equity, the effectiveness, and the appropriateness of care and services falling within the essential levels of health assistance.

Regions must comply with the principles of coordination of the tax system defined by the state legislation (Colasante, 2017). This kind of competence has an intrinsically loose-knit nature, with moving boundaries, such that national legislation can enact detailed pieces of legislation that creep into areas of regional competence, particularly in times of economic crisis.

Albeit a wavering attitude, the Italian Constitutional Court (ICC) recalled that "it is up to the state legislator to determine the broad lines of the entire tax system and to define the limits within which the regulatory power of the State, of the Regions and of the local autonomies can be exercised". Due to the vagueness of the constitutional framework and the nature of art. 119 IC, which is not a completely self-executing provision, the State can carve out a wide margin for maneuvering.

Thus, it is crucial to look at how Italian fiscal federalism is implemented under the renewed constitutional framework. Organic national legislation on fiscal federalism in combination with the national definition of the essential levels is a prerequisite to put into practice the principles outlined in the amended Title V. However, expectations of prompt, systematic legislation were shattered by the legislator's silence. The ICC's warning has fallen on deaf ears as well.[30]

After the failure of some attempts[31]—such that some Italian legal scholars even talked about a quiescence of regional financial autonomy and described the path of Italian fiscal federalism as a stop and go process—Parliament enacted law no. 42 only on May 5, 2009 (Bartole & Giangaspero, 2022; Cecchetti, 2018). This delegated the Government to regulate fiscal federalism, in accordance with article 119 IC. If on the one side, the choice to delegate this regulation to the Government—only fixing principles and criteria—is understandable since such a regulation is so technically complex, on the other side a supplementary step in the implementation process of fiscal federalism has paradoxically tangled the process itself (Scuto, 2010; Valdesalici, 2021). Moreover, this

[30] Among others, it is worth recalling decision 370/2003, Section 7: "It is clear that the implementation of art. 119 is urgent in order to fully implement the new Title V of the IC. Otherwise, the different allocation of legislative competences configured by the new provisions would be contradicted. Moreover, the persistence or even the establishment of forms of financing of the Regions and sub-regional entities inconsistent with art. 119 IC risks jeopardizing the functionality of the system, even locking entire sectors".

[31] The most relevant attempts were the draft law presented by the centre-left Government in 2007 and the draft law known as the "Calderoli Project" presented by the centre-right Government in 2008.

process locked out not only the Parliament but also the Regions from a substantive decision-making process to fulfill their autonomy (Palermo and Wilson, 2013).

By moving into the substance of the law 42/2009, it becomes clear that two pillars need to be focused on here.[32] The first one is the introduction of the so-called "standard costs and needs" criterion, which is supposed to boost the accountability of local and regional governments and to better streamline the expenditure process. The law requires that the criteria under which the current system is financed be gradually overcome. The historical spending criterion should have been gradually replaced with the "standard costs and needs" criterion, under which the transfer of resources is no longer tied to the resources spent in the previous financial period. They are rather "linked to pre-defined benchmarks as well as generally applied and neutral indicators that should make it possible to standardize territorial costs and needs".

In order to trigger the new criterion, some steps are required to be taken satisfying a chronological but overall logical order. Once again, and even more important is the need for the preliminary definition of the essential levels of services on the basis of which the standard needs can be estimated, thus also obtaining the standard costs.

However, while this process has been launched for local entities (municipalities and provinces), these principles have not yet been adopted at regional level; in 2010, the Government enacted decree 216 regulating the move to standard needs for local entities, while decree 68 in 2011 merely "sets the premises" for defining the standard costs in the health sector.

The second important principle enshrined in law 42 is the equalization fund, linked to the previous one. The standard costs and needs criterion, whenever appropriately implemented, can indeed foster the solidarity principle and its preeminent tool, i.e., the equalization fund (Antonini, 2014). While the standard needs are connected with essential levels of services and the protection of fundamental rights, the coverage of all other

[32] It is worth remembering that the process of implementation of law 42 is still ongoing. The decrees approved thus far are decree 85/2010 "public property federalism"; decrees 156/2010 and 61/2012 "the capital city of Rome"; decree 216/2010 "standard costs and needs of Provinces and Municipalities"; decree 23/2011 "municipal federalism"; decree 68/2011 "regional financing system and standard costs in the health sector"; decree 88/2011 "infrastructural equalisation and special State grants"; decree 23/2011 "harmonisation of the budget models"; decree 149/2011 "awards and sanctions".

financial needs mostly relies on the instruments of regional tax autonomy. For both these expenditures, in order to equalize the different fiscal capacities of the Regions, an equalization fund is envisaged. The aim of the fund is to rebalance the differences between tax capacities. The latter are based on the revenue a Region is potentially able to collect through own revenues, given the taxable amount and the statutory rate.

According to some scholars, this equalization fund cannot be considered an expression of either a vertical equalization system or a horizontal one. It could more accurately be defined as a "spurious model". It seems to be "formally vertical" because it is based on a national fund. Nonetheless, the horizontal side can be seen in the fact that it does allow distribution among only some Regions, even though it is fed by all the Regions, in proportion to their respective fiscal capacities (Rivosecchi, 2009).

State-Region Relationship with the Lens of the ICC Case Law During the Economic Crisis

The story of the implementation of the Italian fiscal federation intertwined with the outbreak of the economic crisis that between 2008 and 2012 characterized the global economic context and Europe in particular. While Italy cannot be included on the list of "bail-out" states, i.e., the States that received financial assistance under conditionality regime, the crisis had a huge impact on the Italian legal and constitutional order and, even without formal "conditionality", the Italian Government was prompted by the famous European Central Bank letter to adopt several reforms, including public-sector cuts, changes to the pension system, and, in the realm of social rights, measures to ensure the necessary financial resources to avoid default.[33] These measures affected also, in a significant way, the relationship between the State and Regions in the realm of fiscal policies. This is particularly evident if we examine the case law of the Italian Constitutional Court during the economic crisis.

We can identify three main drivers of the case law during the economic crisis: the long-standing non-implementation of Law n. 42/2009, the

[33] As Tega notes, "Compliance with these requests was implicitly presented as a condition for ECB financial support, namely through massive purchase of Italian government bonds on the secondary market" (Tega, 2014, p. 31).

introduction of austerity policies, and the constitutionalizing of the balance budget rule in 2012.

The case law analysis will follow these three critical aspects of Italian fiscal federalism in times of economic crisis.

The non-implementation of Italian fiscal federalism has been a common argument deployed by the ICC in a series of decisions dealing with the tensions between the regions autonomy and the state will to guaranties certain standards of services and to fulfill unitary goals, especially during the economic crisis, which can be considered a lens for looking at the State-Regions relationship, although in exceptional times.

The joint effect of both the non-implementation of Law no. 42/2009 and the economic crisis has led to a process of centralization of power in the hand of the State, whose intervention is permitted in all the cases where "it responds to the need to ensure a uniform level of enjoyment of the rights protected by the Constitution itself" (ICC 2011, no. 232). In several cases (judgment no. 121 of 2010, judgment no. 232 of 2011), the Court has upheld the State intervention configured as "a temporary consequence of the persistent failure to implement art. 119 Cost. and of imperious social needs, also induced by the current serious national and international economic crisis" (judgment no. 121 of 2010). All these factors are considered by the Court sufficient justifications to legitimize the intervention of the State even when it limits the legislative competence of the Regions in the field of local public transport, in order to ensure a uniform level of enjoyment of the rights protected by the Constitution itself.

Another powerful tool which had a centralizing effect, expanding the areas of intervention of the State, has been the concept of the "coordination of public finance", a transversal matter which endorsed the introduction by the State legislator of very specific constraints for the containment of the public expenditures of regions and local authorities (ICC judgments no. 23/2014 and no. 198/2012). The coordination of public finance has become a pervasive tool deployed by the State and endorsed by the Constitutional Court: as the ICC clearly states in decision no. 64/2016, the finance of the Regions (*omissis*) and local authorities is part of the enlarged public finance and, therefore, the State legislature may legitimately impose on the Regions and local authorities, for reasons of financial coordination linked to national objectives, also conditioned by European obligations, constraints on budgetary policies, even if these inevitably result in indirect limitations on the spending autonomy of local

authorities. The limitations, however, are legitimate only if they leave the Regions the autonomy on resource allocation and if they are temporary in nature (Gallo, 2018).

Moreover, in several cases the ICC ruled on the constitutionality of austerity measures impinging on fiscal federalism and social rights.[34] As noted, by Tega, the ICC rulings on the financial crisis measures in 2012 and 2013 show a very cautious, and sometimes ambiguous stance: on the one hand, the Court states that constitutional values such as equality, solidarity, and local government's autonomy must be reasonably balanced with economic concerns; on the other hand, the Court "keeps these concerns in high consideration and scrutinizes each austerity measure on a case by case basis, taking into account its specific features and effects" (Tega, 2014, p. 75).

The ICC upheld State legislation safeguarding the most vulnerable, despite the lack of competences (see Decisions no. 80/2010 and no. 62/2013). In this jurisprudence the ICC highlighted the pivotal role of the State's duty to protect the inalienable core of human dignity. Where the State legislates to protect situations of extreme need, even without an express remit to do so, its conduct can be justified in light of the fundamental principles set out in Articles 2[35] and 3 of the Italian Constitution.

In sum, with regard to the relationship between the State and regional governments, the economic crisis has heralded a new centralism in the name of the scarcity of resources, through the concepts of the "coordination of public finance" and that of a "minimum standard of essential services", both are seen as State prerogative.

Toward a New Season of Italian Fiscal Federalism?

A new season for the Italian regionalism seemed to be opened by the implementation of the above-mentioned "differentiated regionalism", a process provided by art. 116 c. 3 of the Italian Constitution as amended

[34] See, for example, Constitutional Court Decision no. 116/2013, Decision no. 304/2013.

[35] "The Republic shall recognize and protect the inviolable rights of the person, both as an individual and in the social groups where human personality is expressed. The Republic expects that the fundamental duties of political, economic and social solidarity be fulfilled".

by the constitutional law n. 3 of 2001. Art. 116 c. 3 of the Constitution provides that Regions with ordinary statute can be granted further forms and particular conditions of autonomy, limited to certain matters, in compliance with the principles referred to in article 119 of the Constitution (Rivosecchi, 2022). This provision, which aims to introduce a certain degree of asymmetry in the Italian system, has not been concretely triggered so far.[36]

More in general, the Italian example has been defined a "non-model", since we cannot identify a clear path toward the realization of the federal or even regional principle.

However, more recently the topic has gained momentum, especially after the draft proposal for the implementation of art. 116 c. 3 advanced by the Minister for Regional Affairs, Calderoli. We cannot analyze in detail the overall proposal, which entails different aspects of both substantive and procedural nature; what seems particularly relevant for the topic of fiscal federalism is the link between the process of differentiated autonomy and the knot of fiscal resources and equalization mechanisms, or in other word the tension between asymmetry and unity (Bin, 2008).

The draft proposal urges in particular to define the so-called essential level of services (hereinafter LEPs) concerning civil and social rights that must be guaranteed throughout the national territory. The LEPs represent the expenditure threshold which is necessary to guarantee the uniform access to basic and fundamental services, in order to make rights effective, despite local and regional differences. The definition of the LEPs is a competence exercised by the State and represents an essential element for the transparent development of financial relations between the State and territorial authorities, and the delay in defining them is an obstacle not only to the full implementation of the financial autonomy of local authorities, but also to the full overcoming of territorial gaps in the enjoyment of social rights benefits.

Another fundamental step to avoid that the implementation of differentiated autonomy will create and foster further inequalities among the regions, and therefore among citizens in the access of certain fundamental services, is the introduction of equalization mechanisms in art. 9 of the draft proposal. It is not by chance that art. 116 c. 3 IC itself refers to the

[36] For a broad overview of differentiated regionalism see Violini (2021). Una forma di Stato a regionalismo differenziato? Percorsi e argomenti per l'attuazione dell'art. 116, III comma, Cost., Giappichelli.

principle of art. 119 IC, which provides for the establishment of an equalization fund for the territories with limited fiscal capacity. Asymmetry and equalization are thus the two pillars for the realization of a sustainable differentiated model of federalism/regionalism.

To this regard, we argue that the full realization of fiscal federalism is a pre-condition for the sound implementation of the differentiated regionalism. That's why, given the rise of the debate over differentiate regionalism, even the implementation of fiscal federalism seems more promising than ever.

This is even truer if we consider that the realization of fiscal federalism is now one of the milestones required by the Italian Recovery and Resilience Plan (PNRR), to be implemented by 2026. The Recovery Fund itself has as a primary objective the reduction of the territorial gap among the regions and the realization of social cohesion. To this regard, it is worth noting that 40% of the Recovery Plan's resources are destined to the Regions of Southern Italy, historically more disadvantaged than the regions in the North.

It is of course too early to assess the impact of the differentiate regionalism and of the PNRR on fiscal federalism and to predict if a full implementation of the financial rules between the State and Regions will ever take place. However, current circumstances, both internal and external, represent an unique window of opportunity for the definition of a sound system of State-region fiscal relations which is able to temperate the value of asymmetry and diversity, with the principle of unity: a difficult but necessary equilibrium in order to create a sustainable and a better defined system of State-Region financial relationship.

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Accommodating Diversity or Imposing Uniformity? The Hollowing Out of Provincial Governments in South Africa

Tania Ajam

Introduction

South Africa is a country with substantial diversity across "racial",[1] ethnic, economic, social, cultural, political, linguistic, geographic, and administrative lines, where small spatial concentrations of wealth coexist with vast expanses marred by extreme poverty, inequality, and unemployment. After the country's transition to democracy from apartheid in 1994, the 1996 South African Constitution enshrined justiciable socio-economic rights, created relatively decentralized multi-level government structures comprising national, provincial, and local government spheres within a unitary state, and crafted a system of intergovernmental relations.

[1] All racial descriptors (African, Indian, "Colored", White) in this paper refer to "race" as a socio-political rather than biological construct, drawing on the terminology still used in South African government legislation and statistical publications. The term "Colored" is in quotes to reflect rejection of this arbitrary, apartheid racial classification, along with its associated descriptor "mixed race" which presupposes the existence of "pure races".

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Provincial governments were endowed by the 1996 Constitution with an extremely restricted list of exclusive functions and limited own revenue raising powers (South Africa, 1996), largely reliant on intergovernmental grants from national government. While policies in respect to concurrent functions such as basic education and health are largely set at national government level, provinces play mainly an implementation function, subject to norms and standards set centrally.

This chapter aims to assess the extent to which political, economic, linguistic, and geographic diversity has influenced the design and ongoing implementation of the system of intergovernmental financial relations (IGFR) in relation to the nine South African provincial governments. By reviewing the post-apartheid evolution of the institutional trajectory of provincial governments in South Africa, the chapter also analyzes the extent to which "fiscal federalism"—or IGFR as it is more commonly referred to in South Africa–has accommodated diversity in practice.

Section 2 of this chapter analyzes the genesis and evolution of the nine South African provincial governments. Section 3 examines the role of provincial governments in the IGFR system. Section 4 considers the extent to which provincial diversity influences intergovernmental revenue sharing. Section 5 discusses re-centralization pressures since the adoption of the 1996 Constitution. The devolution of functions from the national to the local government sphere (e.g., housing and public transport to large metropolitan municipalities) also influences provincial-local intergovernmental relations. Section 6 compares the provincial experience of re-centralization to the experience of devolution in local government. Section 7 concludes by reflecting on the gradual hollowing out of provincial government in South Africa. Provincial powers which were already limited in the Constitution have been further attenuated over the last two decades by the re-centralization of functions (e.g., social security, training and vocational colleges to national government and the proposed National Health Insurance system which will centralize current provincial health functions). This is exacerbated by centralized wage bargaining, hence provincial governments have little control over their largest cost driver, introducing budgetary rigidities. Given that provincial governments have few of their own revenue sources and are largely reliant on intergovernmental grants, the escalation in the provincial wage bill has tended to outstrip increases in intergovernmental grants and crowded out other provincial non-wage expenditures crucial for service delivery. This

has been exacerbated by national pressures for fiscal consolidation in the post-pandemic recovery period (Sachs et al., 2022).

The highly centralized application of intergovernmental relations has limited scope for provincial experimentation and innovation. Pervasive state capture and corruption over the last decade have resulted in greater and more complex regulatory environments for provincial governments which further limit innovation and create stark trade-offs between probity and service delivery.

The Emergence of Provincial Governments and the Evolution of the Intergovernmental Fiscal System in South Africa

During the apartheid regime, "White" South Africa was characterized by spatial segregation along the lines of the four designated "racial" groups—Whites, Africans, "Coloreds", and Indians—within its four provinces (the Cape Province, the Transvaal, the Orange Free State, and Natal). There were ten black homelands called Bantustans established within the borders of South Africa for specific "tribes", e.g., Ciskei and Transkei for the Xhosa, Qwa Qwa for the Basotho, and KwaZulu for the Zulu. There were also four so-called "independent" states (i.e., Transkei, Ciskei, Venda, and Bophuthatswana). These served as reservoirs of cheap labor, requiring black people to obtain "passes" to enter "White" South Africa and seek work in farms and mines under the migrant labor system, as part of the apartheid policy of "influx control" (Wilson & Ramphele, 1989).

A cornerstone of the apartheid regime's ideology was "separate development", which rhetorically embodied the ideal of separate but equal development for all "races", but in practice resulted in a racial hierarchy of economic opportunity, social mobility, and access to government services along racial lines (Posel, 2001).

The South African Constitution of 1996 absorbed all these homelands and the so-called "independent" states (see Fig. 1) into the Republic of South Africa and established nine new provinces: Western Cape, Northern Cape, Eastern Cape, Free State, KwaZulu-Natal, Mpumalanga, Limpopo, North West, and Gauteng (see Fig. 2). Provincial government boundaries were "not designed to constitute linguistically or culturally homogeneous entities" since this would have been perceived by the African National Congress party (ANC) as entrenching "one of the most pernicious evils of

apartheid, a state designed along ethnic lines" (Murray & Simeon, 2010, p. 238).

Gauteng, the economic heartland of South Africa, produced about 35% of the country's GDP in 2016, housed about 25% of the country's population in 2017, has a population density of 785 people per square kilometer, but comprises only 1.7% of the country's land area. By contrast, the Northern Cape is the largest province, comprising about 31% of the country's land area, but accommodated only 2.1% of South Africa's population in 2017, with a low population density of only three persons per square kilometer (Alexander, 2018).

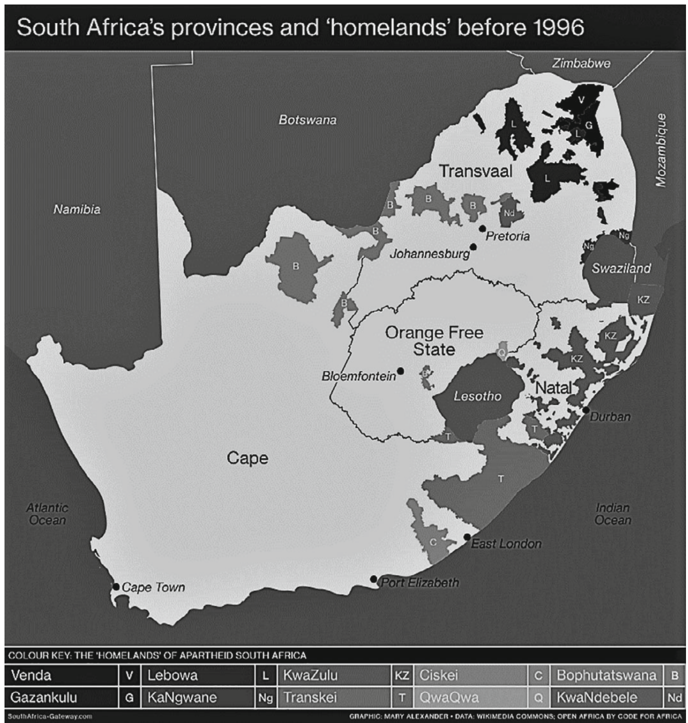

Fig. 1 South Africa's provinces and "homelands" before 1996 (*Note* From "The nine provinces of South Africa", by M.C. Alexander [2018], [https://southafrica-info.com/land/nine-provinces-south-africa/])

Fig. 2 The nine provinces of South Africa after 1996 (*Note* From "The nine provinces of South Africa", by M.C. Alexander [2018], [https://southafrica-info.com/land/nine-provinces-south-africa/])

In February 1990, the ban on the ANC and other political parties was lifted by the National Party (NP) apartheid government, and Mr. Nelson Mandela, the leader of the ANC, was released after 27 years of imprisonment. This fundamental shift was followed by the Groote Schuur Minute, sealing the NP and the ANC's commitment to peace and a negotiated settlement in May 1990. The ANC renounced the armed struggle in August 1990, and the National Peace Accord was signed in September 1991. These events collectively signaled the beginning of a multi-party negotiation process, which included the Inkatha Freedom Party (IFP) based in KwaZulu-Natal, and the homeland administrations. The subsequent Convention for a Democratic South Africa (CODESA I) talks started in December 1991. These talks culminated in the NP's capitulation to ANC demands for an interim government,

general constitutional principles for a non-racial, non-sexist, democratic South Africa in February 1992, and a Whites only referendum held by the NP, in which the reform received overwhelming support from the white electorate. In an atmosphere of extreme tension, fear, infighting, and mistrust, the CODESA II talks forged agreements at the Multi-party Negotiating Forum on a constitutional assembly, an interim government, the release of political prisoners, hostels which housed migrant laborers,[2] dangerous weapons, and mass action. Finally, on November 18, 1993, the interim Constitution of South Africa was ratified paving the way for democratic elections, with the proviso that the two newly elected Houses of Parliament would sit as a Constituent Assembly to draft a new final Constitution (Humphries & Shubane, 1993; Maasdorp, 1993).

At that stage, the decentralization debate centered around regionalism, which sparked intense political controversy on an array of disparate models and generated a vibrant academic literature. The NP's brand of highly decentralized federalism with entrenched regional autonomy (including regional taxation powers) was conceived as an instrument to curtail the future ANC majority government's powers. Given the racial and spatial divides of the apartheid past, the ANC, wary of attempts to dilute its ability to govern the country from a strong center, to curtail redistribution and the potential for political territorial mobilization on the basis of race or ethnicity, punted a unitary state with strong local government, but weak regional elements. The IFP, based in Natal with mainly Zulu support, endorsed a confederationalist approach which would have amounted to virtual secession (Humphries & Shubane, 1993; Maasdorp, 1993; Schlemmer, 1994; Wittenberg & McIntosh, 1993).

The ANC's policy positions on regionalism, which would later transmute into the provinces, were outlined in two policy documents: Ten Proposed Regions for a United South Africa (African National Congress, 1992), which proposed a regional demarcation similar to the developmental regions used by the Development Bank of South Africa, and the ANC Regional Policy (African National Congress, 1993). The latter policy document advocated that the specifics of regional boundaries should be left to the Constituent Assembly, but it did delineate proposals

[2] Migrant laborers from the black Bantustans, "independent states", and neighboring countries such as Botswana and Lesotho were not allowed to bring their families with and were housed in single sex dormitory blocks called hostels, which were epicenters of violence in the 1990s in apartheid South Africa.

on the powers and functions of regions, which later influenced Schedules 4 and 5 of the 1996 Constitution. It also outlined technical arguments against the devolution of taxes, such as personal and company income taxes and value-added tax to regional governments, and advocated instead a form of sharing of nationally collected tax revenue by a proposed permanent Advisory Commission on Fiscal Decentralization, which would later become the Financial and Fiscal Commission created by the 1993 interim Constitution.

Given apartheid history of racial discrimination and exclusion in public services, including in education and health systems, racially segmented labor and financial markets and spatial segregation of residential suburbs, liberation movements—such as the dominant ANC—favored a single, centralized unitary, non-racial state with all citizens entitled to the same level of public services and the same economic opportunities. Simeon and Murray contend that while the 1996 Constitution gives full expression to cultural differences and diversity in the private sphere (e.g., religious and linguistic differences in the education system and eleven official languages), "such differences are to be recognized and institutionalized as little as possible in the political sphere" (2009, p. 546). Aware of how the apartheid government had exploited ethnic and tribal rivalries as part of a divide and rule strategy, ANC leaders were concerned that a political system which legitimated and entrenched such differences might intensify these conflicts, undermining their vision of a united, non-racist, non-tribal South Africa (Simeon & Murray, 2009).

The creation of provincial governments in South Africa was a concession by the ANC to the NP apartheid regime during the negotiated transition to democracy. The ANC favored a strong national government and strong local government, while the NP saw provincial governments as a vehicle for protection of White minority rights and privileges. The creation of the provinces therefore played an important peace building function, because they permitted the NP to achieve a majority in the Western Cape and the Inkatha Freedom Party (IFP) to achieve a majority in KwaZulu-Natal. The National Party also had an interest in protecting the linguistic rights of White Afrikaners; the Western Cape has the largest proportion of Afrikaans speakers, while KwaZulu-Natal, the stronghold of the IFP, hosts the large proportion of isiZulu speakers. After the first democratic elections in 1994, the NP gained control of the Western Cape and the IFP of KwaZulu-Natal (De Villiers, 2007; Lodge, 2005). By 2023, eight out of nine provinces were controlled by the African National

Congress, and only the Western Cape was controlled by an opposition party, the Democratic Alliance (DA).

South African fiscal conditions at the dawn of the new democratic dispensation in 1994 presented a rather bleak picture. Aggregate fiscal discipline was weak. Increasing national government expenditure in the dying days of the apartheid era, coupled with weak revenue collection, created burgeoning debt, raising concerns about fiscal sustainability, and the looming specter of a debt trap (Abedian et al., 1995; Ajam & Aron, 2007; Folscher & Cole, 2006). In keeping with the apartheid philosophy, a highly centralized budget process allocated resources along racial lines, with substantially less per capita being spent on health, basic education, and other services for black South Africans in comparison to their white counterparts.

The Role of Provincial Governments in the South African Intergovernmental Fiscal System

Besides confronting the immediate macroeconomic and equity challenges of the democratic transition in 1994, the incoming ANC government was also charged with the long-term project of implementing the fiscal and socio-economic rights provisions of the newly adopted 1996 Constitution. Unlike the constitutions of many other countries, the South African Constitution gives substantial direction on the type of fiscal institutions that should support decentralized, democratic accountability (e.g., public procurement, generally accepted accounting practice, and intergovernmental revenue sharing).

The adoption of the 1996 Constitution precipitated a complete restructuring of public policy and reconfiguration of the South African public sector into a unitary state with three distinct, but inter-related spheres of government: national government, nine provincial governments, and 257 municipalities in the local sphere. The emerging IGFR system was predicated on the parameters for expenditure assignment, revenue assignment, intergovernmental grants, and borrowing powers as set out in Chapter 13 of the Constitution.

Revenue-raising powers, in terms of the Constitution, remain highly centralized in the national government. The most significant and productive taxes, such as value added tax, personal income tax, and corporate income tax, are thus reserved for the national government, and are collected by a single entity, the South African Revenue Service (SARS).

Provincial governments, by contrast, have few of their own revenue sources. Own revenue sources refer to revenue instrument for which provincial governments have substantial control (in the sense that they can set the revenue base and/or the rate in their own province). Section 228 of the Constitution assigns province revenue sources which are not very buoyant or high yielding, namely "taxes, levies, and duties other than income tax, value added tax, general sales tax, rates on property, and customs duties". Provincial owned revenue sources include gambling taxes, hospital patient fees, and motor vehicle license fees. Income raised within provinces as "own revenue" (mainly from car licenses and hospital fees) amounts to less than 5% of the overall provincial budget (South Africa. National Treasury, 2023). The primary administrative rationale for this centralization is that tax collection is easier to administer at a national level due to economies of scale and the mobility of tax bases across provinces, and that the duplication associated with a more decentralized system is avoided.

Significant expenditure responsibilities have, however, been decentralized to the provincial governments, notably basic education, health, agriculture, and provincial roads. Consequently, there is a substantial vertical fiscal imbalance between the significant expenditure mandates of provincial governments and their restricted own fiscal resources. Provincial governments are accordingly highly dependent on intergovernmental fiscal transfers from the national government (Ajam, 2019).

The functional competences devolved to provincial governments may be concurrent (shared responsibility of national, provincial, and/or local governments) as outlined in Schedule 4 of the Constitution, or exclusive (sole responsibility and discretion of the provincial, municipal, or national government) as outlined in Schedule 5 of the Constitution. Under concurrent functions, such as primary and secondary education and health services, the national government sets policy, but implementation is largely the responsibility of the provinces. The separation of policy, national financing, and implementation (at provincial level) has sometimes resulted in unfunded or partially funded mandates, together with complex coordination problems. Unfunded or partially funded mandates occur when functions are devolved to provinces or municipalities without commensurate funding sources. All residual functions that are not specifically enumerated in Schedules 4 and 5 remain exclusively at the national level (for example, matters relating to foreign affairs, defense, trade

policy). Local government's concurrent and exclusive competences are detailed in part B of Schedules 4 and 5.

Provincial legislation with regard to the exclusive Schedule 5 functions takes precedence over national legislation, except when national legislation is necessary to establish national norms and standards, to maintain economic unity, to protect the common market in respect of the mobility of goods, services, capital, and labor, or to promote economic activities across provincial borders (section 146 of the Constitution). Thus, provinces do not only have a limited degree of fiscal and political autonomy, but this is further weighed against the broader national interest.

Given that provinces have significant expenditure responsibilities and comparatively small own revenues, section 214(1a) of the Constitution confers on provincial governments the right to an "equitable share" of nationally collected revenue. In addition to the provincial Equitable Share grant, which is unconditional, section 214(1c) also permits national government to extend to a provincial government, from its national share of revenue, conditional allocations which are earmarked for specific purposes.

The process by which tax revenue is collected nationally by the South African Revenue Service, pooled together with the proceeds of debt finance and subsequently divided among national and subnational governments, is referred to as revenue sharing. The process is formalized annually in an annual Division of Revenue Act (DoRA) tabled in Parliament. The Fiscal and Financial Commission (FFC), an independent body established in terms of section 198 of the interim Constitution and section 120 of the final 1996 Constitution, has the constitutional mandate to make recommendations to Parliament on equitable allocations to national, provincial, and local government from nationally collected revenues.

The Constitution lists a number of factors in sections 214(2) (a) to (j) to be taken into account in determining a province's Equitable Share allocation. These factors include the need to ensure that they are able to deliver basic services and perform their mandates, economic disparities within and across provinces, differing fiscal capacities and efficiency, and the developmental needs of provinces. Section 220 of the Constitution formally establishes the FFC to give impartial advice to Parliament on the equitable sharing of revenue. The Constitution thus acknowledges that

the revenue-sharing process has both administrative and political dimensions. The technical administrative process requires that the national government annually consults provincial governments, organized local government (the South African Local Government Association), and the FFC. The political process of revenue-sharing culminates annually in the DoRA passed by the National Council of Provinces and the National Assembly of Parliament, together with the national budget.

The unconditional nature of the Equitable Share intergovernmental grant means that the Equitable share is in effect a substitute for provincial governments' own revenue and thereby strengthens the fiscal discretion and integrity of the provincial government as a sphere of government (rather than merely administrative extensions of the national government). The national government cannot instruct provincial governments directly on how to spend their Equitable Share intergovernmental grant, but provincial governments are obliged to adhere to any minimum norms and national standards of public service delivery set by the national government. Furthermore, the conditions of service of provincial civil servants (such as salaries and benefits) are negotiated centrally via collective bargaining in the national sphere. Given that provincial government services such as Health and Basic Education are very labor-intensive, and that personnel budgets constitute the biggest part of provincial government expenditure, in practice, provincial governments have limited fiscal authority.

Provincial governments also have limited borrowing powers, conferred by section 230 of the Constitution. Section 230 imposes the fiscal rule that provincial operating budgets be balanced, permitting debt financing for bridging purposes only within a particular financial year. This effectively rules out borrowing to fund current expenditure in operating budgets. However, provincial capital borrowing is permitted. Under the interim Constitution, the Borrowing Powers of Provincial Government Act, Act 48 of 1996 (South Africa, 1996) was promulgated, which established a Loan Coordinating Committee with identical membership to the Budget Council, to coordinate provincial borrowing. No regulations were ever issued in terms of this Act, and the Budget Council agreed in 1997 that there would be no borrowing until a framework compliant with the final Constitution was finalized (National Treasury, 2001).

The Budget Review in 2001 announced: "Provincial borrowing powers for capital projects will also be phased in over the Medium Term Expenditure Framework. The Budget Council is expected to approve a framework

later this year" (National Treasury, 2001). It was expected that when the 1996 Constitution came into force, new legislation for provincial borrowing powers would be enacted. This had not happened by 2022 and provincial borrowing to date has been limited, which is probably prudent, given the negligible provincial own revenues and poor expenditure controls and financial management practice in many provinces. However, the Gauteng Provincial government did access loan finance of R1 billion (one billion rands) in 2011 to contribute to the construction of the Gautrain light rail infrastructure project (Gauteng Department of Finance, 2011).

Municipalities are endowed with more substantial fiscal capacity, being entitled by the Constitution to impose rates on property and surcharges on fees for services provided by or on behalf of the municipality (for example, for electricity or sewerage). Municipalities are also allowed to borrow, subject to similar restrictions as the provincial government.

In order to balance provincial and national priorities, provincial governments are given a degree of discretion in their delivery of concurrent functions within the parameters set by the national legislative frameworks, provided they conform with minimum national norms and standards of service delivery, and do not conflict with the national economic unity, national security, or minimum national standards, in terms of sections 42(2) and 100 of the Constitution. As observed earlier, the national government in general formulates policies which are then implemented by provinces and municipalities.

This concurrent, overlapping nature of the functional assignment of competences of provinces (and municipalities) necessitates effective intergovernmental relations. Accordingly, section 41 of Constitution places great emphasis on "cooperative government" as the fundamental norm to underpin intergovernmental relations: "[…] organs of state have the obligation to respect the constitutional status, institutions, powers and functions of government in the other spheres" and to "co-operate with one another in mutual trust and good faith" by:

i. fostering friendly relations;
ii. assisting and supporting one another;
iii. informing one another of, and consulting one another on, matters of common interest;
iv. coordinating their actions and legislation with one another;
v. adhering to agreed procedures; and

vi. avoiding legal proceedings against one another.

The Intergovernmental Relations Framework Act of 2005 (South Africa, 1996) outlines procedures to deal with intergovernmental disputes, with the aim to resolve potential conflicts and pre-empt litigation between spheres of government.

In terms of the Constitution, the national government plays an important role in monitoring the compliance of provincial governments with national minimum norms and standards, supporting provincial governments in the discharge of their mandates and intervention (in terms of section 100 of the Constitution), in the event that a provincial government is unable or unwilling to fulfill its executive obligations. This should be read in with section 125(3) of the Constitution, which requires that the national government "by legislative and other measures must assist provinces to develop the administrative capacity required for the effective exercise of their powers and performance of their functions".

For the national government to play its supervisory and support role effectively, it needs to ensure that clear, well-specified service norms, and standards are in place, that the relevant national sector departments have adequate monitoring and evaluation systems to assess compliance with national norms, as well as the capability to build capacity in subnational governments as required.

National norms and standards are typically enshrined in sector legislation for concurrent functions and regulations, issued in terms of the relevant pieces of legislation, for example, the South African Schools Act of 1996 (Act 84 of 1996), and the National Health Act of 2003 (Act 61 of 2003). These norms and standards are therefore not unilaterally introduced by the national government but are the product of consultation with provincial governments in intergovernmental forums, such as the MinMecs,[3] and in the National Council of Provinces legislative process. The absence or poor specification of national norms and standards undermines national supervision and support effectiveness, since effective monitoring and evaluation depend on those pre-defined norms and standards. Where norms and standards do exist, sometimes

[3] MinMecs refer to intergovernmental relations forums consisting of the national Minister of a particular and her nine provincial counterparts, the Members of the Executive Council (MECs) for concurrent functions such as basic education, health, etc.

there is non-compliance due to provincial governments' lack of funds or implementation capacity.

A hotly contested case in point is national school infrastructure norms, which became the subject of a court case in 2012 between an NGO, Equal Education, and the national Minister of Basic Education, Ms. Angie Motshekga, (Equal Education, 2012). On March 2, 2012, Equal Education filed an affidavit in the Eastern Cape's Bhisho High Court against Motshekga, and twelve other respondents, including nine provincial Ministers of Education, the Minister of Finance, and the Eastern Cape Provincial Government. The NGO sought emergency relief for two schools, Mwezeni Senior Primary School and Mkanzini Junior Secondary School in the Eastern Cape, where classes had to be taught in mud classrooms or corrugated iron shacks. They also sought an order that would instruct Motshekga to prescribe minimum norms and standards for school infrastructure (Equal Education, 2012). This was granted by the Bhisho High Court on July 11, 2013. On November 29, 2013, the Minister of Basic Education approved infrastructure norms and standards for the construction of classrooms, access to electricity, water, sanitation, libraries, perimeter security, school safety, sport and facilities, electronic connectivity. The regulations stipulated three, seven, ten, and seventeen year targets, which the provincial Education departments must meet in order to eradicate school infrastructure backlogs by 2030. According to the Provincial Norms and Standards Reports for seven of the nine provinces available on the national Department of Basic Education website, in 2021, provinces such as Limpopo and Mpumalanga still fell short of the 2016 target for ensuring that schools have adequate access to water, electricity, and toilets. Other provinces like the Northern Cape, Western Cape, and Gauteng have achieved these standards but—due to severe budget constraints—still fall short of the minimum standards in respect of schools constructed from inappropriate materials such as asbestos, metal, or wood, overcrowding due to classroom and new school backlogs, poor perimeter security, and no internet access (South Africa. Department of Basic Education, 2022). Huge educational inequalities continue to exist across public sector schools within and among provinces, and between the public sector and the private education sector which, conversely, largely meets first world educational standards.

Since their inception, there have been substantial variations in the governance and implementation capacity across provincial governments and significant differences in service delivery outcomes. Provinces like

the Eastern Cape and Limpopo have struggled with severe capacity constraints, whereas the urbanized, wealthier provinces like Western Cape and Gauteng have exhibited better delivery capacity (Murray & Simeon, 2010). Provincial discretion has been limited, and some provincial governments have been characterized by a pervasive lack of accountability and high levels of maladministration, fraud, and corruption (De Villiers, 2007; Hendriks, 2017; Lodge, 2005; Naidoo, 2009). Since the Zuma administration in 2009, all three spheres of government in South Africa have been subject to widespread corruption and state capture (Swilling et al., 2017). As a result, the regulatory environment—for example, in relation to supply chain management in terms of the Public Finance Management Act 1 of 1999 and its regulations—has become so complex that it has stifled innovation without doing much to deter financial misconduct (Ajam, 2016). Provincial governments are more accountable "upward" to national government than "downward" to their provincial electorates (Murray & Simeon, 2010).

Yet there has been some degree of innovation within the provincial government sphere. An example of provincial innovation includes the provision of antiretroviral drugs for people living with HIV/AIDs, despite the AIDS denialism at national government level during the tenure of former President Thabo Mbeki between 1999 and 2008. Doctor Fareed Abdullah headed the HIV/AIDS program in the Western Cape Department of Health which had pioneered the roll-out of AZT to pregnant women to prevent mother-to-child transmission of HIV, when the national Health Minister, Nkosazana Dlamini-Zuma, and President Mbeki refused to do so (Nattrass, 2008). He acknowledges the role of provincial autonomy—however limited it may be—in achieving that outcome:

> And I was faced with a simple, but difficult dilemma—follow the party line or do the right thing as a doctor. It took me three seconds to decide what to do. I had the authority at that time—public servants had authority—the authority to do things, to order a new drug, to start a new program. So we continued with the treatment program and national couldn't stop it because we really understood the powers that provinces have. Constitutionally, a province can set their own policy and we jealously guarded the right of the province. (Huisman, 2022)

Similarly, the roll-out of Nevirapine—an antiretroviral drug—to prevent mother-to-child transmission had been delayed by the national government, confined only to two pilot sites per province. In July 2002, the Constitutional Court ruled in Minister of Health v. Treatment Action Campaign and Others[4] that Nevirapine be provided to all pregnant women who needed it. A key consideration in the Court's decision was that the Western Cape, Gauteng, and KwaZulu-Natal provincial governments had already begun supplying Nevirapine. In April 2004, the national government changed its policy and extended access to anti-retroviral medications to all South Africans living with HIV/AIDS (McNeil, n.d.).

Provincial Diversity and the Equitable Share Grant

As noted earlier, provincial governments are largely reliant on the "Equitable Share" intergovernmental grant. From total tax revenue and borrowings, debt service costs and a contingency reserve are top sliced, as reflected in Table 1. The balance (R1 663.5 billion in 2022–2023) is then split among the three spheres of government in the "vertical division of revenue" which is a political decision taken by Cabinet.[5] In the 2022–2023 fiscal year, 49.7% of this amount went to national government, 41.2% (R682.5 billion) to the provincial governments collectively, and 9,1% to local government, which has significant own revenue sources such as property rates and tariffs for water and electricity sales.

Table 1 illustrates that intergovernmental allocations to provincial governments consist of the unconditional Provincial Equitable Share (PES) grant (amounting to R560.8 billion in 2022–2023), and conditional grants which are transferred by national government departments to provincial governments. These are earmarked for specific national government objectives delineated in a framework approved for each grant by the national Parliament as part of the annual Division of Revenue

[4] (CCT8/02) [2002] ZACC 15; 2002 (5) SA 721 (CC); 2002 (10) BCLR 1033 (CC) (July 5, 2002).

[5] One U.S. dollar was equal to R17.01 South African rands on January 3rd, 2023. One billion rands R1,000,000 amounts roughly to $58,791.90. One Euro was equal to R17.95 South African rands. One billion South African rands R1,000,000 amounts to €55,699.40.

Table 1 Vertical division of nationally raised revenue in South Africa in billions of rands, 2019/2020 to 2024/2025

R billion	*2019/20*	*2020/21*	*2021/22*	*2022/23*	*2023/24*	*2024/25*	*2025/26*
		Outcome		**Revised estimate**	**Medium-term estimates**		
Total revenue and borrowing	**1,691.0**	**1,789.0**	**1,887.5**	**2,004.0**	**2034.6**	**2137.9**	**2266.5**
Less top slice of which							
Debt service costs	204.8	232.6	268.1	307.2	340.5	362.8	397.1
Contingency reserve	–	–	–	–	5.0	5.0	5.0
Unallocated reserve	–	–	–	–	–	35.7	44.5
Resources to be divided	**1,486.2**	**1,556.4**	**1,619.4**	**1,696.8**	**1,689.1**	**1,734.4**	**1,819.9**
National departments of which:	**749.8**	**790.5**	**823.0**	**854.4**	**828.6**	**835.7**	**877.9**
Indirect transfers to provinces	*2.9*	*2.9*	*3.7*	*4.6*	*4.2*	*4.4*	*4.8*
Indirect transfers to local government	*5.6*	*4.1*	*5.7*	*7.2*	*8.5*	*8.9*	*9.3*
Provinces	**613.4**	**628.8**	**660.8**	**694.6**	**695.1**	**720.5**	**754.7**
Equitable share	505.6	520.7	544.8	570.9	567.5	587.5	614.3
Conditional grants	107.9	108.1	116.0	123.7	127.5	133.0	140.4
Local government	**123.0**	**137.1**	**135.6**	**147.8**	**164.0**	**174.4**	**183.3**
Equitable share	65.6	83.1	76.2	83.7	96.5	103.8	109.4
Conditional grants	44.2	40.0	44.8	48.7	52.0	54.5	57.1
General fuel levy sharing with metros	13.2	14.0	14.6	15.3	15.4	16.1	16.8

(continued)

Table 1 (continued)

R billion	*2019/20*	*2020/21*	*2021/22*	*2022/23*	*2023/24*	*2024/25*	*2025/26*
Provisional allocation not assigned to votes[1]	–	–	–	–	2	4	4
Percentage shares							
National departments	*50.4%*	*50.8%*	*50.8%*	*50.4%*	*49.1%*	*48.3%*	*48.3%*
Provinces	*41.3%*	*40.4%*	*40.8%*	*40.9%*	*41.2%*	*41.6%*	*41.6%*
Local government	*8.3%*	*8.8%*	*8.4%*	*8.7%*	*9.7%*	*10.1%*	*10.1%*

Note [1] Infrastructure fund and other provisional allocations. National Treasury, 2023

Act. Conditional grants include the education infrastructure grant, the national school nutrition grant, the district health program grant, the national tertiary services grant, and the provincial roads maintenance grant. There are also small indirect transfers to provincial governments which are in-kind grants, for instance where a national government department builds school infrastructure on behalf of a provincial government or expands optometry and audiology services to schools.

The Provincial Equitable Share (PES) grant is allocated to each of the nine provinces by means of a largely demographically driven formula, the structure and underlying variables of which are transparently published each year by the South African National Treasury as part of its annual Budget Review document. As outlined in Table 2, the PES formula has generated the largest allocation of 21.4% of the R560.8 billion total provincial revenue pool to Gauteng Province in 2022–2023 (R120 billion), and the smallest allocation of 2.7% of the provincial revenue pool (R14.9 billion) to the Northern Cape Province. The PES formula used in the 2019–2020 division of revenue consisted of six components, and some of the components are based on subcomponents.

1. **An education component** (48%), based on the size of the school age population (ages five to seventeen) and the number of learners (Grade R–12) actually enrolled in public ordinary schools.

Table 2 Total intergovernmental transfers to South African provincial governments, 2023/2024

R billion	*Equitable share*	*% of total*	*Conditional grants*	*% of total*	*Total transfers*	*% of total*
Eastern Cape	73.3	12.9%	14.6	11.5%	87.9	12.7%
Free State	31.4	5.5%	9.3	7.3%	40.7	5.8%
Gauteng	120.8	21.3%	27.4	21.5%	148.2	21.3%
KwaZulu-Natal	115.9	20.4%	26.3	20.6%	142.3	20.5%
Limpopo	65.3	11.5%	11.3	8.9%	76.7	11.0%
Mpumalanga	46.7	8.2%	9.7	7.6%	56.4	8.1%
Northern Cape	15.2	2.7%	5.1	4.0%	20.2	2.9%
North West	40.1	7.1%	9.1	7.1%	49.2	7.1%
Western Cape	58.9	10.4%	14.5	11.3%	73.4	10.6%
Unallocated			0.1	0.1%	0.1	0.02%
Total	**567.5**		**127.5**		**695.1**	

Note National Treasury

2. **A health component** (27%) based on the health risk profile of each province and its health system case load. For example, women of child-bearing age and older persons consume more health services than the population average; therefore, a province with a greater share of women of child-bearing age and of older persons would have a greater health risk profile, which is taken into account in the formula.
3. **A basic component** (16%) derived from each province's share of the national population.
4. **An institutional component** (5%) divided equally among the provinces, which recognizes that some costs of running a provincial government are not related to the size of a province's population or factors included in other formula components.
5. **A poverty component** (3%) based on the province's share of poor households (in other words, people falling in the lowest 40% of household incomes in Statistic South Africa's 2010–2011 Income and Expenditure Survey), supporting the redistributive thrust of the formula.
6. **An economic output component** (1%) based on the Gross Domestic Product by Region (GDP-R) data published by Statistics

South Africa which measures the gross domestic product produced in each province (South Africa. National Treasury, 2023).

The variables on which the PES formula is based reflect the marked differences in the spatial distribution of economic activity and poverty across the nine South African provinces, with population size broadly proxying for the demand for public services provided by provincial governments. The education component is a weighted average of Statistics South Africa's 2021 mid-year population estimates of the school age population in each province (50% weight) and school enrolment data from the national Department of Basic Education's Learner Unit Record Information and Tracking System (LURITS) (weighted 50%). KwaZulu-Natal Province, for example, has the highest school aged population in 2021 (3.033 million learners) but a school enrolment of only 2.891 million learners which suggests that some learners are not attending school or have migrated to other provinces. By contrast, Limpopo Province has a school in enrolment of 1.798 million learners which exceeds the Statistics South Africa estimate of 1.703 million children between the ages of 5 and 17 years (South Africa. National Treasury, 2023).

The variables in the health component of the PES formula attempt to capture the material differences in the health care needs and demands across provinces. As noted earlier, the health component of the PES comprises a health care system case load subcomponent (weighted 25%) and a risk adjusted subcomponent derived from an estimate of each province's proportion of the population without medical insurance and hence reliant on public health services, based on the 2019 General Household Survey (weighted 75%). The health care system case load output subcomponent is based on two variables: each province's share of the average number of visits to primary health care clinics in 2019–2020 and 2020–2021 drawn from the District Health Information System, and the average of each province's share of total patient-day equivalents at public hospitals in 2018–2019 and 2019–2020. In the risk adjusted component, a risk adjustment index is applied to the percentage of each province's population not covered by medical insurance. The risk adjusted index itself consists of a weighted average of five variables: age and sex, total fertility rate (to capture the additional costs of health services to pregnant women), premature mortality (to proxy for a higher burden of disease), sparsity (to capture the higher per capita costs of delivery in regions which

are remote or with low population density), and a multiple deprivation index (based on variables such as highest education levels, the state of the living environment, and poverty based on the ownership of assets or household goods). These capture the vast differences in the social determinants of health across provinces (South Africa. National Treasury, 2023).

Recentralization in the Aftermath of the 1996 Constitution

The future of provincial governments has been shrouded in a substantial degree of prolonged policy uncertainty. In 2007, a policy process to review the provincial and local government system was initiated by the then Department of Provincial and Local Government (currently known as the Department of Local Government and Traditional Affairs), which was to culminate in a White Paper on Provinces and a revision of the Local Government White Paper (South Africa. Department of Provincial and Local Government, 2007). Fifteen years later, there has still been no resolution to this policy process, exacerbating the policy vacuum.

While the future of provincial governments as a distinct and autonomous sphere of government remains unresolved, several individual sector-oriented decisions—in relation to social development for instance—have been taken over time by the national government de facto attenuating the role of provincial governments. Presidential Proclamation R7 of 1996 had, in terms of the 1993 interim Constitution, assigned the administration of social assistance, including the payment of social grants, to provincial governments. On September 6, 2004, the Constitutional Court in Mashavha v. President of the Republic of South Africa and Others[6] ruled that Proclamation R7 was invalid, and that social assistance was not a matter which could be regulated effectively by provincial legislation since minimum norms and standards across the country were required. This judgment paved the way for the promulgation of the South African Social Security Agency Act of 2004 (South Africa, 2004) which centralized the social security function and established the South African Social Security Agency to manage the payment of social grants such as

[6] (CCT 67/03) [2004] ZACC 6; 2005 (2) SA 476 (CC); 2004 (12) BCLR 1243 (CC) (September 6, 2004).

the old age pension, child support grant, foster care grants, and disability grants.

In 2009, a decision was made that Further Education and Training (FET) Colleges (currently known as Training and Vocational Education Colleges), which had formerly been administered by the nine provincial education departments, be made a national competence. The FET Colleges Amendment Act of 2012 moved this function from the Members of the Executive Council for Education of the provinces (i.e., provincial Ministers) and the provincial Heads of Education Departments to the national Minister of Higher Education and Training and the Director-General of that Department (South Africa, 2012). After complex negotiations with the nine provincial education departments, the National Treasury, and the nine provincial treasuries, the funds allocated to FET colleges were transferred to the national Department of Higher Education and Training. The transfer of the function took effect on March 31, 2015.

In the 2015–2016 fiscal year, the port health function was also moved from the nine provincial health departments to the national Department of Health (South Africa. National Treasury, 2015). R380.4 million was also shifted from the PES grant to the national Department of Health. The Financial and Fiscal Commission was consulted both in respect of the FET colleges and port health function shifts and both the basic education and health sector MinMecs and the Budget Council approved. The Budget Council is an intergovernmental forum comprising the national Minister of Finance and the provincial counterparts, plus the nine Members of the Executive Council (MECs) for Finance.

An unsuccessful attempt to re-centralize relates to the provincial roads function. The Administrative Adjudication of Road Traffic Offices (AARTO) Amendment Act of 2019 aimed to create a single national traffic system of road management, shifting from the judicial enforcement of traffic laws through criminal law to a compulsory system of traffic law administrative enforcement through administrative tribunals, administrative fines, and a demerit points system. This would remove the enforcement of all road and traffic laws from provincial and local governments to the national government. In Organization Undoing Tax Abuse v Minister of Transport and Others,[7] the Gauteng High Court

[7] 32,097/2020) [2022] ZAGPPHC 1; 2022 (2) SA 566 (GP) (January 13, 2022).

found on January 13, 2022 that AARTO and AARTO amendment Acts were unconstitutional since they "unlawfully intrude upon the exclusive executive and legislative competence of the local and provincial governments, respectively" [para 45, p. 20]. This demonstrates that the South African courts have, in some cases, tried to preserve the autonomy of provincial governments and municipalities, albeit limited, in exercising their powers and functions and prevent unwarranted intrusion from the national sphere. It remains to be seen whether the national government will appeal this finding.

The National Health Insurance (NHI) Bill of 2019 is still currently being deliberated in Parliament (South Africa, 2019). This aims to establish an NHI Fund which will pool funds from general taxes complemented by mandatory payroll and surcharge taxes into a single fund which is publicly financed and publicly managed. The objective of the NHI is to maximize income and risk cross-subsidization, increase population coverage, and provide health services free at the point of care. The NHI Fund would be the single purchaser of personal health services at the relevant level of care for the South African population through various contracting arrangements from accredited public and private facilities, which would provide the health services, the so-called "purchaser-provider split". Implementing the NHI and the purchaser-provider split would require a substantial re-configuration of the public health system, inter alia, in relation to primary health care, district hospital services (level 1 services), regional hospital (secondary services), tertiary and specialized hospital services, and emergency medical services. This would have far-reaching consequences for provincial health departments.

For example, section 32(2) of the Bill makes provision for the national Minister of Health to amend the National Health Act of 2003 "for the purposes of centralizing the funding of health care services". Section 32(a) permits the national Minister of Health to re-delegate to the provincial health departments the provider functions as "managing agents, for the purposes of the provision of health care services" after the purchaser-provider split, for which the NHI fund will contract with the provincial governments. The Minister of Health may also designate provincial tertiary and regional hospitals as "autonomous legal entities accountable to the national Minister through regulation".

Section 32(3) requires that provincial health department functions be amended to comply with the provisions of the NHI Bill and its transitional arrangements outlined in section 57 of the Bill, "without

derogating from the Constitution or any other law". Section 49(2)(a)(i) of the NHI Bill envisages the "shifting of funds from the provincial equitable share and conditional grants into the (NHI) Fund".

The constitutionality of the NHI Bill implications for provincial governments is likely to be contentious in the Western Cape Province, which is governed by an opposition party, the Democratic Alliance party. The principles of co-operative government and intergovernmental relations enshrined in section 41 of the South African Constitution enjoin the three spheres of government "not to assume any power or function except those conferred on them in terms of the Constitution", and to "exercise their powers and perform their functions in a manner that does not encroach on the geographical, functional, or institutional integrity of government in another sphere".

The Constitutional Court will have to judge whether the reduction in the powers of provincial governments inherent in the NHI Bill is warranted by its potential to promote universal health service coverage and the progressive realization of the constitutional right to health. What is clear is that the fiscal and policy discretion of provincial governments will be greatly reduced in the health domain, tilting the scales more and more toward imposing uniformity, rather than accommodating provincial diversity and innovation.

Devolution and Local Government in South Africa

Although the prime focus of this article is on the provincial governments, it is interesting to reflect on the experience of the devolution of functions to the local government sphere, in particular to large metropolitan city governments. Devolution of functions to local government, despite its strong constitutional framework and the ANC's notional support for strong local government, has in many instances been bedeviled by prolonged delays, uncertainty, and a lack of urgency on the part of the national government.

The national government has dragged its feet in delegating functional areas which are crucial to urban governance of cities, such as housing and public transport. This legislation delegation process has been characterized as "slow and incomplete", often unaccompanied by the devolution of adequate resources, and has been "blamed for diluting, even stunting,

urban autonomy in South Africa" (South African Cities Network, 2022: 77).

One of the reasons for the reluctance to devolve function to the local sphere is that a large swathe of municipalities are dysfunctional. However, it could be argued that this calls for a more nuanced and differentiated approach to devolution rather than "the tendency to recentralize power as a cure for municipal malfunction" (South African Cities Network, 2022: 95).

Section 11(2) of the National Land Transport Act of 2009 (NLTA) empowers the national Minister of Transport to assign any of the transport functions set out in section 11(1)(a) of the NLTA to a municipality to achieve the objectives of the Constitution and the 2009 Act itself, subject to sections 99 and 156(4) of the Constitution and sections 9 and 10 of the Municipal Systems Act. A Cabinet member, in terms of section 99 of the Constitution, has the discretion to assign, by agreement, any executive power or function that is to be exercised or performed in terms of an Act of Parliament to a municipality. Section 156(4) of the Constitution obliges a Minister to assign to a municipality the administration of a Schedule 4A function that necessarily relates to local government if the identified municipality has the capacity to administer the function and the function would most effectively be administered locally. Schedule 4A of the Constitution lists functional areas of concurrent national and provincial legislative competence, including public transport. Section 11(4) of the NLTA also permits a municipality to request the Minister of Transport to assign to it a national function in the NLTA if that municipality has an acceptable integrated transport plan.

In March 2022, Cabinet approved the White Paper on National Rail Policy (WPNRP) which acknowledges that some progress has been made toward the devolution of urban rail (South Africa. Department of Transport, 2022). The cities of eThekwini and Cape Town, for instance, have already conducted feasibility studies on the devolution of passenger rail and have established transport authorities to assume the management authority for urban rail, while the Passenger Rail Agency of South Africa (PRASA), a national government business enterprise with ownership control under the national Department of Transport, delivers the actual services. The WPNRP notes that this arrangement appears to be "work in progress" and that "their separate bus and rail system maps do not show intermodal interchanges with each other" (South Africa. Department of Transport, 2022, p. 84). Acknowledging that cities like Cape

Town, Ekurhuleni, eThekwini, Johannesburg, and Tshwane have "already demonstrated capacity to take on the general management of entities the size of the commuter railways in their jurisdictions", the WPNRP envisages the development and approval of a Devolution Strategy for Commuter Rail to guide the assignment of the commuter rail function to the municipal sphere of government, aligned with the Integrated Urban Development Framework as part of the next National Land Transport Strategic Framework to take effect in 2023 (South Africa. Department of Transport, 2022, p. 84). A Public Transport Funding Model would also be developed to sustainably finance passenger and commuter rail.

In May 2022, the Western Cape Minister of Transport and Public Works, welcomed the WPNRP's affirmation of the imperative for devolution of public transport functions, but—in view of the current "crisis state of the rail system"—expressed concern that the three year timeframe for the development of the Devolution Strategy for Commuter Rail would further delay the process, and called on the national Minister to expedite its finalization to allow devolution to proceed (Western Cape. Department of Transport & Public Works, 2022, np). On December 13, 2022, the Mayor of Cape Town, Geordin Hill-Lewis, released a media statement noting that PRASA now only transports 3% of the passengers it was able to transport a decade ago and asserted that "the national government has allowed a national asset to fall into ruin and has no plan to repair it [...] there is no hope of the national government or its state entities turning around passenger rail and they need to start planning for the handover process without delay" (South Africa. City of Cape Town, 2022, np). He also announced that he had written to the national Minister of Transport, Mr. Fikile Mbalula, on May 23, 2022 to request that an urgent working group be convened to run in parallel with the feasibility study (South Africa. City of Cape Town, 2022). It was reported that by December 20, 2022, he had not received a response from the Minister, despite a follow-up letter on December 1, 2022 (Stent, 2022). #UniteBehind, a commuter activist group, has announced its intention to initiate litigation in the new year to compel the national Minister of Transport to hasten the local control of commuter rail to municipalities or provincial governments, if concrete progress was not made (Stent, 2022).

Similar to the Treatment Action Campaign case discussed earlier, there are instances where national government is also inhibiting innovation at the local government level. A case in point relates to the attempts of the City of Cape Town to reduce its reliance on the national power utility,

ESKOM, which has imposed rolling blackouts (euphemistically dubbed "loadshedding") since 2007, by purchasing renewable energy from an independent power producer (IPP). The City applied for a determination from the national Minister of Energy in terms of section 34 of the Electricity Regulation Act of 2006 to approve the purchase of solar and wind power from the IPP in 2015 but the Minister failed to respond for two years and then announced that applications were on hold for an indefinite period. In City of Cape Town v. National Energy Regulator of South Africa and Minister of Energy,[8] the City argued that it had a constitutional right to procure energy in the manner it deemed best, and requested the court issue an order that the Minister's consent was not required for an IPP to establish a new power plant to supply electricity to the City. Alternatively, it requested the court to declare that section 34 of the Electricity Regulation Act was unconstitutional because it impermissibly encroaches on the constitutional powers of local government. The Gauteng high Court postponed the application indefinitely and referred the matter to both of the parties since it held that the issue was an intergovernmental dispute that resolution should have first been attempted within the mechanisms of the Intergovernmental Relations Framework Act of 2005 before any of the parties could approach a court of law. Since the court did not pronounce the constitutionality of section 34 of the Electricity Regulation Act, the constitutionality of this provision may in future still be challenged.

Hollowing Out of Provincial Governments: Death by a Thousand Cuts?

It is clear that political, economic, linguistic, and geographic diversity has influenced the design and ongoing implementation of the IGFR system in relation to the nine South African provincial governments. However, the analysis of the post-apartheid institutional trajectory of provincial governments in South Africa illustrated that the very centralist, top-down IGFR system has not accommodated provincial diversity and has stifled innovation by provincial governments.

The already limited provincial constitutional powers have been further attenuated over the last two decades by the relocation of functions

[8] (51,765/17) [2020] ZAGPPHC 800 (August 11, 2020).

(e.g., social security, training and vocational colleges to national government, housing and public transport to large metropolitan governments, the proposed National Health Insurance system which will centralize current provincial health functions). This is exacerbated by provincial governments' negligible own revenue sources and therefore their over-reliance on intergovernmental transfers such as the PES, centralized wage bargaining (which means that provincial governments have little control over their largest cost driver, introducing budgetary rigidities, given that escalation in the provincial wage bill has tended to outstrip increases in intergovernmental grants and crowded out other non-wage expenditures). The highly centralized application of intergovernmental relations in a uniform "one size fits all" manner has limited the scope for provincial experimentation and innovation. Finally, pervasive state capture and corruption have resulted in greater and more complex regulatory environments which limit innovation and create stark trade-offs between probity and performance.

The gradual erosion of provincial governments' powers appears to be more as a result of disparate sectoral decisions rather than a deliberate policy decision, by default rather than as a deliberate design in a form of "creeping normality". The term "creeping normality" refers to a situation where a major institutional shift, which would be objected to if it were introduced as a single step or over a short period, can become more easily accepted over time if implemented slowly and gradually. Abolishing the provincial governments as a conscious policy decision would trigger constitutional safeguards (such as the need for a two thirds majority vote in the national Parliament) and garner the opposition of provincial elites who benefit from the status quo. Incrementally denuding the provincial governments of their functions accomplishes much the same thing in a much less political visible way and with consequently less organized opposition. Murray and Simeon noted in 2009 that the reluctance of the ANC to accept a provincial system "means that the government has no clear vision of the role that provinces should play, there is no strong political commitment of leaders to develop the provincial system, and there is no mass support for provincial governments" (2009, p. 547). More than fifteen years later, very little has changed.

Whereas the eight provinces under ANC control seem to have little interest in preserving their constitutional integrity and autonomy, it is interesting that civil society organizations such as the Organization Undoing Tax Abuse (OUTA) have indicated their willingness to take

legal recourse to expedite the devolution of passenger rail functions to municipalities. The climate emergency might trigger similar civil society campaigns in future. It is also conceivable that civil society groups might have increased appetite for litigation either to halt the further centralization of provincial functions or to advocate for further devolution of concurrent functions from national to provincial governments.

There is a fairly large body of work analyzing reform options for the provincial governments (e.g., De Villiers, 2007; Greffrath, 2012; Moeti & Khalo, 2007; Simeon & Murray, 2009). Making major changes (such as abolition or reduction in the number of the provincial governments) however require constitutional amendment. Whether the ANC can muster a two thirds majority to pass such an amendment becomes increasingly less likely. In the 2021 local government elections, the ANC lost several large cities to opposition coalitions. In the forthcoming 2024 general elections, it is quite likely that the ANC may lose some of their current eight provinces to opposition parties or coalition governments. This may be reinforced by political dynamics related to electoral reform, political party funding, and the rise of coalition government, which may create demands for greater accommodation of provincial diversity and further decentralization of powers and functions to provincial governments, or at very least, arresting centripetal pressures.

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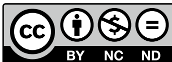

Fiscal Federalism, Intergovernmental Relations, and Conflict Resolution Mechanisms in Spain

Violeta Ruiz Almendral

Introduction: Diversities in the Spanish State of Autonomies

Spain is a diverse country from many different perspectives, for reasons rooted in history and geography(Aja, 2014; Arzoz, 2019). One traditional feature of the so-called "State of Autonomies" (*Estado de las autonomías*) is their asymmetric nature, which is both de facto—geography, climate, language, population, income—and de jure, rooted in the Constitution (Arzoz, 2019). Both types of asymmetries partly explain the role played by political agreements (Ruiz Almendral, 2023, Ruiz Almendral & Vaillancourt, 2013).

The process of decentralization in Spain is linked to democracy. As it has often been pointed out, there was a strong correlation between becoming a decentralized country and acquiring a democracy status as a country (Colino, 2018). From the outset, the very model of decentralization potentially allowed for a substantial level of asymmetry. Thus,

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the procedural framework established by the Spanish Constitution in articles 143 et seq. provided two special procedures for the formation of the autonomous communities, which differed in the speed of gaining authority (fast and slow lanes). Eventually, slow-laners were able to increase their authority and gain access to the maximum level, provided that they follow the process established in article 148.2 of the Constitution.

The original idea was that some provinces and regions, with past experience of self-government, should be given the opportunity to become fast-laners from the very beginning, while the rest would have to start by being slow-laners. This is according to the second transitional provision of the Constitution, which establishes fast access to autonomy for those regions which had approved self-government statutes in the past (beginning of the Twentieth Century). Initially, these were supposed to be Catalonia, the Basque Country, and Galicia. In the end, however, seven Communities became fast-laners, as Andalusia, Navarra, Valencia, and the Canary Islands had access to the higher level of autonomy from the outset. The other regions remained with a lower level of autonomy until the first decade of the current century, when they "caught up" with the higher level of authority. A second, more controversial, explanation for asymmetry lies in the loose recognition of the "historic rights" of some regions, enshrined in the first additional provision of the Spanish Constitution. This eventually resulted in the Basque Country and Navarra having a much greater level of tax authority.

From a strictly legal perspective, Spain is not a federal state, but it is common in the specialized literature to refer to "fiscal federalism" to assess the distribution of powers in matters of expenditure and revenue in Spain, adopting the Anglo-Saxon terminology of those who have mainly dealt with these issues (Castells, 1988; Oates, 1999, 2005).

The Devolution Process and Its Asymmetries

Spain's process to become the current State of Autonomies is unique in that it underwent a complicated process of fiscal decentralization in a relatively short time span. From a fully centralized country in 1978, it had already been divided into seventeen Autonomous Communities by 1982. At the same time, an arduous process of regime change (from Franco's 1939–1975 dictatorship to the 1978 democratic Constitution and the entry in the European Union in 1986), named the *Transición*

brought about substantial legislative reforms and paved the way toward a full democracy (Ruiz Almendral, 2023, Colino, 2013, 2018; Valdesalici, 2018).

At the same time, this also meant a substantial overhauling of the tax system. It is not an exaggeration to say that until the late 1970s, Spain did not have a tax system as such, at least not one that was generally implemented, or which followed the general structure of the tax systems of other OECD countries. The first modern personal income tax was established in the late seventies, with the first corporation income tax. The tax reform undertaken between 1978 and 1985 entailed a substantial increase of tax pressure. Tax revenues in fact quadrupled between 1975 and 1980 (OECD, 2021).

From a fiscal federalism perspective, the high vertical fiscal imbalance with which the Autonomous Communities started off in 1982 was partially resolved by transfers as well as mechanisms of tax sharing (known as "ceded taxes") (Castells, 1988; Herrero et al., 2010; Rodríguez Bereijo, 2015). It is commonplace to state that the vertical fiscal imbalance arises when one tier of government—usually the central government—has a greater power to raise revenues than it actually needs for the exercise of its assigned level of authority, while another one (a subnational unit) is in the opposite situation (Bird & Vaillancourt, 2006; Oates, 1977; Ruiz Almendral, 2023; Ruiz Almendral & Vaillancourt, 2013). Specifically, since 1997, the vertical fiscal imbalance has been addressed partly by sharing the personal income tax revenue, what in practice means that the Autonomous Communities perceive a percentage (currently 50%) of the revenue accrued in their territory. On top of that, the Communities may also establish the tax rates to be applicable in their territory, introduce new tax credits, or increase/decrease those established by the central government.

The Evolution of the Constitutional Framework in Terms of Tax and Finance Power Decentralization

The Spanish Constitution (sections 133 and 157) bestows taxation powers upon the 15 communities which conform to the so-called "common regime". The Constitution also recognizes two types of specific tax regimes: the so-called "foral regimes" (Basque Country and Navarra)

and the Canary Islands tax and fiscal regime (Ruiz Almendral, 2003, 2023).

The Basque and Navarra foral regimes are rooted in history, as is the case of many other institutions in Spain (i.e., civil laws and specific *fueros*). But the legal origin of these exceptions is not to be traced back to historical rights, but to the Spanish Constitution. As the Constitutional Court has repeatedly stated, all subnational financing regimes are evolving systems which must fit in the Spanish Constitution. In fact, the Constitution does not simply recognize all previous historic rights, but rather "what the Constitution guarantees is the very existence of a foral regime, but not each and every one of the rights that have historically made it up" (Constitutional Court ruling (STC) no. 76/1988, FJ 4). The same reasoning has been reiterated, among others, in STC 86/1988, FJ 5; and STC 214/1989, FJ 26. The Constitution does not exactly recognize the historical rights as they once were, but enables the general updating of these foral regimes and provides for them to be applied and developed "within the framework of the Constitution and the Statutes of Autonomy" (STC 208/2012, FJ 2).

In accordance with the recognition of autonomy, the Spanish Constitution (SC) also recognizes communities' "financial autonomy for the development and execution of their authority" (SC, 1978, art. 156). Apart from stating this principle of financial autonomy, the Constitution also enumerates the resources that could constitute the communities' revenue base. The list includes almost all types of possible existing revenue sources: i.e., ceded taxes; surtaxes on existing central government taxes; their own taxes; public debt; and transfers (SC, 1978, art. 157.1).

However, article 157.3 of the Constitution (1978) also allows the central government to approve a special "organic" law (*ley orgánica*) regulating both how the resources listed in section 157.1 will be distributed among the communities, and the limits on the exercise of their financial power on the resources (i.e., whether and to what extent they may create new taxes, etc.).

In practice, this has resulted in the central government having significant power to both limit and control the financial and tax autonomy of the Autonomous Communities. Currently, this organic law is the special law for the financing of the Autonomous Communities, Law 8/1980, *Ley Orgánica de Financiación de las Comunidades Autónomas* (LOFCA), which imposes strict limits on communities' capacity to create new taxes.

The most relevant limitation for tax powers is the prohibition of double taxation (articles 6.2 and 3), which prevents communities from establishing taxes similar to existing taxes created by the central government and the municipalities. Article 9 of the LOFCA adds specific limits related to the construction of the Spanish internal market, which are reminiscent of the European Union (EU) fundamental freedoms, as interpreted by the European Court of Justice (ECJ).[1] Specifically, article 9 c) of the LOFCA (1980) stipulates that taxes established by the Autonomous Communities

> may not constitute an obstacle to the free movement of persons, goods and capital services, nor effectively affect the establishment of residence of persons or the location of companies and capital within Spanish territory, […] nor entail burdens that may be transferred to other Communities. This situation forces a complex dialogue between courts in the interpretation to be given to limits that, at least in their wording, appear to be similar.

The original limitation of Autonomous Communities' common regime tax powers has an obvious explanation. When the Constitution (1978) and the LOFCA (1980) were approved, both the municipal and the central governments had already established taxes on most of the sources of revenues, which has left little tax room for communities.

Autonomous communities under the common regime have made use of the taxation power assumed in the Statutes of Autonomy and recognized by the LOFCA, but the LOFCA imposed prohibition of taxing taxable events previously taxed either by the State and or by the local entities has extensively limited, in practice, their available tax space. This also led to an increase in conflicts, which were traditionally resolved before the Constitutional Court, rather than by agreement.

At the same time, the exercise of regulatory powers through the creation of their own taxes has been uneven, with some innovative taxes (such as taxes on large commercial establishments, or the tax on sugary drinks), and others that have given rise to various problems (such as taxes on environmental installations, or on deposits in credit institutions). In all, tax revenues corresponding to the common regime autonomous communities barely account for 2% of total subnational government revenues,

[1] In the following pages, I follow the general conclusions and explanations that can be found, extensively, in this recent paper by Ruiz Almendral (2022a, 2022b), "*Tax Decentralization and Tax Reform in Spain in the EU context*."

but do constitute the vast majority of tax conflicts between the central government and the Autonomous Communities.

The lack of available “tax space” inspired the reforms undertaken in 1996, which entered into force in 1997, when there was a fundamental change in the financing system of the communities. Simply put, in 1997, some taxes traditionally under the central authority, and including the personal income tax, were transformed into shared taxes (ceded taxes or *impuestos cedidos*), substantially increasing the taxing powers of the communities. Subsequent reforms in 2002 and 2009 have further strengthened communities’ powers over these taxes.[2]

In principle, the goal of these reforms was to make communities more involved in the establishment of taxes and thus more directly accountable to their taxpayers for their expenditure. The reforms undertaken in 1997, 2001, and 2009 by allocating and increasing regulatory capacities over ceded taxes have indeed led to greater fiscal co-responsibility, at least in theory. Ceded taxes have substantially increased the Autonomous Communities’ tax autonomy. In a comparative perspective, few countries in the world have greater tax autonomy at the subnational level of government (Cuenca, 2022; Lago-Peñas, 2021; Herrero Alcalde & Tránchez Martín, 2011; Ruiz Almendral, 2023; Ruiz Almendral & Vaillancourt, 2013; Ruiz Almendral et al., 2018). However, the high decentralization of spending means that there is still a wide imbalance between the two sides of the budget and that common regime Autonomous Communities continue to depend, to a high degree, on transfers or territorialized shares in VAT and excise duties, over which they lack tax autonomy, although they are formally included in the tax revenue sharing mechanism.

The system of ceded taxes is currently in need of a substantial reform, as several issues have arisen over time. First, the original central government’s regulation of some ceded taxes, such as the inheritance and gift tax, net wealth tax and transfer tax, and stamp duty have become obsolete after decades of insufficient attention, in addition to deficiencies in

[2] The most recent reform is more than ten years old. It entered into force on January 1st, 2010. It is regulated in the Law 22/2009 (*Ley 22/2009, de 18 de diciembre, por la que se regula el sistema de financiación de las Comunidades Autónomas de régimen común y Ciudades con Estatuto de Autonomía y se modifican determinadas normas tributarias*). Details about the functioning of the system (Herrero Alcalde et al., 2010; Ruiz Almendral, 2012).

control and management. Furthermore, some Autonomous Communities have substantially lowered effective taxation on the first two, so that they are on the verge of disappearing (Cuenca, 2015).

Second, in the case of personal income tax, the very structure of the regional financing system and its shared nature implies a mismatch between the measures adopted by the Autonomous Communities and their perception by the public (López-Laborda et al., 2020), so that "irrespective of their individual believes on the topic, citizens living in more pro-devolution regions tend to attribute powers to the central government to a larger extent. Put it differently, they tend to sub-estimate the level of current decentralization" (Herrero Alcalde et al., 2018, p. 38).

Third, according to some commentators, the decentralization of property taxation may have generated simulated mobility of tax bases[3] and other negative fiscal externalities, while also posing significant problems from an EU law perspective.

Finally, Communities have also established different deductions and tax benefits in ceded taxes which may be in breach of European Union law, while (mostly) they do not have a significant revenue impact (Ruiz Almendral, 2022a, 2022b, 2023).

The ceded or shared-taxes system has been designed in a way that bestows the central government the power to coordinate and therefore, if necessary, curb or limit the exercise of taxation powers by the Autonomous Communities. From a constitutional perspective, the tool employed is a so-called framework law or *ley marco* (SC, 1978, art. 150.1). In practice, tax sharing (or ceded taxes) follows, as far as regulatory powers are concerned, a system of delegation of regulatory powers (SC, 1978, art. 150.1), which entails that the central authority retains ownership of all ceded taxes (see an explanation of this system in the following rulings: SSTC 161/2012, FJ 3; 19/2012, FJ 11; 25/2016, FJ 2; and 33/2016). This delegation method has different consequences, the main one being that the cession or sharing can be clawed back by the central government (STC 16/2003, FJ 11), and "the [central] authority may modify the scope and conditions of the cession of a tax, or even abolish it [the tax]" (STC 35/2012, FJ 9), albeit on the condition that an

[3] There is no unequivocal evidence of massive changes in domicile as a consequence or in response to the establishment of the Wealth Tax, although maneuvers aimed at its evasion seem to have increased, ultimately feigning a change of domicile that is therefore more apparent than real (Ruiz Almendral 2022a, 2022b; Ruiz-Huerta, 2022).

agreement is previously sought with the affected communities. Furthermore, failure to comply with the terms of the transfer will imply the unconstitutionality of the regional regulations, as this automatically leads to an invasion of the central government competence over these taxes, as the Court has repeatedly pointed out (see STC 21/2022, STC 186/2021, STC 161/2012, STC 197/2012, and STC 35/2012).

This model of tax sharing through a "ceded-taxes" system has allowed a great development of the Autonomous Communities' financial autonomy. However, at the same time, it poses challenges of coordination, bearing in mind that the traditional limits of the national tax system have evolved with the advancements of the integration into the European Union.

A very different system applies to the so-called foral regimes. For them, the functioning of the financial system is radically different to that of the common-system Autonomous Communities and is the result of bilateral negotiation resulting in a convention (Navarra) or an agreement (Basque Country). In a nutshell, under the *cupo* (Basque Country) and *quota* (Navarra) systems, the foral regions run all the risk themselves, and no revenue guarantee is provided by the central government.

Presumably, this status is still attractive for these communities, as they are richer than the Spanish average. Another feasible explanation is that as some claim the actual payment of the quantities (the cupo and quota) was never been properly calculated, the result being that these foral communities may actually be paying less for the same services than the rest of (common-system) communities (De La Fuente, 2022; Monasterio, 2009; Zabalza, 2012). At the same time, the lack of transparency makes it harder to fully analyze it. In a recent work, De La Fuente (2022) points out that

> there is not really, or at least it is not publicly known, a detailed methodology for calculating the quota and the cupo, but only a series of general principles and a one-page annex in which the final amounts of both contributions are fixed without much explanation. Consequently, the critical analysis of the foral model cannot be approached in general terms, as if there were a well-known methodology with technical and/or equity criteria. It necessarily becomes a more complex and risky exercise in which there is no choice but to start by proposing a methodology, which then has to be applied to real data to arrive at reference figures to be compared with the observed results of the model. Since there is certainly no single reasonable way of concretizing and applying the principles contained in the convention, the agreement and the Constitution, the numerical results

> of the present study must be considered as merely indicative. The most important thing is that this exercise forces to concretize, and therefore to put explicitly on the table, a whole series of issues that have to be addressed in order to arrive at concrete figures, and as such shows that many of these issues are not well covered or well solved either in the agreement and the convention, or in the rules and agreements that develop and concretize them. (p. 83)

Among other problematic issues described in De La Fuente's work, attention is drawn to the calculation of the resources needed to finance the competences not assumed by the *comunidades forales*. This would not be correct, and would lead to higher financing, among other factors. This was in fact one of the conclusions of the report for the reform of the autonomous financing system published in 2017 (Comisión de Expertos para la Revisión del Modelo de Financiación Autonómica, 2017).

Spanish Fiscal Federalism in the EU Context

It has become commonplace to state that the interdependence of states has accelerated in recent decades.[4] Spain is a globalized economy, as well as one of the most decentralized and richest countries in the world (Cuenca, 2022; Lago-Peñas et al., 2017; OECD, 2018). Since January 1986, it has also been a member of the European Union. These three dimensions—globalization, decentralization, and Europeanization—fundamentally shape the scope of taxation powers in Spain and must be borne in mind for all diagnoses on the Spanish tax system, and in discussions of reform, as was repeatedly pointed out in the recent report on tax reform (Ruiz-Huerta, 2022).

In practice, the plurality of sources and the variable distribution of authority between the European Union and the Member States, and between the latter and their own subnational entities, such as Autonomous Communities in Spain, gave rise to different assumptions and degree of interference of the limits envisaged by European Union law.

EU law does not simply provide a system of limits, but a new legal framework within which all tax figures, whether harmonized or not, will have to develop. In this context, it is necessary to determine the current

[4] The following paragraphs draw from my paper: Ruiz Almendral 2022b, pp. 37–76.

legal contours within which the tax systems of member states can develop. The EU law driven impact varies substantially depending on the type of tax and tax measure of concern. The EU legal framework itself has evolved to find its own system of rules, which largely depart from the accepted logic of international tax law, based on rules in force in the member states through double taxation treaties, whose bilateral nature is the most visible element of a different logical structure, with interpretative principles that are also different from those that inspire the model of construction of the European Union. This web of principles and rules translates into a polyhedric set of limits that impact the extent and the exercise of taxing power by member states (Ruiz Almendral, 2022a, 2022b, 2023).

However, the assertion that the taxing power of the Autonomous Communities is severely limited by EU law is premature. It is not primarily the EU legal framework, but above all the current context of (further) globalization, accelerated by technological change, that has a decisive impact on the national tax systems, designed for a world that in many respects no longer exists. This has been highlighted in different ways, by the recent efforts of the European Commission, and, above all, with the international tax avoidance maneuvers supported by changes in the way business is done. Problems, such as determining where value is created or generated in the case of new technology services or business models, or even what value should be assigned to data collection, have largely transformed the traditional foundations of taxation, as the OECD and G20's current work shows (Ruiz-Huerta, 2022; Schön, 2018).

From a purely internal perspective, the vertical distribution of tax and financial authority in terms of revenue and expenditure is a key element in any Constitution, and indeed a central part of the Spanish Constitution. The financial and economic constitution in a decentralized country incorporates rules on the distribution of "tax space" and on the coordination between the legislative actions of the different authorities. There is however no single model of decentralization, and if the differences between the U.S. and the Canadian financial constitutions on the distribution of taxation power are substantial, the same occurs in the federal or partially decentralized models within the European Union itself.

An economic union may of course seem intuitively contradictory, by definition, with the development of fiscal federalism (Ruiz Almendral, 2022a, 2022b, 2023; Traversa, 2011). However, practice shows the opposite tendency of coexistence between agreements of greater integration and greater decentralization, without prejudice to the extensive

literature that has shown the reasons, in terms of efficiency, that support the decentralization of certain tax figures, and in general a better coherence and correlation between the distribution of public spending and the responsibility for revenues, precisely to avoid problems of agency ("moral hazard") that would imply a more inefficient use of public resources (Oates, 2005).

The adjustments will necessitate a more advanced model of fiscal federalism, which considers the processes of integration (in the EU) and of decentralization (within the country), present in all constitutions of complex states and therefore not uniquely a European problem.

One of the most obvious areas of influence and limitation to member states powers is tax harmonization. The founding treaties gave primary relevance to indirect taxation as a possible obstacle to building the internal market. In the mid-twentieth century, in an environment of much less mobility, direct taxation was not thought to pose significant constraints to the internal market. Thus, only indirect taxes were subject to harmonization. Article 113 of the Treaty on the Functioning of the European Union (TFEU) contains a mandate for harmonization of "turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition" (2012, p. 48). In fulfillment of this mandate, value added tax, excise duties, energy taxation, and taxes on the raising of capital were established.

The most tangible consequence of tax harmonization is the requirement for member states to establish harmonized taxes in their territory, as well as the impossibility of establishing other taxes equivalent to them. This second element has specific relevance for subnational taxation. It would not be possible to bestow any type of regulatory powers to the Autonomous Communities in the case of VAT or excise duties, except in a very limited way. The same applies to the transfer of regulatory powers in the case of corporate transactions of the tax on capital transfers and documented legal acts.

Thus, the shared-taxation system implemented in Spain as of 1997 (ceded taxes) did not provide for the attribution of regulatory powers over these taxes. Subsequently, part of the collection of these taxes would be attributed to the Autonomous Communities, following a model already in force in other federal states, where the decentralization of consumption taxation has been progressively ruled out.

Specifically, in the case of VAT, Article 33 of the Sixth Council Directive 77/388/EEC of May 17, 1977 on the harmonization of the laws of the member states relating to turnover taxes prevents the introduction of any other “turnover” tax, with limited exceptions such as those provided for in the so-called “outermost” regions (such as the Azores or the Canary Islands). In the case of excise duties, Article 3 of the Council Directive 92/12/EEC of February 25, 1992 on the general arrangements for products subject to excise duty and on the holding, movement, and monitoring of such products establishes a threefold limitation. First, the same products covered by the directive (mineral oils, alcohol and alcoholic beverages, and manufactured tobacco) may be subject to other indirect taxes for specific purposes, provided that such taxes comply with the tax rules applicable to excise duties or VAT for the determination of the taxable amount, assessment, chargeability, and monitoring of the tax (Sixth Council Directive, 1977, Art. 3, Sec. 2). Second, member states may impose taxes on different products, provided that this does not affect trade between member states because this would give rise to border-crossing formalities (Sixth Council Directive, 1977, Art. 3, Sec. 3). Finally, member states may tax the supply of services in so far as they are not in the nature of turnover taxes, including those relating to products subject to excise duties (Sixth Council Directive, 1977, Art. 33).

The prohibition of the establishment of VAT-like measures has been the subject of more than thirty cases before the ECJ, which has mostly rejected the equivalence of the measure at the origin of the dispute. To be equivalent to VAT, a tax must be applied across the board to all transactions in goods and services. The four characteristic features of VAT must therefore meet the following:

> VAT applies generally to transactions relating to goods or services; it is proportional to the price charged by the taxable person in return for the goods and services which he has supplied; the tax is charged at each stage of the production and distribution process, including that of retail sale, irrespective of the number of transactions which have previously taken place; the amounts paid during the preceding stages of the production and distribution process are deducted from the VAT payable by a taxable person, with the result that that tax applies, at any given stage, only to the value added at that stage and the final burden of that tax rests ultimately on the consumer. (Joined Cases C-283/06 and C-312/06: *KÖGÁZ rt and Others v. Zala Megyei Közigazgatási Hivatal Vezetője; OTP Garancia Biztosító rt v. Vas Megyei Közigazgatási Hivatal*, 2007, p. 2)

As such, Article 33 of the Sixth Council Directive does not preclude the maintenance or introduction of a tax which does not have one of the essential characteristics of VAT (inter alia, Banca Popolare di Cremona, para 27, Judgment of 3 October 2006, Banca Popolare di Cremona, C-475/03, EU:C:2006:629). As recalled in *KÖGÁZ rt and Others v. Zala Megyei Közigazgatási Hivatal Vezetője*, the relevant element is to determine whether the measure established has the effect of jeopardizing the functioning of the common system of VAT by being levied on the movement of goods and services and on commercial transactions in a way comparable to VAT (citing Pelzl, Banca Popolare di Cremona; and EKW and Wein & Co - Judgment of 8 June 1999, Erna Pelzl, Joined Cases C-338/97, C-344/97 and C-390/97, EU:C:1999:285; Judgment of 9 March 2000, EKW and Wien & Co, C-437/97, EU:C:2000:110). This will be the case for those measures which have the essential characteristics of VAT, even if they are not identical to it in all respects.

A further example of the impact of harmonization on ceded taxes is the case of the tax on retail sales of certain hydrocarbons (*Impuesto sobre las Ventas Minoristas de Determinados Hidrocarburos*, "the IVMDH"). Originally a ceded tax, it was designed as a kind of surcharge that could be "activated" (or not) by each Autonomous Community, and whose collection was to contribute to the financing of health care competences, the decentralization of which had just been completed (hence the name "*céntimo sanitario*", or "health cent"). Later, in the *Transportes Jordi Besora case* (Judgment of February 27th, 2014, Transportes Jordi Besora, C-82/12, EU:C:2014:108), the tax was declared incompatible with Directive 92/12/EEC.[5] The result of this judgment was not surprising. This undoubtedly influenced the refusal to limit the effects of the judgment, with the ECJ stating, among other considerations, that the incompatibility of the tax had already been established in the EKW and Wein & Co. judgment (Evangelischer Krankenhausverein Wien v. Abgabenberufungskommission Wien et Wein & Co. HandelsgesmbH v. Oberösterreichische Landesregierung, 2000), where it had already been recalled that the tax was incompatible with Directive 92/12/EEC. The reason for their incompatibility is that Article 3(2) of the Directive only allows mineral oils to be subject to indirect taxes other than the excise duty established by the Directive if they "pursue one or more specific

[5] Repealed and replaced by the Council Directive 2008/118/EC on December 16th, 2008 concerning the general arrangements for excise duty (see art. 1).

purposes" and if, in addition, they comply with the tax rules applicable in relation to excise duties or VAT for the determination of the taxable amount, chargeability, and monitoring of the duty. Still,

> member states shall retain the right to introduce or maintain taxes which are levied on products other than those listed in paragraph 1 provided, however, that those taxes do not give rise to border-crossing formalities in trade between member states. Subject to the same proviso, member states shall also retain the right to levy taxes on the supply of services which cannot be characterized as turnover taxes, including those relating to products subject to excise duty. (European Union Law, 2009, art. 3.3)

Intergovernmental Tax Relations and the (Limited) Role of Agreements

Overall, asymmetry in devolution of powers helps explain the role of bilateral and multilateral agreements in the assignment and actual implementation of authority.

The existing tension between, on the one hand, the desire to rationalize the distribution of competences by equalizing them among the different Autonomous Communities and, on the other, the persistence of the aforementioned underlying asymmetry, which has its origin in the "choice principle", is manifested, as far as agreements are concerned, in the coexistence of multilateral and bilateral logics. This is clearly reflected in the matter of regional financing. Thus, the elevation to legal status of a series of matters that until now were exclusively covered by agreements does not eliminate the role of the latter, but rather brings them back to an appropriate logic, since it seems indisputable that the agreements between the state and the autonomous communities play an important role in the articulation of the transfer of taxes. These agreements take place in two bodies, the General Council for Fiscal and Financial Policy and the Joint or Mixed Commissions, which obey, respectively, a multilateral and a bilateral logic. This is expressly recognized, among others, in STC 13/2007, FJ 8; 31/2010, of June 28th, FJ 130; and 204/2011, FJ 7, which address the role the Fiscal and Financial Policy Council currently plays as a body for coordinating financial powers between the state and the autonomous communities.

Of course, such an institutional solution has often been criticized for its lack of transparency, as those agreements take place behind closed doors

and the results are only partially made public. This is the so-called "executive federalism" that may give rise to a deficit of democracy (Cameron & Simeon, 2001; León-Alfonso, 2007). It has been argued that most of this political discussion should take place in the Senate, which, at least in theory if not in practice, is the representative chamber of the autonomous communities.

As is the case in all federations, political agreements about the allocation of resources have also played a relevant role in shaping the financing system of the Autonomous Communities. Agreements are an essential part of cooperative federalism and cannot always be substituted by debate in Parliament.

That said, a reform of the Spanish Senate is probably necessary, as this would be the best way to reinforce these agreements. Such a reform should serve to give the Senate sufficient authority to fully discuss legislation affecting autonomous communities, in a similar fashion to the German Federal Council.

At the same time, in practice, the so-called "choice principle" (*principio dispositivo*) has a very limited role, if at all, in determining the financing authority of Autonomous Communities.[6] In fact, the latter are not entitled to choose exactly how that authority is financed, at least not in the sense of determining the financing model.

This interpretation of the choice principle, as the right to decide the financing system has been expressly rejected by the Constitutional Court in STC 204/2011, (FJ 7). The Court recalls that the choice principle, contained in SC article 147.2 d., cannot be interpreted in the sense that each Autonomous Community can decide, on its own, which part of the financing system should be applicable to itself, or even if it should be applicable to itself at all, as it should be remembered that the central government, within the margins granted to it by the Constitution and respecting the principles and the autonomous financial competences stipulated therein (particularly in art. 157 EC), is constitutionally empowered to establish one or another system of autonomous financing [...]. It is

[6] The choice principle refers to the voluntary nature of Spain's decentralization. It is embedded in arts. 143 et seq of the Spanish Constitution. Thus, the system of distribution of authority rests on the so-called "principio dispositivo", which may be translated as the choice principle. The Constitution does not then assign explicit authority to Communities, but affords them the possibility of taking authority over a group of matters listed in sections 148 and 149 (Borrajo Iniesta, 2004; López Guerra, 1993; López Guerra, 1996).

therefore a regulatory model whose apex (the LOFCA) is part of the block of constitutionality and which can vary according to the political decisions of the central legislator (organic and ordinary), with the participation of the Autonomous Communities, a model on whose goodness or functionality, as pointed out in STC 68/1996, of 4 April, it is not for this Court to pronounce (SSTC 192/2000, FJ 10 and 68/1996, FFJJ 3 and 9).

Consequently, to confer binding force on the will of the Autonomous Communities would not only annul the exclusive power of the State to configure the financing system of the Autonomous Communities that it considers most suitable, but would also deprive it both of exercising its powers of coordination (art. 156.1 EC), and of guaranteeing the effective implementation of the principle of solidarity enshrined in art. 2 of the Constitution (SSTC 13/2007, FJ 9 and 31/2010, FJ 135).

Therefore, according to the Court, the choice principle cannot be interpreted in the sense that the Autonomous Communities must be the ones empowered to choose the system under which they must be financed (STC 204/2011, FJ 7).

The Central Role of the Spanish Constitutional Court as a Conflict Resolution Mechanism

To date, the most relevant conflict resolution mechanism in Spain is the Constitutional Court. There was always agreement, during the 1978 Constitution discussions, for the need to create a constitutional Court (Pérez Tremps, 1985). Despite the name, it is not exactly a court, as it is not part of the judicial branch (see titles VI and IX of the Constitution, which separately deal with judicial powers and the Court) (Arzoz, 2021).

Taking into account that the vast majority of the matters listed in the Constitution are shared between the central and subnational governments, it is not hard to imagine that this has been a source of permanent conflict between these two tiers of government. As the only body competent to resolve such conflicts, the Court has undertaken a very important task in the evolution of the "State of Autonomies" (López Guerra, 1998).

This role has been reinforced by the open-ended or unfinished nature of the different constitutional provisions regarding subnational autonomy, and by a certain pedagogic tendency of the Court to fully explain and thus serve to clarify the rules governing the "State of Autonomies".

It is often wrongly assumed that the Court has served to mitigate diversity or even limit it. In fact, the opposite is true, as has often been pointed out (Aja, 2014; Borrajo Iniesta, 2004; López Guerra, 1998). An analysis of the Court's case law shows its upholding of Autonomous Communities' authority in different areas, as López-Laborda, Rodrigo, and Sanz-Arcega show. There are many examples that illustrate the contribution of the Court to the devolution process (Arzoz, 2021).

For example, the Court has also been key in defending and upholding the official status of those regional languages recognized in the statutes of autonomy. Already in the eighties, the Court insisted that the 1978 Constitution recognizes the plurilingual reality of the Spanish Nation and that this reality is a cultural value not only acceptable, but also worthy of being promoted. From this reality, a series of legal consequences derive in terms of the possible attribution of official status to the different Spanish languages, the effective protection of all of them, and the configuration of individual rights and duties in linguistic matters (for example, SSTC 165/2013, FJ 4; 32/1986, FJ 1). This of course comes at a price, as Xavier Arzoz points out:

> it is the Court who has given rationality and viability to the whole system. The other side of the coin is that the Court's contribution has probably been excessive, as it has not merely applied but defined the rules, almost irreversibly for political actors. (Arzoz, 2021, p. 428)

The Court, of course, has also been crucial in upholding democracy and maintaining the rule of law, which was breached by an independentist minority in the Community of Catalonia in 2017 with the organization of an illegal referendum, after enacting a number of laws contrary to the Statute of Autonomy of Catalonia and the Spanish Constitution, in what has been named a process tantamount to an incomplete or attempted coup d'état. During September and October of 2017, the Government of Catalonia disobeyed every order issued by the Spanish courts, which had stressed that organizing a referendum for secession was in defiance of the Spanish Constitution and the Statute of Autonomy of Catalonia.[7] As in any parliamentary democracy, disobeying direct Court

[7] In order to fully understand why this was not a case of the right to independence (which is of course legal), but rather of upholding the rule of law and democracy, it is recommended reading the Supreme Court case, available in English (STS, October 14,

orders and ignoring the fundamental laws that govern them—such as the Spanish Constitution and the Statute of Autonomy of Catalonia—invariably carries harsh penalties. As the Spanish Constitutional Court has repeatedly insisted in more than twenty rulings addressing the Catalan independence issue, the people of Spain (including all Catalans, not only those citizens who aim at seceding) are the constituent power who have the right to decide their future. As the Court has also pointed out, independence is of course a legitimate political aspiration, but as is the case with any other legal ideology, it must follow the rule of law, which implies, among other things, obtaining the consent of the Spanish *demos*, and not just a part of it (among many others, STC 90/2017).

Another key element of the contribution of the Spanish Constitutional Court to the formation of the State of Autonomy is the case law on equality. This is particularly relevant since Spain is a country with such a long tradition of centralized rule. In this context, the Court stated early on that the principle of equality in a multilevel state such as the State of Autonomy should not be interpreted as precluding a different legal position of citizens. As early as 1981, the Court also recalls that although the authority of the Autonomous Communities is limited to the territory, this territorial limitation of the effectiveness of the rules and acts cannot mean, in any way, that these bodies, in the use of their own competences, are prevented from adopting decisions which may produce de facto consequences in other parts of the national territory. The political, legal, economic, and social unity of Spain prevents its division into watertight compartments and, consequently, depriving the Autonomous Communities of the possibility of acting, when their acts could have consequences beyond their territorial limits, would necessarily be tantamount to depriving them, purely and simply, of all capacity to act (STC 37/1981, FJ 1).

2019, (case number 20907/2017) in the criminal law case followed before the Spanish Supreme Court, is available in English here: https://www.poderjudicial.es/cgpj/es/Poder-Judicial/Noticias-Judiciales/El-Tribunal-Supremo-condena-a-nueve-de-los-procesados-en-la-causa-especial-20907-2017-por-delito-de-sedicion https://www.poderjudicial.es/stfls/TRIBUNAL%20SUPREMO/NOTAS%20DE%20PRENSA/20191216%20STS,%20Sala%202,%2014-10-2019%20-%20Sentencia%20proc%C3%A9s%20INGL%C3%89S.pdf.

As established in the proven facts of the court cases, the Catalonian authorities embezzled public funds to arrange the independence referendum and promoted massive public riots on September 20th and October 1st aimed at defying several judicial investigations and the enforcement of the law (Plaza, 2018).

Also early, the Court denied the central government to use its harmonizing powers in a pre-emptive way before the Autonomous Communities had exercised their powers. In STC 76/1983, the Court upheld the appeal of unconstitutionality brought by the Basque Government, the Basque Parliament, the Executive Council of the Generalitat of Catalonia, the Parliament of Catalonia, and fifty members of the *Cortes Generales* against the Draft Organic Law Harmonizing the Autonomous Process (LOAPA). This is one of the fundamental rulings in the construction of the "State of Autonomies". The Court recalls that there is no constitutional basis for defending equal rights for the Autonomous Communities. The Constitution enshrines the equality of individuals and social groups, but not that of the autonomous communities. Although equality does exist in the subordination of the autonomous communities to the constitutional order, the latter can be unequal in terms of the procedure for access to autonomy and the determination of the content of their statute and their powers; it is precisely the autonomous regime that is characterized by a balance between the homogeneity and diversity of the public legal status of the territorial entities that comprise it. Without the former, there would be no unity or integration in the state as a whole; without the latter, there would be no true plurality or capacity for self-government, which characterizes the state of the autonomous regions (STC 76/1983, FJ 2 a.)

In finance and taxation matters, the Court has reinforced the Autonomous Communities' spending power (the leading case is still STC 13/1992, and earlier STC 37/1987) and the right of Autonomous Communities to create taxes, within the limits of the Constitution.

Therefore, even if the Court has substantially contributed to shaping the "state of autonomies", since the nineties, different voices have proposed the Court to play a more limited role in this regard, in favor of a stronger role for the Senate (López Laborda et al., 2019). As López Guerra pointed out more than twenty years ago, it has become routine in Spain "to discuss any law of certain importance in two forums, a first debate takes place in the Parliament, a second and decisive one in the constitutional Court" (1998, p. 263).

A possible solution is to reinforce the role of the Senate, something traditionally rejected by some Autonomous Communities (the foral communities, but also Catalonia) that would rather continue having a bilateral relation, and not share the same forum with the other Communities. Autonomous Communities are represented at the Senate, which

operates as a second revision legislative chamber. However, the Senate is only in theory a representative chamber of the Autonomous Communities. Two reasons explain this: first, most senators are elected by universal suffrage from provincial voting districts, while only a minority is appointed by the Parliaments of the Autonomous Communities. Second, the Senate has very limited powers vis-ávis the central government's law-making process (i.e., no veto rights) (López Guerra, 1993).

The Future(s) of Spanish Fiscal Federalism

As I revise these lines (April 2023), there is a current debate on the constitutionality of the new *impuesto temporal de solidaridad de las grandes fortunas* (temporary solidarity tax on large fortunes, ITSGF), approved by the central government as a "complementary" tax to the *impuesto sobre el patrimonio* (IP), may raise doubts about its compatibility with the financial autonomy of the Autonomous Communities and, more specifically, with the very framework of tax devolution in force since 1997, which includes the delegation of certain regulatory powers to them. In fact, at the time of writing, the Constitutional Court has agreed to hear the appeals of unconstitutionality filed by the autonomous communities of Madrid and Andalusia against the new "temporary solidarity tax on large fortunes".

As defended elsewhere, the tax may not be contrary to the Constitution (as argued by Madrid and Andalusia in their filed complaints before the constitutional Court), but it certainly is contrary to the spirit of ceded taxation (Ruiz Almendral, 2023). Legally speaking, it is true that ceded taxes belong to the central government, as established in their regulation. But the question arises as to whether this was the most suitable mechanism, as well as whether action should not have been taken by using control mechanisms, so that the questionable use of regulatory powers in ceded taxes is not resolved only via claims before the Constitutional Court.

On the other hand, there is a percentage of the central government using its powers to harmonize regional taxation. In the highly controversial case (there are four dissenting votes) resolved by STC 26/2015, of February 19th, the Constitutional Court declared the tax on bank deposits established by the central state, with a zero-rate tax, to be compatible with the Constitution, with the sole purpose of "harmonizing", i.e., eliminating, taxes of the same type that had already been

established by several autonomous communities. The Court affirms that although it is a zero-rate tax, it is a real tax, since the legislator has a wide margin to establish a tax with other additional purposes, not strictly speaking for tax collection but for organizational purposes. More importantly, in this case, the Court reiterates that the state has the power to coordinate its own tax system with those of the Autonomous Communities (SC, 1978, art. 149.1.14), as well as the pre-eminence for occupying taxable events pursuant to article 6.2 of the LOFCA. Thus, it can be concluded that the state will also be competent to create a tax whose central purpose is the coordination or harmonization of the taxation of credit institutions, in accordance with the title of coordination contained in articles 149.1.14, 133, and 157.3 of the Spanish Constitution. Furthermore, the very mechanism to cede taxes is, by itself, a coordination mechanism, which is why the *ley marco* (SC, 1978, art. 150.1) is used in it.

But of course, the long-term question is how fiscal federalism in Spain could and should be shaped. As I have argued elsewhere (Ruiz Almendral, 2023), the examination of Court cases brought about in the past 30 years, in particular on ceded or shared taxes, illustrates how the decentralization of taxation power in Spain has been carried out without sufficiently considering European integration. Often, measures established by the Autonomous Communities hardly comply with EU law. Of course, it must also be considered that the case law of the European Court of Justice also shows the challenge for national tax systems derived from EU law and the current interpretation of the principle of non-discrimination. But, even beyond the strict scope of the European Union, the difference in treatment between residents and non-residents, traditionally key in international taxation (or fiscal federalism), has since long been eroded. Of course, as has often been stressed, the problem with the ECJ's doctrine is that it often reveals an impossibility: in reality, to strictly comply with the non-discrimination mandates, perfect harmonization would have to be achieved in some taxes.

Ultimately any attempt to establish a system by means of case law is, by definition, doomed to fail. Even if the Constitutional Court has played a crucial role in the very existence of fiscal federalism in Spain, Courts answer the question put to it and decide based on the cases that are admitted and examined. They do not, by design, examine the system as a whole, as that would be beyond their power and role. It is for legislators

to adapt the different tax laws and regulations and integrate them, so that the result is a coherent and systematic, albeit multilevel, tax system.

Tax decentralization is not inherently incompatible with economic integration, nor is it more inefficient. On the contrary, in a context of erosion of some tax bases, it is possible to think of local taxes that would better resist this phenomenon, to the extent that less-mobile bases are taxed. This requires a better process to undertake tax reforms, which will need to consider both the integration in the European Union and the highly decentralized nature of the Spanish State of Autonomies. This process will need to take into account the analysis of the expenditure side. All reforms to further increase tax decentralization had as one of the objectives the increase of Autonomous Communities' fiscal responsibility. This can only be fully achieved if the exercise of tax powers is also linked to the degree of tax expenditure and the principle of fiscal and budgetary stability.

In any event, the concern for greater coordination in the exercise of regulatory powers and in the tax assignment mechanism is far from new. But it has become even more serious in recent years. In 2014, the so-called "Lagares Report" proposed eliminating the wealth tax (proposal 54), harmonizing the inheritance and gift tax (proposals 55 et seq.), and partially abolishing the transfer tax and stamp duty (proposals 62 et seq.) (Ministerio de Hacienda y Función Pública, 2014). In 2017, the Commission on the Autonomous Region Financing System (para. 42 and 44, p. 18) also proposed a sort of regulatory harmonization.

Finally, and much more recently, the (2022) White Book (Libro Blanco) for tax reform has also stressed the need to better coordinate the exercise of tax powers in a multilevel setting (Ruiz-Huerta). In particular, the case of wealth taxation (including the inheritance and gift tax), the race to the bottom has become obvious, and the problem is no longer that of clashing with EU law, but rather the disappearance of such taxes, which no longer would be a piece of the system to ensure better equality overall. The White Book states:

> The exercise of regulatory powers over these taxes has involved an evolution that calls for reflection on the need to find an optimal framework of balance between fiscal co-responsibility, as an expression of financial autonomy, and the requirement to guarantee the application of wealth taxation with criteria of efficiency and equity, in accordance with the

principles of justice in the tax system proclaimed in article 31.1 of the Constitution. (Ruiz-Huerta, 2022, p. 619)

In this context, the legal system has tools that allow, on a regular basis, better coordination of the exercise of taxation powers by the autonomous communities and local entities. All this considering that the Spanish Constitution does not design a single model of regional or local financing, but rather a legal structure with different options, in which the central government has ample powers to coordinate the system and ensure that the different pieces fit better together.

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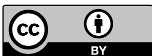

The United Kingdom's Territorial Funding Arrangement: A Holding Together Tool?

Francisco Javier Romero Caro

Introduction

The accommodation of territorial diversity is one of the greatest challenges that complex societies must face. Today, many federal systems are encountering a loss of solidarity and an upsurge of interregional disparities. These have exacerbated dormant tensions and intergovernmental conflicts that in certain cases also spark secessionist movements. Funding arrangements are a vital component of any system of shared government, as the lack of resources to finance constitutionally assigned competences would render them inoperable, thus reducing autonomy to an empty vessel. Equalization mechanisms play a key role in managing diversity within a multilevel state, because they are designed to achieve a certain degree of horizontal redistribution among territorial subunits. This chapter explores the internal architecture of the United Kingdom's territorial funding arrangement from a legal perspective, with the aim of investigating its integrative and disintegrative effects in relation to

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Scotland (and to a minor extent, also to Wales). This is done to determine the impact of fiscal arrangements on diversity management, and if such arrangements can function as tools to hold a country together and discourage secessionist attempts.

Although the United Kingdom lacks a specific equalization program due to the territorial configuration of the country—which is a strongly centralized state in which devolution has a history of fewer than twenty-five years—this does not mean that there is not a mechanism that partially fulfills this function, specifically, the Barnett formula.[1] This mechanism, introduced by the Chief Secretary of the Treasury Joel Barnett, is the method of calculation of UK public spending for the different nations that make up the UK (Rutherford, 2013, 39). It was intended to bring convergence in per capita spending across the UK, and thus featured an equalizing rationale. Consequently, for the purposes of this chapter, the Barnett formula will be viewed as an equalization mechanism since, in addition to revenue sharing, it also performs an interterritorial redistributive function.

This analysis will be predominantly legal, focusing on all sources of law, including secondary legislation, soft law, and political agreements. The final aim is to evaluate if and to what extent the "Barnett system," due to its equalizing function, can be conceived as an instrument of nation building that contributes to reducing territorial tensions and accommodating diversity, thereby reversing disintegrative trends. This analysis evaluates the integrative and disintegrative potentials of the elements of the internal architecture of equalization mechanisms. In particular, the main hypotheses are that equalization mechanisms:

- raise the cost of secession in subunits that are net receivers of funds;
- have an integrating function as they promote economic development and cohesion;
- tend to enhance a sense of belonging and solidarity among constituent units by fostering national unity.

The concepts of integration and disintegration used in this analysis are borrowed from the literature of European integration and applied to the

[1] The term was coined by David Heald in 1980. Curiously, Heald joked about the possibility of Barnett becoming more famous than Goschen someday, something that reality has confirmed (Heald, 1980, 12).

internal dynamics that occur in multilevel systems between the central government and the territorial subunits, as well as among the subunits themselves.

One of the most influential definitions of integration was coined by Wallace (1990, 9), who characterized this phenomenon as "the creation and maintenance of intense and diversified patterns of interaction among previously autonomous units." This definition, although originally intended for sovereign states joining into a supranational organization, is nevertheless useful for studying the dynamics that affect the relationship between center and periphery within a multilevel state.

Applying this definition, the territorial participation in the governance of the equalization compact will be described as an integrative force, since it contributes to strengthening the ties between the national government and the territorial subunit(s) by promoting dialogue and cooperation while respecting and protecting the political autonomy of the subunit(s).

The political dimension is also relevant when studying equalization mechanisms or describing their internal architecture. For this reason, the role of political actors will be considered following Haas' (1968, 16) vision of integration as a process "whereby political actors in several, distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new political center." Although this concept refers to the creation of a new political center—that of the European institutions—in this case the political center in question is represented by the central institutions and thus the parent state itself. Therefore, those elements of equalization that contribute to reinforcing the loyalty of territorial subunits toward the center are considered a step toward further integration.

In contrast to integration, disintegration has not attracted as much interest, and the elaboration of a definition has not been pursued in depth. Only Scheller and Eppler (2014, 26) have attempted to fill the vacuum—conceptualizing this phenomenon by defining disintegration as those "erosion processes promoted by individual or collective actors [...] which lower the legal, economic, territorial, socio-cultural and/or legitimating integration level" undermining "the unity of the internal market, the Monetary Union and the European legal area." Within nation-states, these processes lower territorial integration, undermine the unity of the state, fuel internal tensions, and encourage opportunistic and divisive behaviors that hinder cooperation between the different parts of a multilevel state. Applying Scheller and Eppler's rationale, those

aspects of equalization that weaken the ties between a territorial subunit and the national level, thus hindering dialogue and cooperation, will be considered disintegrative. Similarly, lack of participation by the territorial subunits will also be understood as promoting disintegration, since this may result in isolation or opportunistic behavior that undermines the principle of horizontal solidarity.

In sum, integration and disintegration are dynamic processes that can happen at the same time at the institutional, territorial, economic, or even socio-cultural levels (Scheller & Eppler, 2014, 26). The article will analyze the integrative and disintegrative potential of the different elements of equalization mechanisms in terms of diversity accommodation, by focusing on the territorial dimension of integration. The other dimensions (economic, institutional, etc.) will also be considered, as far as they are instrumental for territorial (dis)integration. The aim is to identify the aspects that may increase the allegiance to the state by promoting dialogue and cooperation among the different components of a multilevel state, thus contributing to accommodating diversity, as well as those factors that may hinder these values by fostering disintegration and increasing contestations of the current political settlement which could in turn fuel secessionist movements.

The choice of the United Kingdom as a case study is not trivial. In fact, among Western countries, the United Kingdom is the most recent state to experience a secessionist challenge following the Scottish independence referendum in 2014.[2] This challenge is still potent, particularly considering the will of the Scottish National Party (SNP) to hold a second consultation after leaving the European Union.

Territorial Diversity in the United Kingdom and Scotland's Secessionist Aspirations

The origins of the territorial configuration of the United Kingdom date back to the union of the parliaments of England and Scotland in 1707, with the passing of the Acts of Union that led to the creation of the

[2] Spain suffered the Catalan independence challenge in 2017, although this, unlike the Scottish case, was based on illegal acts carried out by the Parliament and Government of Catalonia, which were annulled by the Constitutional Court, leading to the conviction of several politicians and activists, later pardoned by the Spanish government. See Romero Caro (2022, 13–15).

United Kingdom of Great Britain. The independence of Ireland in 1916 after the failure of Home Rule and the progressive loss of the colonial empire have shaped the current model (Kendle, 1997), which was decisively transformed after the approval of devolution for Scotland, Wales, and Northern Ireland in 1999. However, the establishment of self-government through the Scotland Act did not stop the secessionist aspirations of the Scottish National Party (SNP). After an initial failed attempt in 2010, in 2012 the Scottish government agreed with Prime Minister David Cameron to hold a referendum on Scottish independence.

Although the Scottish electorate voted "no" by 55.36% to 44.70% with a high turnout of 84.59%, support for independence was higher than London had expected when it authorized the referendum. This result demonstrated the need to extend Scottish self-government to counter the secessionist bid. The support for independence was evidence of the failure of the British government's strategy of excluding devo-max (the devolving of all powers to Holyrood other than defense and foreign affairs) as an alternative in the referendum, which, instead of weakening the SNP's aspirations, had ended up boosting them.

The extension of self-government was granted by the Scotland Act of 2016. This Act recognizes the permanent nature of the Scottish government and parliament—granting the latter powers to reform the electoral system subject to a reinforced two-thirds majority. Additionally, the Sewel Convention was codified, whereby the Westminster parliament agrees not to legislate on those matters devolved to the Edinburgh parliament without the express consent of the latter. On the fiscal and taxation front, Scotland's financial autonomy was strengthened—giving the territory greater powers over income tax, VAT, and air tax. Finally, Scotland also assumes powers in areas such as social services, employment, transport, abortion, and Crown property located in Scotland (Page, 2019, 127–138).

The reform of Scottish self-government was the culmination of the process initiated in 2010 which intended to ease the tensions between London and Edinburgh, and left behind the question of independence as the referendum was characterized by both parties as a decision for a generation. However, the United Kingdom's exit from the European Union following the 2016 referendum, in which the majority of the Scottish population opted to remain, substantially altered the starting conditions. In fact, remaining in the European Union was one of the main arguments against independence, as it would mean leaving the common market and

significantly weakening the Scottish economy. The frustration generated by Brexit against the will of the Scottish electorate is coupled with a growing sense of grievance on the part of the regional executive as it believes that the withdrawal from the EU has led to an incipient process of recentralization. For example, the London government refuses to return to Scotland part of the competences repatriated from Brussels, notably those in areas such as agriculture or fisheries (McEwen, 2019). These factors have provoked a revitalization of the pro-independence option, with the Scottish government led by the SNP demanding a second referendum after Brexit is fully completed. The British government's refusal to authorize a second referendum prompted the SNP to appeal to the UK Supreme Court (UKSC) with the intention of validating the passage of a law calling for a new consultation on Scottish independence, set for October 2023. However, this possibility was unanimously rejected by the UKSC, which deemed that a referendum on independence relates to a matter reserved to the UK parliament as it concerns the Union of the Kingdoms of Scotland and England.[3] In response to this rejection, the SNP plans to approach the next general election as if it were a plebiscite on the issue, with the intention of obtaining a resounding mandate with which to pressure London into accepting a second referendum.

Exploring the Features of the UK Territorial Funding Arrangement: The Barnett Formula

As this analysis will be framed following a legal perspective, it will focus on those components that are related to the notion of fiscal constitution in the broader sense, hence not only paying attention to those elements "formally incorporated in some legally binding and explicitly constitutional document," but also "customary, traditional, and widely accepted precepts" (Buchanan & Wagner, 1977, 24). This includes sources of law without formal constitutional status and political facts that influence the interpretation and implementation of the rules and determine the way in which a system functions and evolves, as in this case theory cannot be separated from practice. Thus, the components that make up the internal architecture of equalization mechanisms will be investigated with the aim

[3] Reference by the Lord Advocate of devolution issues under paragraph 34 of Schedule 6 to the Scotland Act 1998 [2022] UKSC 31.

of identifying the integrative and disintegrative effects that these elements have in the territorial accommodation of diversity and, in particular, of national minorities in the UK. A brief description of them is presented below, before delving into the analysis of their (dis) integrative potential in relation to subunits facing secessionist challenges. These components include:

The legal entrenchment of the program, i.e., the legal foundations of equalization programs that can be classified into three main models: constitutional entrenchment, legal enactment, and an informal consensus on the goals of fiscal equalization via intergovernmental cooperation (Shah, 2007a, 294).

The nature of the redistribution refers to the determination of the overall funding of equalization with a particular emphasis on the origin of the funds (vertical and/or horizontal dimension). Additionally, it is also possible to draw a distinction between open-ended systems, i.e., those in which there is no upper limit to the total pool of equalization, and close-end models wherein the total pool of money is exogenous as it is generally linked to the revenue raised by a certain tax which depends on the economic cycle (Ahmad & Brosio, 2018, 179–180). Lastly, there are integrated programs in which all subunits receive transfers and stand-alone programs that only envisage transfers to those subunits that qualify for equalization if they fail to meet the general standard.

The level and components of equalization. In this regard, it is possible to distinguish between the level of equalization and the components that the system would try to equalize. The level of equalization alludes to how much equalization would be pursued, taking into consideration the potential tradeoffs with respect to economic growth, financial stability, or political incentives (Ahmad & Brosio, 2018, 171–174). Additionally, equalization can be on gross or net terms. Gross equalization is directed toward bringing relatively poorer subunits in line with the national average or to another standard, leaving the fiscal capacity of the richer subunits unaffected. In contrast, a net equalization program aims to elevate the fiscal capacity of the relatively poorer subunits at the expense of the fiscal capacity of the richer. The second element, the component of equalization, refers to the economic magnitude that the mechanism aims to equalize, i.e., revenue capacities or expenditure needs.

The degree of conditionality. Conditional or earmarked transfers are a common feature in multilevel states, in which the central government imposes a series of requirements upon the transferred funds which must

be satisfied by the territorial subunits in order to receive them (Shah, 2007b, 5–6). In most of the cases, these conditions are input-based, with the national level conditioning the transfers to a specific and exclusive type of expenditures (e.g., health, education, infrastructure, social services, etc.). A second possibility is to establish output-based transfers, by conditioning the funds on the accomplishment of a certain result but without imposing any obligation on how to achieve that goal. Furthermore, conditionality can vary in scope—resulting in either soft or hard conditionality. The strings attached to a transfer can be classified as soft when they require only adherence to broad and generally undisputed principles, such as accessibility to public services or the prohibition of interterritorial discrimination. In contrast, hard conditionality is prescriptive, as the territorial subunits need to meet specific criteria such as balanced budgets, a given degree of spending allocated to a program, or a minimum level of taxation.

The institutional administering of the program. Equalization compacts are complex financial schemes that require an institutional framework to manage their implementation and functioning. Although different institutional arrangements can be used, such as a central government agency, the dominant pattern in comparative perspective is to allocate this function either to an independent arm's length agency or to an intergovernmental forum.

The length of the program. Equalization mechanisms can include sunset clauses. These establish the maximum length of the program in place, which will expire after its completion if it is not renewed. Such renewal can extend the program either in its current form, or in a revised fashion. Another possibility is to let the program expire and then establish a new one, although this new program would be similar in nature, especially if the main principles governing equalization were entrenched in a norm such as the constitution or a national law.

Dispute resolution. First, a distinction must be made between mere political criticism and legal disputes. While political criticism of the equalization compact can be channeled through the institutional (frequently also intergovernmental or technical in nature) framework responsible for managing the program, legal disputes may end in court. Since the latter may require the interpretation of constitutional and legal provisions as the result of an intergovernmental conflict that generally involves one or more territorial subunits and the national level, the issue is normally adjudicated to the highest court in the land.

Legal Entrenchment of the Program

The distribution of financial resources among the different nations that make up the United Kingdom has been a controversial issue since the nineteenth century. The first precedent of a formula to allocate spending dates to 1888, when the Chancellor of the Exchequer George Goschen implemented a mechanism to calculate funding for services in Scotland and Ireland compared with England and Wales. The Goschen formula allocated the funds on a population ratio of 80-11-9 to England and Wales, Scotland and Ireland, respectively (House of Lords, 2009, 19).

The Barnett formula, a sophisticated update of Goschen, is an allocation mechanism of the tax revenues from the UK government to be spent by the devolved administrations of Scotland, Wales, and Northern Ireland. Although it was introduced as a temporary solution in 1978 as a tool for assigning block grants to the executive departments that ran the administrations of the three territories (Brown et al., 2018), the formula has continued in place and gained importance with devolution. Due to the formula's nature and the peculiarities of the British system, the Barnett formula is not legally entrenched. Thus, it is neither enshrined in a statute nor given any legal or constitutional form. As a result, the Barnett formula is simply a policy of the British government, set out in an internal document of the Treasury; the Statement of Funding Policy (Keep, 2022, 12).

The origins of the Barnett formula are not entirely clear because the decision to adopt this scheme was not publicized by the British government. In fact, the decision was only made public in 1980 during a Select Committee hearing by the Scottish Secretary George Younger (Heald, 1980, 12). This informal consensus was agreed within the Labour government of Callaghan in the run-up to the failed first attempt at devolution and was meant to be a temporary solution for allocating government spending to Scotland. It was conceived as an automatic mechanism to territorially distribute public spending and avoid internal disputes between government ministers on how much the changes in public expenditure should be allocated between England and the rest of the country (Barnett, 2000, 70). Initially designed for Scotland, the formula was later extended to Northern Ireland in 1979 and to Wales in 1980.

Although the devolution plans of the Callaghan government faded after the adverse referendum results in Wales and Scotland (Bogdanor, 1999, 188–200), the Barnett formula was kept and continued in place

after the Conservative victory in 1979 as a convenient mechanism to allocate spending to the Scottish, Welsh, and Northern Ireland Offices. Hence, despite the Barnett formula not being a product of devolution per se, it has been precisely this process of territorial distribution of power that has highlighted its importance while at the same time questioning the need for legal entrenchment. In fact, devolution posed an opportunity to settle the legal entrenchment of the formula and constrain the power of the Treasury over its amendment, which is unlimited in its current form (Keep, 2021, 9). However, despite some calls made at the time for the Barnett formula to be enshrined in the devolution legislation (it was included in the White papers as Mclean, 2005, 86 notes), the system did not change and remains in force today with only minor modifications from its original design.

Consequently, the Barnett formula rests on an informal decision by the Treasury, as if it were a matter of internal policy within this branch of government and not a matter of law (Bell & Vaillancourt, 2018, 85). Thus, the British government is free to change the allocation system at any time, without consulting the devolved administrations or securing an approval in parliament (Keep, 2022, 12). This lack of legal entrenchment can be conceived as a disintegrative force, as it results in transfer payments depending exclusively on political actors, thus limiting the degree of certainty about the territorial financial arrangements in the long term and hindering the financial planning of the devolved administrations. This issue was highlighted as one of the weaknesses of the devolution system since it leaves the Scottish and Welsh executives "at the mercy of the goodwill" of the government of the day in order to secure their funding.[4] This is particularly noticeable in light of the limited initial fiscal powers of these administrations, which were later enlarged in the case of Scotland and, to a lesser extent, Wales.

Despite the lack of solid legal foundations for the Barnett formula, the threat of repeal or substantial alteration by the national government without the consent of the devolved parliaments seems low. Although as a matter of law this would be within the prerogatives of the British Cabinet due to the absence of any legal entrenchment, in practice, such a decision would shake the foundations of devolution and would lead

[4] Conservative Party press notice 1558/97 dated 29 November 1997.

to direct confrontation between London and the executives of Edinburgh, Cardiff, and Belfast. Thus, it should come as no surprise that the Treasury normally consults the devolved administrations on any changes to the Statement of Funding Policy. In fact, a substantial alteration of the Barnett formula that would decrease the funding of the devolved governments adopted without their consent would not only jeopardize the system of devolution, but also boost support for secession. Moreover, such a decision does not seem plausible because of the internal dynamics of the British system of government, which is characterized by a high degree of mutual trust and respect for unwritten rules and conventions. Furthermore, considering the formula's long-standing precedent—the formula has lasted for more than half century without substantial changes—it could be argued that the devolved administrations have a de facto guarantee that the Barnett formula is not going to be substantially changed or repealed by the British government without prior consultations with the affected devolved administrations (Bogdanor, 1999, 249–250). This informal guarantee is based on the existing high levels of mutual trust in the UK's political practice, substantially reducing the disintegrative potential that could be embedded in a system without any legal or constitutional safeguards.

Notwithstanding the expectations at the time of its creation that the Barnett formula would be a transitional system to be replaced by a more complex allocation model, this did not happen with the implementation of devolution in 1999 or the significant extension of taxation powers to Scotland following the approval of the Scotland Act of 2016, which only led to minor changes to the formula. The core of the system is unlikely to change in the near future, as the simplicity and informality of the system are considered two of its strengths. Even more so if one considers that opening a complex debate about a hypothetical reform would probably require a negotiation process with the devolved governments and the inclusion of the compact in a legal statute, thereby reducing the current unlimited powers that the British executive enjoys over the allocation of spending.

Nature of the Redistribution

The funding of devolution by the UK government is based on a block grant system. These grants are adjusted annually by the Barnett formula according to the population size of each nation and a comparability

index that captures the extent to which a policy area is devolved (Heald, 2020, 522). The formula is designed to give each devolved government the same pounds per capita adjustment in funding, following the subsequent logic: any change made by the UK government to public spending in England on devolved functions leads automatically to a change in the budget of the devolved administration in reference to their relative population. The formula is defined as follows:

$$\text{Change in the devolved budget} = \text{Change in UK government spending} \times \text{Comparability percentage} \times \text{Population share}$$

The comparability percentage refers to the extent to which a policy area is devolved, which is set by the Treasury in the Statement of Funding Policy (HM Treasury, 2021, 44–70). These percentages range from 100% for those areas that are fully devolved—such as health or education—to 0% for matters that are the sole responsibility of the UK executive such as defense, foreign affairs, or international trade. In the case of policy areas where the British government stills retains some competences, the percentage is set accordingly between 0 and 100. It is also important to note that the comparability percentages also vary from nation to nation as the scope of devolution differs. For instance, justice is devolved in Scotland and Northern Ireland but not Wales, while the powers over work and pensions are almost fully devolved in Northern Ireland but to a much smaller extent in Scotland and Wales. For its part, the population share of the four nations is determined yearly by the Office for National Statistics in relation to that of England, with the most recent data being 9.67% for Scotland, 5.60% for Wales, and 3.35% for Northern Ireland (HM Treasury, 2021, 43).[5]

The total pool of resources allocated by the British government to the funding of the devolved administrations is determined on an ad hoc basis in the national budget as a result of the spending assigned to England (Edmonds, 2001, 9–12). Consequently, increases to the spending in England will lead to larger transfers to the devolved governments, while cuts in spending in England will result in a decrease in the funding of

[5] The population estimates used in the Barnett formula vary by departmental program as some services like Home Office are compared with England and Wales while in some cases the comparator for Northern Ireland is with Great Britain.

the devolved administrations. These changes to the devolved administration's block grant are commonly denominated "Barnett consequentials" (Keep, 2022, 10). Such a model gives a wide margin of flexibility to the British executive to adapt to economic shocks and achieve macroeconomic stability at the expense of the finances of subnational governments. However, the formula-driven nature of the model reduces the uncertainty embedded in the system, as the devolved administrations can predict the changes that will be applied to the block grant once the budget is released by Whitehall.

The block grant system that finances devolution is a vertical grant paid solely by the British government from its general revenue. Additional funds transferred to the devolved administrations fall outside of the Barnett formula, as this mechanism does not consider spending in other areas such as welfare (Bell, 2015, 211). Although vertical models can be interpreted as an integrating force that reduces secessionist claims in those subunits that are receivers of funds—i.e., the three devolved nations—this argument is obscured in the British case because of the existing trade-off between transfers and autonomy. In this case, seceding would imply losing the block grant but also a significant gain of financial autonomy as this is quite low in a centralist system like that of the United Kingdom. For this reason, the integrative potential of the block grant system should be understood as essentially neutral. However, it is also potentially unifying if the British executive presents itself as a benevolent benefactor that increases the funding of the devolved administrations by deciding to allocate more spending to England, because this decision would result in the "Barnett consequential" of transferring more resources to the devolved governments. In this way, the British executive could try to use the system to increase loyalty toward London, cultivating a sense of belonging to the common polity of the UK; a strategy that would only work in case of increased spending and that could easily backfire if the "Barnett consequential" results in a decrease in funding for the territorial administrations.

The financing system of the devolved governments by the British executive is, in essence, an integrated revenue sharing mechanism in which subunits receive funds from the British government to cover the costs of the devolved powers. Because the block grant is financed from general revenue, the system is open-ended with no limit to the total amount of funds, as these are determined by the application of the Barnett formula to the previous block grant. This system avoids the perverse incentives

of zero-sum game programs, as the devolved nations do not compete for increased funding, since funding is dependent on the level of spending in England. Thus, the combination of these two characteristics—an integrated open-ended system in which all subunits receive funding without competition—results in a low potential for conflict and can be considered to be an integrative force.

Level and Component of Equalization

The Barnett formula determines the significance of the changes to the expenditure of Scotland and Wales in relation to the previous block grant. The size of the block grant and starting levels in per capita spending were initially set in 1979 and have evolved with time alongside the increase or decrease of English spending. Additionally, some block grant adjustments have been introduced to reflect the devolution of new tax powers or welfare responsibilities to the devolved nations (Keep, 2022, 21–22).

For various reasons, such as the economic backlog of Scotland and Wales with respect to England, the original block grant allocated a greater level of public spending to Scotland and Wales than their population figures justified (Barnett, 2000, 70), resulting in a spending per capita significantly higher than in England. For instance, the overall spending level per capita in Scotland in 1979 was 22% higher than in England (House of Lords, 2009, 21). These differences in per capita spending were intended to be transitory, because the formula was planned to cause spending per capita on comparable devolved spending to converge across the four nations (Bell, 2015, 210). As the devolved nations have higher level of per capita spending, equal increases of funds represent a smaller increase in percentage, reducing the gap and progressively achieving convergence in per capita spending—a phenomenon commonly known as the "Barnett squeeze". Consequently, the Barnett formula should lead to full equalization of revenue on comparable devolved services in the long run, allocating yearly public spending equally across the four nations (Montes-Nebreda, 2021, 337). In a certain sense, the Barnett formula should result in a process of reverse gross equalization, progressively achieving the convergence in the spending per capita of the devolved nations without affecting those of England.

However, practice has proven this convergence to be much slower than expected. There are several factors that explain this slow progress. The first is that the formula does not consider the different rates of population

growth (Heald, 2020, 523). Although the formula indexes the variations in spending by the population share of each devolved nation, the base line—the block grant—remains unchanged. As the initial block grant accounted for surplus per capita spending in the regional administrations, these higher levels of spending in Scotland and Northern Ireland—and to a lesser extent in Wales—with respect to England were locked in the system. Further, with the population in England growing steadily, Scotland's population share has declined, slowing down the process of convergence (Cuthbert, 2020, 435–437). A second reason is that convergence only takes place when the spending in England is increased. If it decreases, as is the case during periods of austerity, the convergence effect of the Barnett formula is reversed—widening the gap in per capita spending between England and the devolved nations (Paun et al., 2021, 15). Additionally, formula-bypasses also work against convergence. These are changes to the block grant that are made outside of the scope of the Barnett formula, and that consequently do not result in a "Barnett consequential". This was the case of the spending on the Olympics in London, or the increase in funding to Northern Ireland as part of a 2017 Confidence and Supply agreement between the Conservative Party and the Democratic Unionist Party.

The UK system of territorial funding is based exclusively on revenue capacity without taking into account any assessment of expenditure needs. As Lord Barnett himself has acknowledged, focusing only on the variations in expenditure was a deliberate decision in pursuit of simplicity as the system was intended to be a "stopgap until a needs-based system came into operation" (Barnett, 2000, 69). However, the formula has survived the passage of time and the implementation of several rounds of devolution without paying attention to the actual needs of these territories. As a result, the Barnett system has allowed the spending per capita in the devolved nations to remain higher than in England, generating discontent among English politicians that see it as unfair—including Lord Barnett himself (Heald & Mcleod, 2005, 100).[6] This is particularly pronounced in the case of Scotland, which enjoys markedly higher public spending than England despite being close to the UK average in terms of economic

[6] See Barnett's fierce criticism of his own creation in an article published in the Daily Mail the 21 September 2014: https://www.dailymail.co.uk/debate/article-2763744/I-demand-shamefully-unfair-Barnett-Formula-scrapped-LORD-BARNETT-architect-hated-subsidy-Scotland.html.

output per person (Paun et al., 2021, 20). The reasons for this dissatisfaction, which can be considered a disintegrative force, come not from the fact that Scotland receives a higher amount of funding per capita, but from the general perception that this allocation exceeds the needs of that territory. This argument is based on several assessments carried out by the Treasury over the years. Although these reports recognized that the devolved nations had greater needs than England due to geographical and socio-economic factors, they also found that the three devolved nations were overfunded when compared to similar needs in England (Paun et al., 2021, 17). In fact, a report by the House of Lords in 2009 concluded that Scotland presented the greatest difference (18 percentage points), followed by Wales (10 points) and finally Northern Ireland (5 points) (House of Lords, 2009).

This perception of unfairness has generated recurrent debate about the need to reform the Barnett formula to include some sort of needs base criteria—or to replace it if this proves impossible. One of the most comprehensive reform proposals was put forward by the Holtham Commission in 2019. Established by the Government of Wales to study the funding of devolution, this commission delivered a report which called for replacing Barnett with a needs-based formula, because the current system fails to recognize the greater public service funding needs of Wales relative to England (Independent Commission on Funding & Finance for Wales, 2010, 16–29). More precisely, the Holtham Commission suggested the adoption of a needs-based formula that would take into account six different variables relating to demographics, deprivation, and costs, which would then be used to identify the need for public services and therefore greater funding[7] (Independent Commission on Funding & Finance for Wales, 2010, 20).

Although the proposal to replace the Barnett formula was rejected by the British government, the UK executive agreed to include a needs-based factor, known as "funding floor," to address the concerns of future underfunding due to convergence.[8] This floor has a clear integrative potential for Wales as it guarantees that the devolved spending allocations that result from the Barnett formula will not fall below 115% of per capita

[7] These variables were number of children, number of older people, ethnicity, income poverty, prevalence of ill health, and sparsity of population.

[8] See "The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework."

spending on similar services in England, limiting the convergence effect at that rate.[9] This integrative force also applies to Scotland because of the expectation that this solution could be applied to that territory in the future in the event of a similar scenario, since Scotland stands to lose the most if a strictly needs-based system were introduced, as its per capita funding is greater than its needs (Mclean, 2012, 647).

Scotland, Wales, and Northern Ireland have enjoyed public expenditure levels above those of England since the middle of the twentieth century, a situation that has been preserved under Barnett. Although theoretically designed to achieve full equalization with England in the long term, the expected "Barnett squeeze" has not materialized in practice for the aforementioned reasons. Therefore, the practical application of the Barnett formula can be considered as an integrative force in relation to the devolved nations, as this mechanism has allowed subunits to maintain higher levels of per capita spending than in England, without fearing a budget "squeeze." Moreover, this integrative potential has been reinforced by the "funding floor" approved for Wales, which will guarantee a minimum funding level of 115% with respect to England despite any reform to the system currently into force. Conversely, the maintenance of the gap in expenditure per head between England and the devolved nations can paradoxically be understood as a disintegrative force with respect to England. Not only because the system has not delivered the expected convergence and thus has kept England underfunded, but also because it has failed to address the diverse spending needs that exist among English regions. A study conducted by the Institute for Government concluded that there are significative differences in spending among English regions—with the regions in northern England and the Midlands appearing to be relatively underfunded, and London appearing to benefit from a disproportionately high spending per person (Paun et al., 2021, 20). This imbalance, combined with the lack of convergence—which is most pronounced in the most deprived areas of England—has the potential to increase territorial tensions and create backlash toward Barnett, promoting disintegration. In fact, fear of an English backlash about expenditure inequalities is not new, as this was identified as a risk in the late 1970s during the first devolution debates (Heald, 1980, 11).

[9] Currently, a transitional factor of 105% applies as long as the relative Welsh Government funding per head remains above 115% as agreed by the British and Welsh executives in the 2016.

A possible solution to this conundrum would be the implementation of a needs-based model and the division of England into regions following the path initiated by London in 1998. However, the first seems politically impossible given the likely negative reaction of the devolved nations—particularly in Scotland where it could be used as a *casus belli* by the secessionist movement—while the second seems to have been discarded after the devolution plans to North East England were rejected in a 2004 referendum.

Conditionality

The grants that the devolved administrations in Scotland, Wales, and Northern Ireland receive to fund their spending are not subject to any degree of conditionality—a situation that contrasts with the tight control exercised by the British government over spending carried out in the regions in England by local and health authorities, which are largely obliged to closely adhere to the UK government's priorities (McLean & McMillan, 2003, 47). Hence, the devolved governments are free to decide if and how they want to spend those funds without any obligation to meet minimum standards of service provision (Bell, 2015, 211). This means that officials in Edinburgh, Cardiff, or Belfast are not bound by the spending decisions of Whitehall. They are affected by the "Barnett consequentials," as the increase or decrease in spending in England leads to changes in the block grant due to the operation of the Barnett formula, but they can allocate the additional money (or the necessary cuts) however they wish. In other words, these administrations are free to allocate the block grant among different departments without any interference or scrutiny from the Treasury. This freedom is one of the Barnett formula's greatest advantages (Edmonds, 2001, 13). If the block grant increases due to higher spending in England in, for instance, health, the devolved administrations are not required to spend the additional funds in health. In fact, technically, there is no obligation to spend the money from the block grant on devolved functions, and the funds could also be used to cut taxes or to increase the savings and create a budgetary surplus. However, this is difficult in practice because much public spending is guided by demand, thereby limiting the scope for discretion (Edmonds, 2001, 10).

In any case, the absence of conditionality in legal terms does not imply that it does not exist from a political point of view (Bell & Vaillancourt, 2018, 85). For instance, it would be difficult to justify to the electorate the underfunding of public services if transfers from London were not reduced. On the other hand, in the event of a spending cutback in England, the devolved administrations could shift the blame to the central executive for any cuts they would be forced to make, and frame the inconvenience as a consequence of the Barnett formula.

The block grant allocations to devolved administrations work as substitute of own revenue without carrying any limitations or constrains, and consequently embed a strong integrative potential that could be used to discourage secession. This is a particularly relevant factor in the case of Scotland, particularly considering that this territory is overfinanced in relation to its needs and that the system grants Scotland a comparatively better financial position in relation to the other nations—without any strings attached. Thus, the unconditional overfinancing of Scotland that results from Barnett can be portrayed by the UK as a benefit of the Union, in order to foster a sense of loyalty to the UK common project and to persuade Scots to strengthen their allegiance toward the center and reject the path to independence.

Institutional Administering of the Program

The administering of the UK block grant is the exclusive right of the British government as part of its economic and budgetary policy. A central government agency, the British Treasury, determines the allocation criteria—presently the Barnett formula—and oversees the transferal of funds to the devolved nations for the funding of devolved functions. Therefore, due to the design of the system, the devolved nations' expenditure depends upon the success of English ministers in defending their programs against the Treasury with the size of the grant being updated yearly as a result of the "Barnett consequentials" (Heald, 1980, 16). This leaves the regional institutions exposed to the budgetary policy of the British government in relation to England, a policy over which they have no direct control. However, this lack of decision-making power does not mean that the devolved administrations have refrained from expressing their opinion on the matter, since there is a long tradition, even before devolution, of Scottish politicians lobbying the Treasury in order secure higher funding for Scotland (McLean & McMillan, 2003, 54–55).

The centralized nature of the transfer scheme in which the national level institutions are solely responsible for the management of the Barnett formula entails the risk of generating a centrifugal force, precisely because of the lack of territorial participation in the administration of the system. However, this potential for disintegration is attenuated by the established practice of the British Treasury of consulting with devolved administrations on the Statement of Funding Policy. Moreover, the Treasury also commits to consult with these bodies on any proposed changes to the Statement (Keep, 2022, 12). The custom of consulting the devolved administrations increases the predictability of the system, facilitating the work of these governments in preparing their budgets. This cooperation is the result of the high degree of mutual trust that exists within the UK, and is not limited to devolution-related transfers but also encompasses other grants provided by the UK government not covered by the Barnett formula. These include welfare or public sector pensions, which are negotiated between London and the devolved administrations (Keep, 2022, 5–7).

The main forum for consultation and debate between the UK government and the devolved administrations in financial matters has traditionally been the Finance Ministers Quadrilateral, an intergovernmental forum where the Chief Secretary to the Treasury and devolved finance ministers meet to discuss the funding of devolution (Gallagher, 2012, 201). However, the quadrilateral suffered many of the common shortcomings of the weak system of intergovernmental relations in the United Kingdom; because of this lack of institutionalization the forum did not meet regularly, as it was subject to the political situation and will of the British government. Some of these flaws have been addressed during the revamping process that the British system of intergovernmental relations underwent (Anderson & Schnabel, 2022), with the creation of the Finance: Interministerial Standing Committee (F:ISC). The F:ISC should typically meet each quarter with the aim of considering the impact of economic and finance matters affecting the UK[10]. Although it is still too early to gauge its effects in practice, all indications are that the Treasury will maintain its lead role, consolidating the centralized nature of the management of devolution financing (McEwen, 2022) despite the

[10] See Terms of Reference for the Finance Interministerial Standing Committee paras. 2 and 6.

complaints from the devolved administrations—notably Scotland—about their demands to the Treasury falling on deaf ears.

A possible solution to this deficit in intergovernmental cooperation, as a 2009 report of the House Lords suggested, would be the creation of an arm-lengths agency following the Australian model (House of Lords, 2009, paras. 72–76). This independent body would be charged with the oversight and scrutiny of the decisions taken by the Treasury regarding the application of the Barnett formula, including whether certain spending programs result in "Barnett consequentials" for the devolved nations. However, despite the integrative potential that this solution would provide by eliminating a large part of the political component in these decisions, this is unlikely to happen in practice due to the reluctance within the UK government to relinquish control of the system. A more feasible option, according to the Institute for Government, would be tasking the National Audit Office or Office for Budget Responsibility with the duty to "report annually on how changes in the devolved budgets have been calculated, drawing particular attention to any subjective decisions about whether certain programmes should incur in "Barnett consequentials" or other disagreements about how the rules should be applied" (Paun et al., 2021, 38). However, no progress has been made so far in this regard, and it is unlikely in the near future.

Despite the weak and mostly informal nature of intergovernmental cooperation in the UK, there are signs of change in financial matters in the wake of the pandemic, with the number of meetings and the flow of information continuing to increase. Due to the health crisis, the devolved administrations demanded additional funding to implement their pandemic response packages without having to wait for the "Barnett consequentials" after the money was spent in England first. The main argument behind this claim was the lack of certainty over additional allocations that complicated the task of efficiently planning, as the British government was often uncertain how to proceed. In fact, some "Barnett consequentials" that were initially allocated were later subsequently withdrawn when the UK government decided to fund several programs by moving money within existing budgets, rather than using additional funding (Hudson, 2020). These sudden changes in the funding meant that some "Barnett consequentials" did not materialize and consequently the devolved administrations did not receive the expected funds. In fact, the Barnett formula only applies to increases or decreases in spending and not to redirections of funds as the total spending does not change. In

order to respond to the claims of the devolved nations, the Treasury came up with an innovative solution, an "unprecedented upfront guarantee" (HM Treasury, 2020). This decision was aimed at giving the devolved administrations certainty and financial flexibility for their budget planning by guaranteeing a minimum coronavirus-related funding to these administrations, regardless of the effective spending allocated by the British government in England (HM Treasury, 2020). Although this decision was an exception to the general rule, it is an example of the increasingly common cooperative initiatives in the British system thanks to the high levels of mutual trust, which work effectively to mitigate the disintegrative potential of a centralized system in which the Treasury is growing more sensitive to the demands of the nations.

Another element that deserves attention is the process of adjusting the block grant to reflect the devolution of new tax powers or welfare responsibilities, as it is one of the most complex and controversial aspects of managing the system. These block grant adjustments (BGA) are intended to ensure that neither the UK government nor the devolved administration is left worse off as a result of the devolution of fiscal powers (Keep, 2022, 21). For this purpose, the block grant is revised upwards in case of the transfer of powers over welfare (as this translates into greater spending requirements), or revised downwards in the event of the transfer of tax powers to adjust for the increased revenue raising powers of the devolved administration. In addition to these changes to the block grant in the base year, the BGA must be indexed in the subsequent years to account for factors such as economic growth or inflation to avoid imbalances that could hinder the financial situation of the UK government or the devolved administration. The methodology used to carry these technical adjustments is agreed upon between the UK executive and the corresponding nation in the so-called fiscal frameworks.[11]

The BGA has been particularly relevant to the Scottish case after the partial devolution of income tax in 2017, with some guarantees being introduced in the Fiscal Framework to ensure that the Scottish government's overall level of funding would be unaffected if Scotland's

[11] See the agreement between the Scottish government and the UK government on the Scottish government's fiscal framework, 25 February 2016 and the agreement between the Welsh government and the UK government on the Welsh government's fiscal framework.

population were to grow differently from the rest of the UK.[12] In the Fiscal Framework, the UK and Scottish governments agreed on a method for making the necessary adjustments for taxation and welfare to the block grant as a result of the devolution of powers on these matters. These negotiations are not often easy, given not only the technical complexity of the calculations, but also the significant political repercussions of the outcome. For this reason, the agreed methodology was only valid for a transitory period and was due to be reviewed by an independent commission following the UK and Scottish parliament elections in 2020 and 2021.[13] The results of this report will serve as basis for a joint agreement between the UK and Scottish governments,[14] with this being another example of devolved nations' participation in shaping financial relations with the UK government via intergovernmental negotiations.

Length of the Program

The Barnett formula was introduced in 1978 as an easy and straight forward solution to allocate spending among England and the other three nations. As Barnett himself admitted, he assumed that it would be temporary until a more sophisticated method could be devised (Barnett, 2000, 69). Nevertheless, its success has far exceeded the expectations of its creator—who has ended up repudiating the formula—and has remained in force to the present day with minimal modifications.

As a mechanism designed to allocate spending, the formula is not time-bound and therefore its validity should be understood as indefinite. In fact, it will theoretically continue in force even if convergence in spending per capita between England and the other nations were achieved. It is simply part of the Treasury's internal policy and thus it could be changed at any time without previous announcement or consultation with the devolved governments. Consequently, it is not possible to determine any positive or negative effects of Barnett's indefinite nature in relation to territorial integration. Thus, the formula is configured as a given, with all

[12] The agreement between the Scottish government and the UK government on the Scottish government's fiscal framework, 25 February 2016, paras. 17 and 19.

[13] Ibid, para. 22.

[14] Ibid, para. 23.

the governments involved assuming its long-term continuity since there are no political incentives for reform.

The absence of sunset clauses or formal obligations for review does not mean that the British system lacks periodic evaluation and assessment of how the funds are distributed. As stated earlier, this is done by HM Treasury in the Statement of Funding Policy, which is updated periodically during the spending reviews. Spending reviews are the processes by which the UK government divides the total spending between departments (Keep, 2022, 6). These reviews are usually done on a multiannual basis, without any established schedule. For instance, the review carried out in 2021 set the department budgets up to 2024/2025, and was the first multi-year spending review since 2015 (Harari et al., 2021, 4). Spending reviews have a decisive impact on the budgets of devolved administrations, as the Barnett formula takes the changes in the UK government department's spending to calculate the annual change in the devolved administrations' block grants. Thus, the timing of these is crucial because the decision made by the UK government directly affects the elaboration process of the budgets of the devolved administrations, which need to know the "Barnett consequentials" to set their spending limits.

The fact that spending reviews usually cover periods from two to four years is welcomed by the devolved administrations as it gives them some level of certainty with which to plan their spending in the medium term. However, despite the multiannual character of the spending reviews, it is not uncommon for the UK government to change the amount allocated to certain departments—known as departmental expenditure limits—at other fiscal events such as the annual budget or subsequent budget revisions. This leaves the devolved governments in a difficult position, as their budget planning is dependent on these changes which impact their overall spending envelope. Additionally, the lack of transparency by the UK government as to when these spending programs will be announced further complicates the budget planning of the devolved governments, because it is not possible to identify what "Barnett consequentials" will result from these announcements since Barnett calculations made internally by the Treasury are unlikely to see the light of day until the next UK budget (Hudson, 2020). For this reason, the devolved administrations usually need to postpone their budget until the UK government has set its own in order to be certain of the funding they will get from London for that fiscal year.

Dispute Resolution

Despite the Barnett formula being conceived as an easy and straightforward solution to allocate spending between England and the other three nations, this has not prevented conflicts from arising. There are two main sources of disputes in the UK system of devolved financing. The first comes from how certain spending decisions are territorially allocated by the Treasury as this allocation determines the application of Barnett. For instance, if a certain spending program is defined as "UK wide," it will not result in any "Barnett consequentials." If that spending is perceived by the devolved administrations as territorially concentrated in a particular area, it would most probably create discontent and, consequently, encourage disintegration. The same situation applies when certain spending decisions are defined as "related to England and Wales" when, in reality, all the spending will be carried in England as they concern a matter not devolved to Wales. The Welsh government views these situations as unfair, since that spending will result in "Barnett consequentials" for Scotland and Northern Ireland but not for Wales.

As a result, there have been disagreements about the way in which the Treasury interprets and operates the Barnett formula. In such cases, the Treasury outlines the procedure to be followed in the Statement of Funding Policy, committing itself to consider the issue and respond to the devolved administration in the event of a dispute over "whether it is believed the principles [outlined in the Statement] have been broken" (HM Treasury, 2021, 8). However, this consideration will be in a way that "mirrors the arrangements between HM Treasury and United Kingdom departments" (HM Treasury, 2021, 8), meaning that the Treasury will retain the final say—essentially acting as judge and jury. This is because, as the Treasury notes, funding policy and public expenditure allocation across the UK are non-devolved matters and remain the responsibility of the UK government (HM Treasury, 2021, 8).

Probably, the most notorious conflict was the one that arose following the Treasury's decision to classify all the spending for the London 2012 Olympic Games as UK-wide expenditure. This decision meant that the spending related to the Olympics—including that for regenerating and connecting East London—was outside of the scope of the Barnett formula and consequently would not result in any "Barnett consequentials." The devolved nations argued that this spending would have

resulted in "Barnett consequentials" if it had been carried out independently from the Olympics (Keep, 2022, 12) and decided to raise a formal dispute within the framework of the Memorandum of Understanding and Supplementary Agreements signed between the UK government, the Scottish Ministers, the Welsh Ministers, and the Northern Ireland Executive Committee in October 2013. The MoU created a Joint Ministerial Committee tasked with the job of considering disputes between the administrations if these could not be resolved bilaterally.[15] The process of settling intergovernmental disputes that cannot be resolved directly between the responsible department and its devolved counterpart involves a meeting of ministers from the different governments, which is chaired by a UK government minister from a non-involved department (Paun et al., 2021, 22). The devolved ministers can make their case with the possibility of asking for independent analysis to help find an acceptable middle ground.

After several meetings, the devolved administrations and the UK government reached an agreement to solve the dispute concerning the application of the Barnett formula to funds for regeneration and transport within the budget for the Olympics Games of 2012. The agreement provided the devolved administrations with "Barnett consequentials" worth 30.2 million pounds (16 for Scotland, 8.9 for Wales, and 5.4 for Northern Ireland) for the Olympics-related spending carried out after 2010 (Cabinet Office, 2011).

A complaint made in 2020 by the Welsh government about the Treasury's decision to classify the construction of a high-speed rail line as "expenditure in England and Wales" had a different outcome. Cardiff complained that this spending would result in "Barnett consequentials" for Scotland and Northern Ireland but not for Wales. Despite the joint designation, the line would not benefit Welsh citizens as it would lie entirely within England. However, the Treasury declined to change its policy, arguing that heavy railway infrastructure is not devolved to Wales and thus the spending could not be classified as strictly English. This decision infuriated the Welsh government, as it contrasted with a 2015 decision where a similar project was considered as spending in England only. These seemingly contradictory decisions reinforce Alan Trench's characterization of the Treasury's power over the block grant and formula

[15] Memorandum of Understanding and Supplementary Agreements, arts. 24 and 26.

system as arbitrary, because it "acts as both judge and jury in its own cause" (Trench, 2010).

A second source of disputes has recently surfaced in Scotland as a consequence of the devolution of tax powers over income taxation. These discrepancies are normally a result of the application of the fiscal framework. The dispute resolution mechanism embedded in the fiscal framework applies to the BGA, but not to other disputes arising from the interpretation made by the Treasury about whether certain spending decisions made by the UK government result in "Barnett consequentials." The framework envisions a first stage where differences can be settled at working level by the government officials.[16] If this proves impossible, concerns are escalated to the ministers who would then discuss the issue in a meeting. If the conflict persists, the disputed finance would be paused, meaning that no decisions or actions can be taken by either government in relation to the disputed amount until the dispute is resolved.[17] Both governments would then seek technical advice and use that input to solve the dispute.[18] If it is not possible to reach an agreement the dispute falls, and the fiscal transfer between governments would not take place—again reinforcing the Treasury's dominant position by compelling the Scottish government to accept a middle ground solution.[19]

If either government wishes to pursue the dispute further, it could be referred to the F:ISC as this body has replaced the "Protocol on the Resolution and Avoidance of Disputes" attached to the Memorandum of Understanding between the UK government and the devolved administrations. However, it is still too early to judge the effects of the new mechanism, since it has not yet been applied in practice.

At the theoretical level, along with the resolution of disputes through intergovernmental negotiations there is the option of launching a court challenge. However, it is very unlikely that disputes over the Barnett formula could lead to a challenge before the UK Supreme Court due to the formula's lack of legal entrenchment. It is doubtful that the UK Supreme Court would accept hearing a challenge on the application of the

[16] The agreement between the Scottish government and the UK government on the Scottish government's fiscal framework, 25 February 2016, para 99.

[17] Ibid, para 100.

[18] Ibid, para 102.

[19] Ibid, para 103.

formula referred by the devolved administrations, since the issue would not be enforceable as a matter of law. For these reasons, and despite the Court being considered as impartial—or even slightly pro-devolution during its short history—it is not surprising that no cases have been brought before the UKSC. This is also the general trend in similar models, such as Canada or Australia.

Although the British system has developed different dispute resolution mechanisms through intergovernmental cooperation, the integrative potential of these mechanisms depends on the Treasury's willingness to find a common ground solution. This is because the current dispute resolution mechanism allows the UK government to determine the outcome of disputes of which it is a party, and to do so without having to give a full account of its decisions such as whether a certain spending announcement produces extra funding for the devolved bodies (Paun et al., 2021, 38). The Treasury has demonstrated some sensitivity to the interests of devolved nations, as illustrated by the example of the Olympics. Similarly, intergovernmental cooperation within the fiscal framework has helped to resolve BGA disputes related to side effects of the UK government's decision to raise the personal allowance that would result in lower tax revenues for the Scottish government. If this cooperative trend continues, the disintegrative effects will be kept to a minimum, bringing the devolved nations closer to the center and allowing them to channel their demands. Nevertheless, there remains latent potential for disintegration subject to the political situation—because as the dispute over the high-speed train in Wales demonstrates, the Treasury retains the power of unilateral decision.

Concluding Remarks

The territorial question has been a recurring debate in the United Kingdom's history. Despite its traditional unitary character, the different nations that make up the UK have expressed, in different degrees, the desire for self-government throughout their history. Conflicts around the territorial distribution of financial resources predate devolution, with the first precedent—the Goshen formula—going back to 1888. Although initially designed as a temporary solution to allocate spending among the executive departments that ran the administrations of the three territories, the Barnett formula has continued in place, gaining extraordinary importance within devolution. The Barnett formula was conceived as an automatic mechanism that would avoid internal disputes between

government ministers over how changes in public expenditure should be allocated between England and the rest of the country. This would reinforce a sense of unity, solidarity, and equality among the nations, in line with the traditional unitary ideal of the United Kingdom. The lasting fortune of Barnett, despite its lack of legal entrenchment, lies in its simplicity and in a common understanding of the need to guarantee enough funding to the devolved administrations, as the contrary would provoke disintegrative trends—particularly in Scotland. Table 1 provides a graphic summary of the analysis carried on in this article.

The United Kingdom's territorial funding arrangement can overall be seen as a holding together tool as since its inception it has allowed for a greater level of public spending in Scotland, Wales, and Northern Ireland than that which would be justified by their population. Although per capita spending was intended to converge over time, the process has been much slower than expected—to the benefit of the devolved administrations, which have maintained higher levels of per capita spending than in England. Furthermore, it must be noted that the so-called "Barnett consequentials" translate into unconditional funding, over which the devolved administrations have full spending autonomy. Thus, the Barnett system allows room for the UK government to strengthen loyalties toward London, as shown by the different formula-bypasses carried out in recent years or the introduction of a funding floor in relation to Wales. The flexibility that Barnett entails has cultivated a sense of belonging to the common polity of the UK, at the expense of creating some resentment in England. This holds particularly true in Scotland, where the United Kingdom's government tries to display the overfunding of that territory as one of the benefits of the union that would vanish with secession, leaving Scotland in a precarious financial situation. Indeed, it is no surprise that the Scottish government has never been in favor of replacing the Barnett formula with a needs-based system, as this would lead to a reduction in Scotland's per capita funding.

The Barnett system also features some disintegrative trends in relation to the devolved nations, although these have had little effect in practice. The dreaded "Barnett squeeze" that could result in a reverse full equalization to the English average has not materialized in practice due to the different rates of population growth and the different formula-bypasses. The latter show the bargaining power that the devolved governments have, especially in the event of hung parliaments or weak executives. Surprisingly, the disintegrative potential of Barnett may be greater in

Table 1 Summary table

Component			*(Dis)Integrative potential**	*Factors to consider*
Legal entrenchment of the program	Absence of legal entrenchment: informal policy by the UK Treasury		Disintegrative ↓	Informal consultations with devolved administrations
Nature of the redistribution	Vertical from general revenue		Neutral/ Integrative ↑	Only positive if spending is increased
	Open-ended system		Integrative ↑	
	Integrated system: block grant performs revenue sharing		Integrative ↑	
Level and component of equalization	Full equalization for devolved services (in practice)	England	Disintegrative ↓	Regional differences across England are not addressed
		Devolved nations	Integrative ↑↑	Maintains higher levels of per capita spending than in England
	Reverse gross equalization (in theory)	England	Neutral	
		Devolved nations	Disintegrative ↓	Long-term Barnett squeeze effects
	Revenue on comparable devolved expenditure	England	Disintegrative ↓	
		Devolved nations	Integrative ↑↑	115% needs-factor floor for Wales
Conditionality	No		Integrative ↑↑↑	Funds can be spent on non-devolved matters
Institutional administering of the program	Central agency with increasing intergovernmental cooperation		Disintegrative ↓	High mutual trust and fluent cooperation
Length of the program	Indefinite: updated during the spending reviews		Neutral	Conceived as temporary but maintained for political reasons

(continued)

Table 1 (continued)

Component			*(Dis)Integrative potential**	*Factors to consider*
Dispute resolution	UK Supreme Court	Perceived as impartial and pro-devolution	Integrative ↑	Not used in practice to solve financial disputes
	Intergovernmental cooperation (Fiscal Framework and F:ISC)	Treasury maintains a privileged position	Disintegrative ↓/Integrative ↑	Depends on the Treasury's willingness to find a common ground solution

*The number of arrows (from 1 to 3) refers to the intensity of the (dis)integrative potential of each component
Source Compiled by the author

England's case than in the other three nations. Not only because it fails to address the different spending needs that exist among English regions, but also because it perpetuates higher levels of spending per capita in the devolved nations than in England. The fact that Scotland benefits the most has only increased discontent in some regions of England, where the threat of secession is perceived as a leverage wielded to maintain these higher levels of per capita spending.

The administering of the funding arrangement by the British Treasury is one of the most controversial elements of the system, as this body acts as judge and jury in case of any disputes. However, conflicts have been kept to a minimum thanks to a consolidated tradition of consulting with the devolved administrations on any issues related to the Statement of Funding Policy. Furthermore, cooperation has been recently strengthened with the creation of new intergovernmental bodies such as the F:ISC. The pandemic has proven to be a catalyst that has increased cooperation in financial matters with the creation of new mechanisms to guarantee the funding of the devolved administrations. Increased cooperation has also extended to the block grant adjustments that result from the further transfer of fiscal powers to Scotland, with its government effectively lobbying the UK government to avoid any potential negative effect to its public finances.

The success of the Barnett formula has far exceeded the initial expectations and has lost its temporary nature as a mechanism simply for

allocating funding among the nations. The gradual development of a system of territorial autonomy has underpinned the Barnett formula as one of the core elements of devolution, making financial relations a tool to accommodate diversity and hold the country together by guaranteeing a higher per capita level of spending in the devolved nations than within England, while also keeping conflicts over funding manageable. In any case, the system—beyond the particularities of the Westminster model—has room for improvement, especially with regard to the participation of devolved governments in the management of the system. The new UK system of intergovernmental relations is an opportunity to address these shortcomings, although it is still uncertain if the Treasury is willing to relinquish its privileged position and engage in a more cooperative approach with the devolved administrations.

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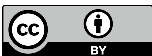

Diversity Accommodation and Fiscal Federalism: Comparative Remarks from a Constitutional Law Perspective

Alice Valdesalici and Francisco Javier Romero Caro

Introduction

The eight case studies of this edited volume connect two strands of federal studies, i.e., fiscal federalism and diversity accommodation, and are tasked with answering two closely interrelated questions. On the one hand, the different authors try to figure out if and to what extent the need to accommodate diversit(ies) has worked as a determinant of financial relations and their evolution, including a thorough investigation of which types of diversity are the drivers of this trajectory. On the other hand,

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Despite the common conception of the chapter, section 1 has been elaborated by Alice Valdesalici, section 2 by Francisco Javier Romero Caro, whereas the introduction and section 3 have been elaborated by the two authors together.

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they attempt to explain to what extent fiscal federalism has an overall positive and/or negative impact in accommodating diversities, thus resulting in institutional solutions with an integrative or disintegrative potential toward the federal system as a whole.

Put differently, the two questions should enable us to comprehend to what extent financial agreements and relations are successful in accommodating diversit(ies) and thus have an integrative potential, or vice versa, disregard existing diversities and end up exacerbating dormant tensions and triggering intergovernmental conflicts, thus manifesting a disintegrative potential.

This analysis starts from an observation of the different systems at stake from a constitutional law viewpoint, supplementing the analysis with an investigation of the practice and the role of politics in determining the overall equilibrium. The comparative observation of this type of examination brings out at least three critical points that deserve commentary, as each of them offers some insights drawn from the case studies investigated in this volume. These are: the cause-effect affair, the balance affair, and the participation affair.

First. The Cause-Effect Relation: A Complex Affair

The overall analysis rests on the assumption that synapses exist between these two domains of federal research, fiscal federalism and diversity accommodation, which could benefit from an integrated approach. Ultimately, an amplified view would allow us to approximate the causes of the investigated phenomena and appreciate the impact on its trajectories. However, isolating the different types of diversities and their precise impact on financial arrangements is not a simple and straightforward task.

Besides the multidimensional nature of diversity, which goes well beyond the differences that are traditionally placed under the magnifying glass, i.e., language, religion, ethnicity, or culture, the observation of the case studies brings out that the various differentiating factors frequently overlap or intersect one another and have a diversified spread across the territories that make up the federal system. These various circumstances

hinder the understanding of what factor is the cause of what institutional setting. Put simply, 'one argument can thus cause or hide another one'.[1]

A layering of diversities is, for instance, found in **Australia,** where the financial agreements are meant to cope with strong horizontal imbalances caused by ample territorial diversity among the six States and the two self-governing territories. Subnational governments differ widely in community size (costs associated with big cities and very small communities), population growth and composition, remoteness, Indigenous status, and economic strength (e.g., mining production, property sales, taxable payrolls, natural disasters, and employees).

As such, large discrepancies exist in fiscal capacity and service cost. This is well reflected in the wide scope of the equalization program and of federal transfers in general, which have been adopted to accommodate existing diversities. Moreover, these programs are channeled into the system through the strong de facto involvement of SNGs. Despite the central role the Commonwealth Grant Commission plays in the apportionment of resources in general and in equalization in particular, the Commission's role is complemented in practice by '*sophisticated institutional arrangements*', in which '*the States are complicit and adept at working the system to their advantage*'.[2]

Brazil is another interesting example in which territorial inequalities are rooted in strong socioeconomic inequalities, resulting from the concentration of industrial and economic activities in the South and Southeast of the Country, with the North and the Northeast being rural and underdeveloped. The Midwest experienced rapid growth and moved away from the group of the poor states to the group of the rich ones. The existing imbalances have been determinant in forging the design of fiscal federalism. However, the outcomes are not effective in coping with and reducing inequality to the extent that the persistence of this 'disease' is telling.

[1] Recalling Eva Maria Belser's remarks during the opening of the workshop 'Non-Renewable Natural Resources in Federal Political Systems' held at Eurac Research on July 8, 2023.

[2] Galligan, B. (2012). Fiscal Federalism: Then and Now. In G. Appleby, N. Aroney & T. John (Eds.), *Future of Australian Federalism: Comparative and Interdisciplinary Perspectives* (pp. 320–338). Cambridge University Press, p. 321.

In **Spain,** diversity comes from many different perspectives. The State of Autonomies combines de facto diversity, based on factors such as geography, climate, language, population, or income, with *de jure* asymmetries rooted in the Constitution. One of the most significant constitutionally enshrined asymmetries in Spain is the different tax regime that the Basque Country and Navarra enjoy as a legacy of their historical rights (*fueros*). The *foral* system is radically different to that of the common-system Autonomous Communities, being based on bilateral negotiations between these territories and the State. Although these regions run all the risks themselves with no revenue guarantees provided by the central government, the *foral* system, in practice, has resulted in a financially advantageous position for these territories.

Besides this set of diversity features that are pretty common to a wide range of countries and territories within them, certainly those analyzed in this book, there are also other differential factors related to cultural, religious, ethnic, and politics that affect overall fewer cases, and that can be either concentrated in an area or scattered across the country, depending on extra-legal factors of the case at stake or, in certain cases such as South Africa, on choices of constitutional design.

In South Africa, political, economic, linguistic, and geographic diversities have influenced fiscal federalism, as well as intergovernmental relations thereof. An attempt to give them accommodation is the provincial equitable share (PES), which is allocated to each of the nine provinces through a largely demographically driven formula. The structure and underlying variables of which are published each year by the SA National Treasury as part of the annual budget review documents. In particular, the variables on which the PES formula is based reflect the marked differences in the spatial distribution of economic activity and poverty across the nine provinces.

Within this scenario, **Canada** is the paradigm of a multinational federation. The need to ensure the coexistence of different peoples under a common system provides an additional element to the existing territorial complexity. Within it, an important variety of minority national communities is found (French Canada, English-speaking Canada, and Indigenous Canada, the latter including the First Nations[3]), each of them with its own internal specificities and, not surprisingly, a specific financial arrangement.

[3] Within this group there are indeed three distinct peoples: First Nations, the Inuit, and the Métis.

In fact, the different groups are granted four different models of fiscal federalism, which in theory should accommodate the existing diversities as well as their needs or interests: one agreement exists within the federal government and the provinces, another one within the former and the territories, a third one defines the relations between the federal government and the First Nations, and a fourth one concerns the Indigenous Peoples.

However, the extent to which diversities are accommodated is different among the groups, giving rise to *de jure* asymmetries on top of the *de facto* asymmetries. For instance, while provinces have access to several tax-bases and natural resources revenues, and are granted ample control over autonomous revenue sources, this is not the same for territories. For the latter, the majority of revenues are dependent (and thus controlled) by the federal government. Furthermore, the control over natural resources remains a debated issue, with different arrangements across the three territories. The situation is completely different for First Nations, which still lack appropriate funding mechanisms, despite some improvements that were theoretically expected with the changes to the Indian Act introduced from 1988 onward. Finally, the fourth model is still underdeveloped and markedly complex, especially because each Indigenous community is subject to diverse conditions, and at present, more than twenty-five arrangements have been reached with the different Indigenous governments.

India is another example of this kind. Cultural heterogeneity is commonly intertwined with a wide economic gap, in a combination that frequently gives rise to ethnic conflicts and, in certain cases, secessionist attempts (e.g., in Assam, Punjab, and Kashmir). Partly due to the possibility of comparing multiple examples within the same order, the Indian case is a good illustration to give evidence of the impossibility of clearly separating the impact caused by one factor compared to another. Conversely, it emerges that it is precisely the interplay between multiple factors (e.g., cultural and economic) that pave the way to centrifugal drives. At the same time, however, economic deprivation or (a perception of) injustices alone are not able to fire up separatist claims without the concurrency of a sense of separate identity from the rest of the population in a country.

This is clearly shown in both the Catalan and the Scottish cases, in which identity issues are coupled with a sense of unfairness concerning the received economic treatment.

Moreover, when it comes to Catalonia, the fact this is a rich territory further fuels the overall resentment, also because the costs of secession tend to be lower than for poorer entities. The overall result is that cultural claims frequently hide economic claims. For instance, the secessionist *procés* in Catalonia cannot be understood without the frustration caused by the great recession and its deep consequences in Spain, a situation that was taken advantage of by the Catalan government to ask for a new fiscal arrangement in a similar fashion to those of the Basque Country and Navarra. The rejection of this claim by the central government in 2012 was rapidly instrumentalized as a catalyst for Catalan independence, with the claim of unfair economic treatment being one of the main driving forces of the secessionist movement.

On the contrary, economic stability and remaining in the EU's common market were decisive factors for the rejection of the Scottish independence option in 2014. However, the **United Kingdom**'s exit from the European Union after the 2016 referendum, in which the majority of the Scottish population opted to remain, substantially changed the landscape, strengthening support for secession as Brexit is perceived to be a weakening force for the Scottish economy.

While it is undisputed that diversity as a conceptual category is a common feature of every federal system, it is tough to establish which differential factor was, and is, decisive with respect to a given (fiscal) federal equilibrium and its maintenance over time. In other words, it is difficult, if not impossible, to reconstruct whether and in what terms a specific differential factor rather than another was found to be determinant in favor of choosing one institutional solution over another, or of prompting its reform. The diversities that mark each federal system surely impact the overall balance between financial autonomy and solidarity, but it is not always easy or straightforward to assess the influence each one has exerted on such equilibrium and its change over time. Following the political debate before and after the conclusion of an agreement could facilitate the perception of the cause-effect relation. In fact, the arguments brought forward by the different entities as individuals or as a group promote an advancement in the understanding of the cause-effect nexus. Such an investigative approach must however be cautioned, as it can be misleading in some cases. There are in fact instances in which technical arguments conceal territorial interests that would benefit one unit over another. Put differently, the force of a technical argument can be used to mask political wills expressed by specific territorial interests.

Such an approach is a valuable tool for understanding if the necessary precautions are taken. The **Spanish case** is remarkable in this respect. In fact, the factors to which the population criteria should be adjusted to in order to share the resources of the Fund for the Guarantee of Fundamental Public Services have little to do with the economic rationale, but are rather the result of the political compromise, whereby an Autonomous Community ends up pushing for a certain correction because it goes to the benefit of its territory and not because it is more effective with respect to the goal pursued with the fund.

The same goes for equalization in **Australia.** Until the last reform adopted in 2018, the system was meant to provide a full equalization of existing disparities. Being a zero-sum game, it should come as no surprise that the richest States, such as Western Australia, tended to question the merits and effectiveness of the system, giving rise to political tensions both between the States as well as the States and the Commonwealth. With the 'Treasury Laws Amendment Act 2018' (Making Sure Every State and Territory Gets Their Fair Share of GST), the rules of the game have been changed to ensure—among other things—a gradual transition from full to 'reasonable' equalization. Such a result, combined with the role of intergovernmental institutions and agreements in managing the political dimension of fiscal federalism, supports the conclusion that this change is, with a good approximation, the result of an accommodation of diversity—in this case of economic nature.

Second. Financial Tools for Diversity Accommodation: the (Fair) Balance Affair

Each financial constitution is a balance between autonomy and solidarity. This is done through two main sets of instruments: i.e., fiscal autonomy and financial equalization. Meant in a broad sense, the first one includes all subnational revenues whose amount is linked to the principle of territoriality, and with respect to which entities eventually enjoy a degree of legislative and/or administrative autonomy. The second one includes all grants whose amount is not linked to the principle of territoriality, i.e., all resources that are not proportional to the fiscal capacity of the territory.

The combination of these two pillars is one of the key determinants of the overall federal equilibrium. The latter, however, is evidently changing not only between the single cases, but also within the same system: it transforms over time and space as legal or contextual factors transform

themselves. If the presence of a *quid* of differentiation constitutes an inherent component of any federal system, the extent to which subnational governments are vested with tax autonomy and the scope of the equalization mechanisms is central in determining the overall degree of differentiation allowed for a system at a given time.

The cases analyzed in the volume show a great variety in such balancing. Indeed, we find subnational governments enjoying extensive fiscal autonomy, such as the Canadian Provinces and the Spanish Autonomous Communities. In **Canada,** a multitude of financial arrangements do exist to address the diversities within the federation. Along with the federal government, the provinces have extensive tax autonomy. Also, in **Spain,** Autonomous Communities have substantial autonomy over taxes, but this does not entail a completely autonomous exercise of taxing powers and takes forms resembling those of a 'tax-base sharing'. Predominantly, the Autonomous Communities have a large tax-varying power over the so-called ceded taxes. These are established by the federal level, which can then opt for ceding to subnational governments a share of the yield together with certain legislative and administrative powers.

Apart from these two cases, however, the other systems explored in the volume record overall a strong centralization of the power to tax. This is the case in **Italy,** where both ordinary and special regions have little authority to tax, basically limited to a tax-varying power over the few devolved taxes. Similarly, the Constitution of **India** assigns most broad-based taxes to the center, including taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic liquors), and customs duty. In the **UK,** only Scotland is vested with the power to set a Scottish rate on income tax. For its part, in **Brazil**, subnational governments do not have full autonomy to apply their most important taxes, narrowing the scope of the states' tax base. In the same vein, taxation powers in **South Africa** are highly centralized because of historical reasons, with the African National Congress being reluctant to share the tax bases with the provinces.

In these systems, fiscal autonomy is basically reduced to the existence of tax-revenue sharing schemes, which can be based either on the principle of territoriality or on redistribution criteria. The latter typically combines equalization mechanisms with federal transfers of various kinds. It is not by chance that **Australia** has one of the strongest systems of fiscal equalization in the federal world, introduced and developed over time to cope with an ample vertical fiscal imbalance, coupled with a deep horizontal

imbalance. Also, **Canada** has a rather strong equalization scheme, but the latter coexists—as mentioned above—with a significant tax autonomy of provincial governments. Nevertheless, the latter has been mitigated over the years by the established practice of concluding 'tax rental agreements', which *de facto* shift certain decisions to the federal government, or at least limit the margins of allowable tax differentiation.

At the same time, the perception of fairness of a given balance changes over time as circumstances transform. The equilibrium between autonomy and solidarity components in financial relations has not only to be reached, but it has to be kept with continuing adaptions to the evolving context.

Such a conclusion brings out a paradox necessarily associated with any federal system of public finance. On the one hand, the very function of fiscal autonomy and financial equalization is to accommodate interterritorial diversities. On the other hand, the balance reached for the purpose of diversity accommodation inevitably gives rise to intergovernmental conflicts. Financial relations necessarily have an 'adversarial' nature, as diversities characterizing different entities will never find complete satisfaction within a given federal equilibrium.

This is not only due to the need to balance composite and often opposing interests and needs, but precisely because a certain degree of differentiation belongs to the essence of a federal system, without which federalism simply fails to exist. Aside from pitting the richer against the poorer entities, where the former typically want more fiscal autonomy and the latter more redistribution of resources, intergovernmental relations are further complicated when these differential factors are overlaid with other ones of a cultural and identitarian nature. In these cases, the dependence on resources from another level of government could have an assimilating, diversity-eroding impact. In contrast, in another system, such a financial setting could be perceived as granting an adequate financial endowment, i.e., a fair balance. This could occur through stringent conditions attached to the use of transfers. This is the case in **India** (e.g., Assam, Punjab, and Kashmir). The Union government does not ensure fiscal autonomy to regions with minority groups, especially where secessionist movements exist. Rather, these territories are kept in a position of strong financial dependence from the center, so that the costs of secession are high and the benefits of staying in the Union are very remunerative.

Albeit with notable differences, a similar dynamic occurs in the **United Kingdom**, where the devolved administrations are dependent on the

decisions made by the UK government in relation to England. In this regard, Scotland experiences an analogous pattern with, at least, the existence of a perception of such dependency, a factor that precisely played an influential role in supporting the secessionist claim. A similar perception can be found in **Spain**, where some Autonomous Communities believe the State does not leave them sufficient margin to exercise their financial (or tax) autonomy, damaging their growth potential by perpetuating a system with, what they understand to be, clearly centralizing features. Paradoxically, this view is not exclusive to those subnational governments where secessionist claims exist, as this vision of the model is also shared by the Autonomous Community of Madrid.

A somewhat similar situation is that of the **Italian** regions seeking the application of Article 116.3 of the Constitution, that is the constitutional provision that allows access to augmented autonomy under certain conditions. The pioneers of this new way of Italian regionalism are, not by chance, three of the richest regions, and where there exists even a weak identity factor, this has been exploited to try and push for the advancement along this institutional pathway. For instance, this is the case of the referendum held by the Veneto Region in 2017. It is of interest to emphasize that the questions that failed the judicial scrutiny of the constitutional court clearly exhibit an *extra ordinem* nature of the 'contestation'. Not only because of the request that the Veneto region may become an independent and sovereign republic, but also because of the other questions which show that the issue of 'adequate distribution of resources between regions' is anything but perceived as fair and accepted.

In practice, an adequate, i.e., fairly perceived and broadly accepted, compromise in this field is difficult to achieve. The paradox inherent to financial agreements, above illustrated, makes any reached balance temporary by nature, sooner or later giving rise to intergovernmental conflicts. At the same time, the comparative observation of the practice makes it emerge that fiscal federalism tends to be more effective in accommodating diversities if financial compensation is perceived as fair, and it is perceived as fair if the differentiated interests are channeled through the decision-making process.

Third. The Participation Affair

The success of financial agreements in governing these dynamics—balancing autonomy and solidarity, while guaranteeing a certain stability over time and keeping conflicts within the constitutional borders—varies from one case to another. Despite the ample variety of existing solutions, one element stands out from the rest. This is the degree of acceptance by subnational governments of the rules of the game. This circumstance has to do with the level of trust in the system, a factor that is strongly influenced by the effectiveness of subnational participation in decision-making over fiscal federalism.

A basic assumption in this respect is that diversit(ies) have an impact and are successfully accommodated, as long as subnational governments are given an effective voice in the decision-making process, and the related factors and interests are channeled through the political process, i.e., subnational governments participate in the making and the changing of decisions on fiscal federalism.

With respect to this element comparative analysis reveals a wide variety of architectural solutions and of the interests effectively represented by the different paradigms, as well as ample gradation of subnational government involvement. Moreover, at least in part, this is independent of the legal force accorded to such participation. In other words, while the mandatory and binding nature of the positions expressed by different levels of government (or individual entities) is a strong guarantee for subnational autonomy, even where such a position is not accorded legal force, the political nature often ends up playing a *de facto* binding role (e.g., in Spain). This is especially true where there is a lack of consensus on alternative solutions, and even in cases where the position is not unanimously accepted (e.g., Australia). If anything, those 'outside the choir' may, over time, catalyze the consensus needed to call the decision further into question.

The idea is that the financial dimension of federal systems has a strong impact on intergovernmental dynamics. Besides being a 'cause' of conflicts, fiscal federalism can be a tool of intergovernmental 'conflict management'. However, the extent to which a financial agreement is successful in this respect is influenced by the degree of acceptance of a given financial setting, a factor the latter that is very much linked to the degree of subnational government participation in financial-related

decisions and the extent to which the federal equilibrium reflects existing diversities and gives them all a fair (balanced) accommodation.

In this regard, a central role is played by the involvement of subnational governments in determining the rules and the limits of intergovernmental financial dynamics. When participation is effective, there is a concrete chance that the different interests are given a voice, and thus existing contestations tend to be placed within the constitutional borders. Put differently, contestations exist, but they do not challenge the existence of the financial arrangements or the unity of the Country.

A sort of equilibrium has been reached in **Australia.** There, financial equalization has been treated as a technical problem credited to the Commonwealth Grants Commission (CGC), an independent and statutory body beyond the political arena, vested with the task of advising the Commonwealth on the GST redistribution among States and Territories, and providing recommendations in accordance with the terms of reference of the Commonwealth Treasurer. However, the Commission's role is complemented in practice, to the extent that the financial rules of subnational financing are mostly the result of intergovernmental agreements reached among the executives of the two levels of government. Numerous forums exist for easing financial relations between the Commonwealth and the States, involving the respective executive at the different levels. At the peak there is the newly established National Cabinet, through which the Commonwealth and the States enter into agreements and make all political decisions related to financial relations.

The comprehensive intergovernmental process, overseen by the National Cabinet and operating across multiple hierarchical tiers, constitutes a substantial driver of "hyperexecutive federalism". While these accords primarily assume the form of "soft law," characterizing their provisions solely in political or moral terms oversimplifies their nature. Despite the theoretical possibility of parliamentary endorsement modifying agreements deemed "constitutionally unenforceable", empirical evidence suggests the stability of such agreements over time is due to their underpinning by robust political commitment. This entails that a broad consensus is necessitated for any alteration of the *status quo*.

Simultaneously, individual claims may encounter frustration; for instance, the Northern Territory lacks mechanisms to secure supplementary resources. In stark contrast, economically robust Western Australia has achieved notable success in advocating for a transition from full to partial equalization. This advocacy is rooted in the inefficiencies

engendered by the prior system. Wealthier entities have thus been able to recalibrate the system in their favor, demonstrating that economic prowess can function as a catalyst for transformative change. Divergent perspectives on the attributes and ambit of equalization periodically surface among the States, particularly during consultations conducted by the Commonwealth Grants Commission. These perspectives predominantly mirror the economic potency of the respective territory. Although some States have exhibited shifts or tempered their stances over time, the discourse primarily revolves around the impact of equalization on efficiency and incentivizing growth. Given the zero-sum nature of equalization in Australia, with the system designed to effectuate complete equalization of extant disparities, the wealthiest States, typified by Western Australia, often interrogate the efficacy and merits of the system. This dynamic begets political frictions between the States and, concurrently, between the States and the Commonwealth, which are channeled and accommodated through the multiple intergovernmental fora.

Conversely, inadequate or feeble participation more readily provides a fertile ground for the emergence of subversive modes of dissent from the established constitutional order. Thus, the ultimate outcome hinges significantly on the contours of decision-making processes, particularly the extent to which subnational governmental interests are piped through this process and act as determinants of its outcomes. The fact that **Canada** is a multinational federation adds complexity to this frame, as there exists a plurality of self-identified political communities, and the institutional design of the federation should ensure the empowerment of all of them in a satisfactory way. However, this is not the case in practice. The lack of involvement of the different provinces and territories in Canada opens the way for the federal government to use the transfers as a 'political weapon' to reward compliance with priorities set by the federal level. Formally speaking, the decision-making power over the different aspects of financial relations—except for the case a constitutional amendment is needed—is vested solely in the federal government, with changes being enacted as part of the federal budget, as they represent federal spending programs.

This is not the case for all financial agreements. In practice, provinces and territories are frequently represented through intergovernmental meetings, which—although informal in nature—ensure the participation of subnational governments in the negotiation process. Not surprisingly, provinces enjoy substantial independence from the federal government in terms of revenues. In comparison, for territories and Indigenous Peoples,

data shows a substantial reliance on federal transfers, and, in certain cases, 'chronic underfunding'.

In setting the balance between autonomy and solidarity, participation thus appears to play a key role. However, although provinces can influence the decision-making process, the fact that there is no legal obligation to do so makes it possible for the federal government to unilaterally alter the equalization compact, or extend it in its present form without any intervention from the former as it happened in 2018 and 2023.

With respect to this, the **Spanish** case is interesting, as it emphasizes such a trajectory further on. The Fiscal and Financial Policy Council (FFPC) functions as the pivotal body tasked with coordinating fiscal interactions between the central state and the Autonomous Communities (ACs). Comprising the National Minister of Finance along with the Finance Ministers of each Autonomous Community (augmented by the Finance Councilors of the Autonomous Cities of Ceuta and Melilla), this intergovernmental body assumes a key role in shaping the fiscal landscape. While the accords forged within the FFPC lack legally binding force, their practical political implications are substantial. Notably, these recommendations can be endorsed by a two-thirds majority in an initial vote, with a simple majority sufficing in a subsequent round. It is pertinent to underscore the voting mechanism, wherein the central government holds a position of privilege vis-à-vis the Autonomous Communities. Whereas each Community wields one vote, the central government commands a vote count equivalent to the aggregate of all Communities. This preeminence on the part of the central authority curtails the decision-making capacity of subnational governments, for in a subsequent vote, the central government can advance with the support of just a solitary Autonomous Community. This compression of subnational interests, in favor of federal interests, has, over time, propelled a shift toward bilateral relations, particularly in the context of more affluent entities. This evolution has been so pronounced that it necessitated intervention by the Constitutional Court to delineate the interplay between the principles of multilateralism and bilaterality.

This is quite evident if one looks at the functioning of the system, as this arrangement of powers also emerges in the legal framework, where instances are found in which the legislature provides for deviations from multilateralism, through the involvement of joint state-autonomous community commissions. In the regulatory framework, though, the contrast is only apparent. In fact, in the Spanish legal system, both

principles—multilateralism and bilateralism—come to legitimately shape intergovernmental financial relations. It could not be otherwise because both bilaterality and institutional asymmetry belong to the essence of the so-called 'dispositive principle'. However, for the coexistence of one and the other, compliance with certain rules is necessary, as illustrated by the Constitutional Court. In sum, the FFPC, as a multilateral forum, is assigned powers in relation to all those aspects of the financial activities of the Autonomous Communities and of the public finance system that—by nature—require coordinated implementation. As such, "the intervention of the Joint Commission can neither ignore nor circumvent this framework of interterritorial coordination and cooperation, but must necessarily respect it". The result is that the multilateral dimension must be integrated with the functions that are attributed to the Joint Commissions both by the Statutes and by the LOFCA itself, which as bilateral bodies are called upon "to give concrete application in each Community to the criteria agreed upon in the sense of the CPFF".[4] This is to say that bilateral agreements can be made, but they must be gentlemen's agreements. Otherwise, if decisions were made to depend on the will of one single entity, it would be like "granting an Autonomous Community a veto right over the powers of the State", thus nullifying its exclusive power on public finance and the powers granted to it in terms of coordination and solidarity.[5]

If this dynamic is brought back to the practice, the lesson to be learnt is that those diversified interests that are channeled through the decision-making process, and are thus given a chance to be discussed and represented in the institutional dimension, tend to have greater chances if not to determine the result of the negotiation process, at least to influence its trajectories.

Subnational participation remains rather low in **South Africa**. This is due to the absence of a clear commitment by the dominant party to a model of federal decentralization. The desirability of subnational structures is still debated, leading to unstructured cooperation in fiscal intergovernmental agreements. In fact, the provinces, a second level of government, have not been consolidated. Rather, they are experiencing

[4] Spanish Constitutional Court, judgement no. 13/2007 (LF 8).

[5] Spanish Constitutional Court, judgement no. 13/2007 (LF 9); and also, no. 31/2010 (LF 310).

a gradual process of hollowing out in which their functions are either transferred up to the central government or down to cities and municipalities. Advances in strengthening the position of the provinces in financial matters need to pass for a higher involvement in the decision-making process, primarily over the expenditure priorities and the allocation of funding. In **Brazil,** the dynamic is different, as it is the over representation of sparsely populated areas in both legislative chambers that has consolidated a model in which contrasting views on the fiscal structure and the distribution of transfers exist. The conjunction of interests of some of these states with the rich and densely populated states has resulted in the latter abusing the institutional system to prevent further redistribution. However, political fragmentation, together with institutional legacies and economic dynamics, is a potent obstacle to an institutional reform that would give the states a powerful voice in shaping future intergovernmental fiscal relations and transfers.

The nexus is clearly emphasized in **India**, providing a test case for confirmation of the so-called 'Twin Catalyst Thesis'. What is of interest here is the contribution that the Indian case offers about the role of the institutional dimension of fiscal federalism. In India, the thesis set forth is verified where two preconditions coexist: the presence of ethnically and economically marginalized minority groups, and the inability of intergovernmental institutions to provide an effective response to the needs emerging from them. Therefore, if the lack of adequate intergovernmental institutions has led to the substantial political disempowerment of subnational governments and has in many circumstances paved the way for secessionist movements, more generally the comparative perspective shows that the lack of institutions and rules ensuring the effective involvement of subnational governments impinge the degree of acceptance of the rules and practices of fiscal federalism, as such increasing the inherent instability of federal systems.

In this respect, the institutionalization of forms of contestation between the national and subnational governments can be effective in ensuring the constant maintenance of the constitutional order, while granting a (dynamic) equilibrium among the opposing forces. However, if the concept of 'contestatory federalism' is adapted to the nature and function of fiscal federalism, it emerges that contestations can both determine the maintenance and the evolution of a system, or its breach. The overall result very much depends on the tools the different levels of government can resort to contest the existing equilibrium and favor its change.

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