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# International perspective for a sound intergovernmental finance system in the Philippines

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This paper describes briefly the different forms of equalization, principally focusing on the distinction between revenue equalization versus cost equalization. In addition, some international country case studies from Australia, Canada, Germany, and Switzerland are presented. Based on these country cases, suggestions are made as to how the Philippines can avoid pitfalls in the area of fiscal federalism and what lessons it can learn from other countries for the next 20 years. This will enable readers to decide how common or unique the Philippine experience is, and what achievements and failures can be observed in the Philippines in comparison with other developing countries.

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***Keywords***: fiscal federalism, grants, fiscal autonomy, Australia, Canada, Germany, Switzerland, Philippines

## 1. Introduction

The decentralization of expenditure and public functions is only "one side of the coin" of fiscal federalism. Just as well it has to be settled how this delegation is financed and how independent the subnational and local

[1] The findings, interpretations, and conclusions expressed in this paper are entirely those of the author. They do not necessarily represent the view of the ILPF GmbH and the BITS GmbH.

authorities are in their provision of public goods and services. A reasonable intergovernmental finance system has to consider the following principles:[2]

- revenue autonomy, subsidiarity, and connectivity (*local accountability*)
- transparency of the tax system and direct impact of the tax burden (*benefit tax link*)
- reference to local circumstances and neutrality of the taxes with regard to the private sector
- tax bases, which are not affected by economic fluctuation and are also viable
- simplicity of tax system

At first glance, these five principles seem to be trying to "square the circle" and even at second glance, it has to be admitted that no federal or unitary country in the world has implemented a public finance system that fulfils these five principles completely. Various countries have chosen different ways to reach these goals and thus the conception of how to finance subnational and local services differs significantly. The respective advantage and disadvantages of each method can best be assessed in a general comparison.

The Anglo-Saxon countries like Canada, the United States, and the United Kingdom provide their local authorities with a very extensive system of property taxation. A local property tax has the advantage that a direct link between benefit and cost of the public goods can be established. This direct link between the preference of the citizens in local public goods and the policy makers, who have to provide the local public goods, cannot be created by grants or transfers. Besides a local property tax, a group of European countries—namely, Switzerland, Belgium, Croatia, and the Scandinavian countries—give significant tax autonomy to their local authorities and therefore a local surcharge on the personal income tax is common.

Furthermore, a third possibility to finance local authorities has been chosen by Austria, Germany, and Poland, which developed a local tax system with its own revenues as well as tax sharing. Nevertheless, vertical grants are also needed in the Anglo-Saxon, Scandinavian, and German models. Grants and transfers avoid external effects and spillovers; for example, a local jurisdiction benefits from the services of other local authorities without participating in the cost. This situation often exists in the relationship

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[2] For detailed description, see, for example, Spahn [1995] as well as Werner [2008a].

between a metropolitan city and its suburbs. A reasonable solution of this problem is the FOCJ (functional, overlapping, and competing jurisdiction) concept (see Frey and Eichenberger [1995]), but for developing countries like the Philippines the FOCJ concept is not realizable. Moreover, the school communities of the Swiss canton of Zurich and the North American special districts are the only successful examples of the FOCJ concept.

Sometimes a country restricts local accountability, because it substitutes local taxation for vertical grants. These negative scenarios can be found in the Netherlands, Wales, Ireland, and Scotland. In case local authorities cannot generate sufficient finances from taxes and grants, municipalities will use charges and fees to fill the financial gap. These developments occur not only in China (see World Bank [2002]) but also in a rich country such as Norway, where "since 1980 user charges have been the fastest growing revenue component of Norwegian local and county governments" [Borge 2000:703].

## 2. Revenue or cost equalization for the Philippines?

An equalization system can be mainly based on revenue equalization or cost equalization. Well-known examples of revenue equalization are the Canadian equalization system between the provinces (see Boadway [2004]; Bird and Vaillancourt, [2007]) and German equalization between the Länder (Werner [2003]; Spahn and Werner [2007]; Werner [2008b, 2008c]). In contrast, Australia and Scandinavian countries such as Denmark or Sweden (see Werner and Shah [2005]) base their respective equalization systems on the concept of cost equalization. In the following paragraphs the different ideas of revenue and cost equalization are explained and illustrated by the examples of Germany and Switzerland.

Germany is a federal state with a three-level administrative structure. In addition to the federal government, whose ministries are based both in Germany's capital, Berlin, and in Germany's former capital, Bonn, there are 16 federal states (*Bundesländer*) and 12,007 municipalities.

In Germany, tax revenues are distributed among the individual regional administrative bodies both according to own assigned revenues and revenue sharing. This, for example, means that the tax receipts from the real property tax are available to the municipalities in full, while they also receive a fixed percentage of the tax receipts from the value-added tax (VAT) and the personal income tax (PIT). The distribution of the most important tax revenues is shown in Table 1.

**Table 1. Tax revenue assignments between the central government, the federal states, and the municipalities in 2010**

| | Central government | Federal states | Communities | Revenues |
|---|---|---|---|---|
| Consumption tax[3] | 100% | | | €81.713 billion |
| Inheritance tax | | 100% | | €3.763 billion |
| Property tax | | | 100% | €11.197 billion |
| Personal income tax | 42.5% | 42.5% | 15% | €172.064 billion |
| Value-added tax | 51.4% | 46.4% | 2.2% | €180.041 billion |
| Corporate income tax | 50% | 50% | | €12.041 billion |
| Interest rebate | 44% | 44% | 12% | €8.709 billion |
| Trade tax[4] | 14.8% | 7.7% | 77.5% | €34.500 billion |

Source: Author.

Germany's fiscal equalization among the federal states is based on article 107 of the German constitution and consists of several levels. Generally, the horizontal fiscal equalization among the federal states can be classified as

- the distribution of corporation tax and personal income tax
- the distribution of value-added tax
- fiscal equalization among the federal states (narrow definition)
- and the allocation of additional funds by the central government[5]

Generally, the fiscal authorities in the respective federal states are entitled to receive, in full, the tax revenues from the state's own taxes and a share of both the income tax and the value-added tax, according to the principle that taxes are collected in the place where they were generated.

When apportioning the corporation tax, the principle of the business location of the trade tax applies, while the apportioning of the personal income tax between the federal states is based on the principle of the taxpayer's place of residence.

The law of segmentation and the principle of the taxpayer's place of residence have the following impact on the companies and the local tax

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[3] Tax on mineral oil, electricity, tobacco, spirits, coffee, and sparkling wine.

[4] The breakdown refers to the 2001 tax year. The municipal share of the "German Unity" fund and the municipal share of the reformed fiscal equalization system were added to the central government.

[5] To facilitate the description as a whole, the new regulations in the "Solidarity Pact II" are not mentioned, such as, for example, the so-called premium model, which was introduced from 2005 onward.

offices.The companies and firms have to pay the wage tax of their employees to their local tax office.The local tax office has to transfer the wage tax of the employees if they live in another state.This situation is quite usual in Germany because a huge number of employees commute from the suburbs to city center—especially at the city-states of Hamburg and Bremen—or drive a long distance to their place of work—for example, from the eastern state of Thuringia to the western state of Hesse. Table 2 shows that this "clearing effect"[6] has an enormous impact on the city-states of Hamburg and Bremen as well as on the state of Hesse in fiscal year 2003.

**Table 2. Effect of place of residence on the wage tax for 16 states in fiscal year 2003**

| | Population | Balance at the wage tax due to the law of segmentation | |
|---|---|---|---|
| | in Mio | Amount in € Mio | Portion of the wage tax |
| States with a negative balance at the wage tax segmentation | -- | -- | -- |
| North Rhine-Westphalia | 18,073 | - 1,973 | -4.3% |
| Baden-Wuerttemberg | 10,680 | -1,199 | -4.7% |
| Hesse | 6,089 | -1,505 | -8.6% |
| (Hanseatic city) Hamburg | 1,732 | -2,446 | -34.5% |
| (Hanseatic city) Bremen | 0,663 | -0,352 | -22.3% |
| States with a positive balance at the wage tax segmentation | -- | -- | -- |
| Bavaria | 12,397 | 57 | 0.2% |
| Lower Saxony | 7,989 | 1,811 | 14.8% |
| Rhineland-Palatinate | 4,056 | 1,448 | 23.5% |
| Schleswig-Holstein | 2,817 | 1,093 | 28.8% |
| Saarland | 1,063 | 32 | 1.8% |
| Berlin | 3,391 | 147 | 2.5% |
| Saxony | 4,334 | 708 | 18.7% |
| Saxony-Anhalt | 2,536 | 563 | 28.3% |
| Thuringia | 2,383 | 512 | 25.2% |
| Brandenburg | 2,576 | 738 | 31.6% |
| Mecklenburg-Western Pomerania | 1,738 | 365 | 26.6% |
| Total | 82,518 | 7,474 | 4,6% |

Source: Kitterer and Heilmann [2005:18].

[6] To lower the administration costs, there exists a distribution key for this process in Germany, which is recalculated every three years.

This principle of apportioning the taxes is also applied when determining the percentage that the federal states receive of the value-added tax. Article 107, section 1, clause 4, of Germany's constitution stipulates that at least 75 percent of the generated VAT to which the federal states are entitled has to be distributed among the federal states according to the number of their inhabitants.The remaining 25 percent is distributed as an additional percentage to the financially weak states. Particularly because of Germany's reunification and the resulting incorporation of the new federal states into the Federal Republic of Germany, this financial redistribution has gained enormous significance. Figure 1 serves to better illustrate the instrument of VAT redistribution and its effect in fiscal year 2004.[7]

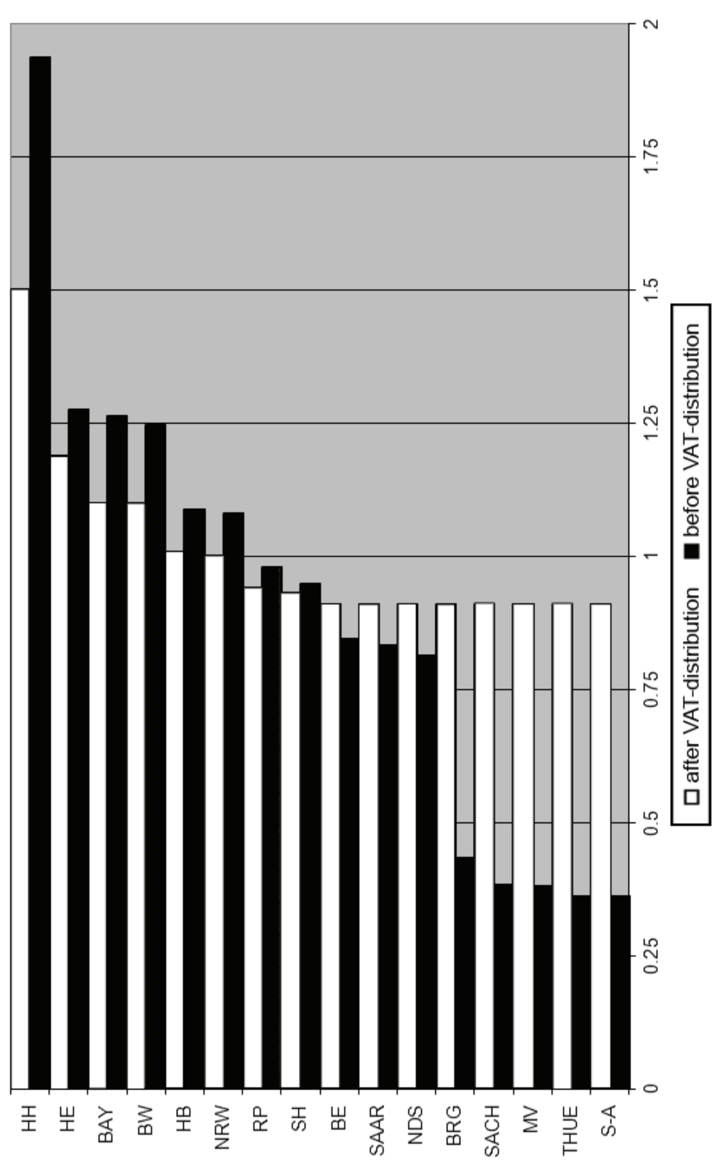
It is clearly recognizable that already by redistributing the VAT, the new and financially weaker German states have come very close to reaching the average level of financial strength of the federal states.

Under the narrow definition of the fiscal equalization system among the federal states, there are direct horizontal transfer payments between the federal states. The legal basis of these transfer payments is section 4 of the fiscal equalization law (*Finanzausgleichsgesetz*).

So as to determine the financial strength of every single federal state, one has to calculate the financial strength indicator in the fiscal equalization system. This figure is composed of a state-specific total sum of state taxes as well as 50 percent of the municipal taxes. The federal states of Bremen, Hamburg, Lower Saxony, and Mecklenburg-West Pomerania are allowed to reduce their financial strength indicator on account of seaport charges, but the coastal state of Schleswig-Holstein is exempted from this regulation. All in all, this reduction due to port charges amounting to a yearly total of about EUR 150 million

Under the fiscal equalization system, the financial requirements of each state are determined on the basis of an equalization indicator, which is calculated by multiplying the number of inhabitants of that state by the average nationwide per-capita figure of the state and municipal tax revenues. While state tax revenues are considered completely, the municipal taxes are only taken into account at 50 percent of this collection. Moreover, the inhabitant numbers of the city-states of Hamburg, Bremen, and Berlin have been "readjusted"—that is, their inhabitant numbers have been multiplied by the factor 1.35. This "adjustment" is very controversial in

[7] Each of the 16 federal states has an abbreviation, which is explained in the appendix.




Source: Author's calculations.

**Figure 1. Effect of the redistribution of the remaining percentage of VAT in 2004**

Germany (see Baretti et al. [2001:16-18]; Hickel [2001:4]). Besides, there are additional allowances of 6 percent when calculating the financial requirements for densely populated regions for the noncity-states [Andel 1998:524].

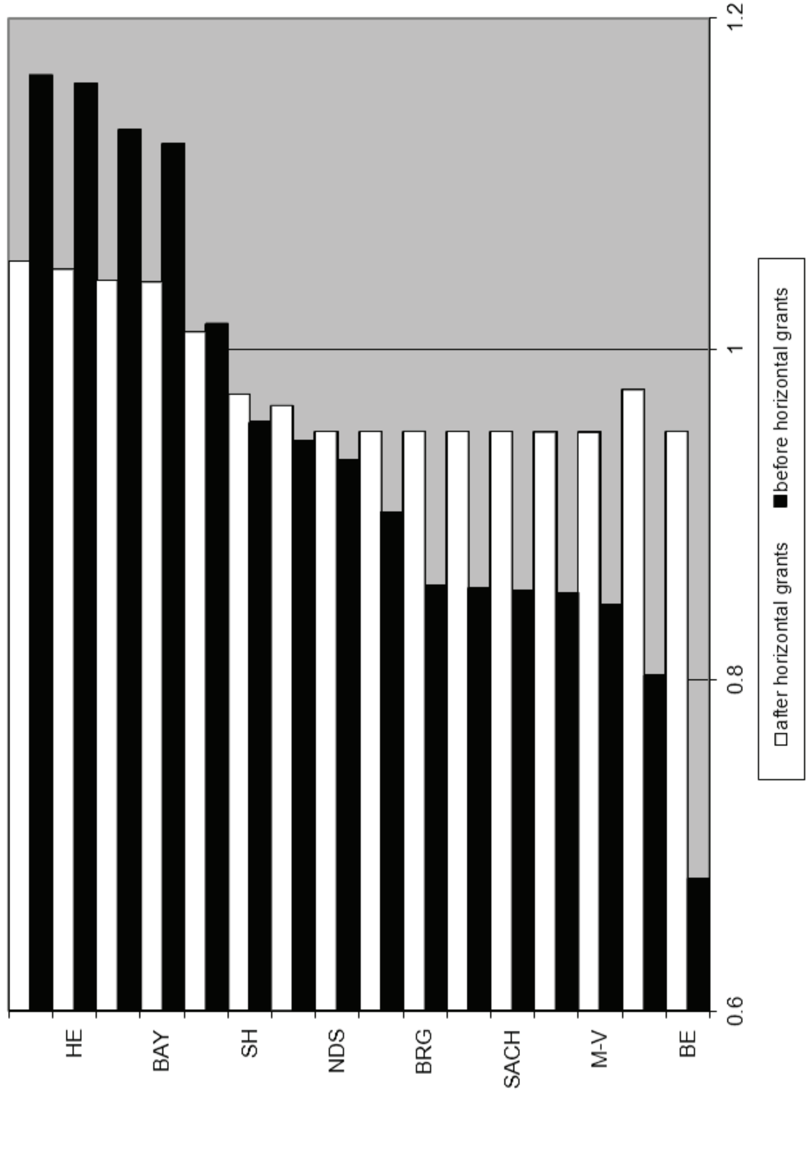
If the financial requirements of a federal state are higher than its financial strength, this state will receive equalization funds from the financially stronger states, whose financial strength is higher than their requirements. By means of these equalization funds, the "recipient states" among Germany's federal states are able to increase their financial strength to at least 95 percent of nationwide financial strength. At the same time, the financial strength of the "donor states" must not fall below 100 percent of the average nationwide financial strength. Figure 2 outlines the effect of the horizontal fiscal equalization among Germany's federal states in 2004.

On account of the additional funds allocated by the central government, there are vertical grants from the federal government to the federal states. In 2001, the equalization volume of the central government's additional funds amounted to about EUR 12.6 billion in total.

Regarding the central government's allocation of additional funds, a distinction can be made between the allocation of deficit-coverage funds and special requirement funds.[8] The deficit-coverage funds enable the financially weak "recipient states" to reach 99.5 percent of the average financial strength of the federal states. The allocation of special requirement funds means that for particular reasons, some federal states receive additional funds from the federal budget. Thus, for example, about €0.75 billion a year flows to all those federal states with less than four million inhabitants in order to compensate for the disproportionately high political and administrative costs. The Hanseatic city of Hamburg does not benefit from this regulation. In addition, there are special allocations of funds for budgetary crises (Bremen and Saarland), for the abolition of special charges relating to Germany's division (Berlin and all new federal states) as well as for the integration of the new federal states into the fiscal equalization system (Bremen, Saarland, Rhineland-Palatinate, Lower Saxony, and Schleswig-Holstein). Figure 3 illustrates the effect of the vertical grants in 2004.

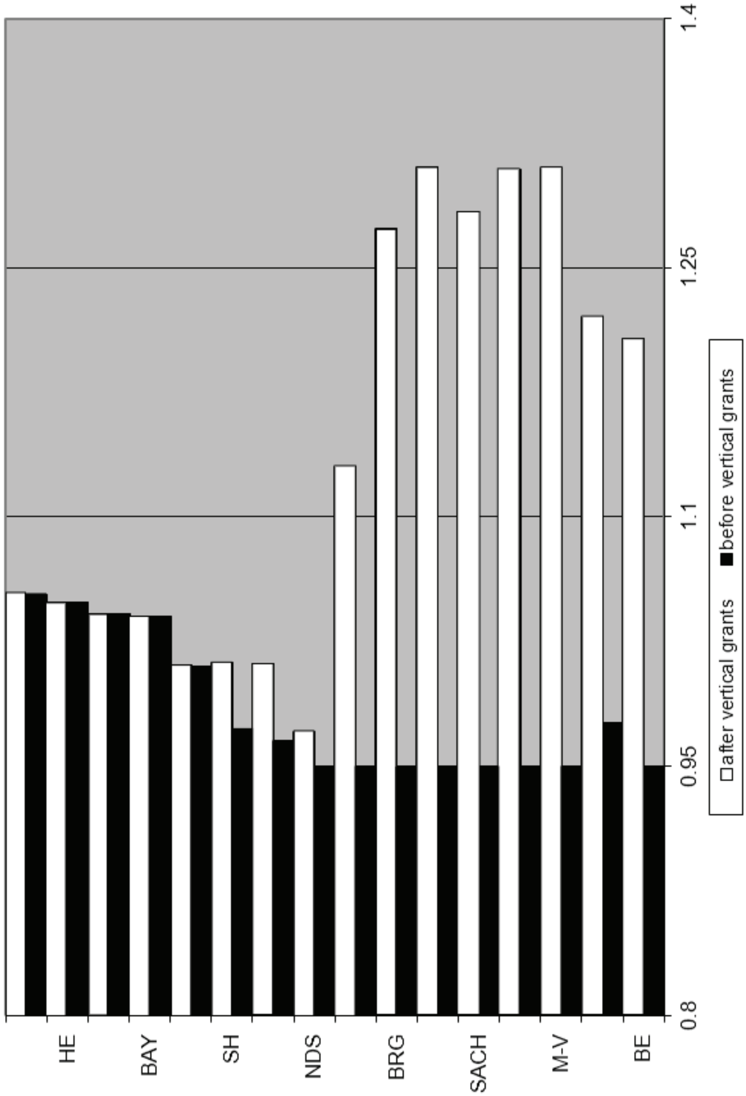
The fiscal equalization system in its current form is a highly contentious issue. The federal states of Baden-Württemberg, Bavaria, and Hesse have filed successful lawsuits at Germany's constitutional court in Karlsruhe.

[8] A detailed description of the vertical funds and their criteria is located in the appendix.




Source: Author's own calculations.

**Figure 2. Effect of the horizontal fiscal equalization as a percent of mean financial strength among Germany's federal states in 2004**




Source: Author's calculation.

**Figure 3. Effect of the vertical allocation of funds on the federal states in 2004**

For this reason, a reform of the fiscal equalization system had to take place before the end of 2002, as otherwise the way it is currently practiced would have been unconstitutional from 2003 onward and thus would have lacked legal legitimacy. On 23 June 2001, the federal states and the central government agreed on a reform of the fiscal equalization system, which comes into force from 2005 onward and will last until 2019.

With Germany's Solidarity Pact II and the corresponding changes to the law, numerous interconnected elements of Germany's fiscal federalism have been reformed. All in all, the following areas have been affected by the changes to the law:

- the allocation of the respective VAT share to the federal states
- fiscal equalization among the federal states (narrow definition)
- the allocation of additional funds by the central government
- the "German Unity" fund

From 2005 onward, when allocating each federal state a share of the VAT, the current system of a replenishment rate of 100 percent will be replaced by a relative replenishment system. By changing this rate, a higher VAT volume altogether will be distributed, and more financially weak states will reap the financial benefits of the remaining share of the VAT.

In the horizontal fiscal equalization among the federal states, some parameters of the assessment basis will be newly defined. As a result, from 2005 onward the coastal states of Hamburg, Mecklenburg-West Pomerania, Bremen, and Lower Saxony will no longer be able to claim port charges as a factor in reducing their tax strength. At the same time, the central government will allocate vertical grants of about EUR 35 million per year in financial compensation to the affected states.

The readjustment of inhabitants in the three city-states of Hamburg, Bremen, and Berlin by a factor of 1.35 will persist; however, from 2005 onward, thinly populated states[9] will also be taken into account when assessing municipal taxes. At the same time, the current municipal assessment of inhabitants, which was graded according to the size of the municipality and the density of its inhabitants, will be scrapped.

[9] The federal state of Mecklenburg-West Pomerania is taken into account with the factor 1.05, the state of Brandenburg is given the factor 1.05, and Saxony-Anhalt is allowed to multiply its municipal tax requirements by 1.02.

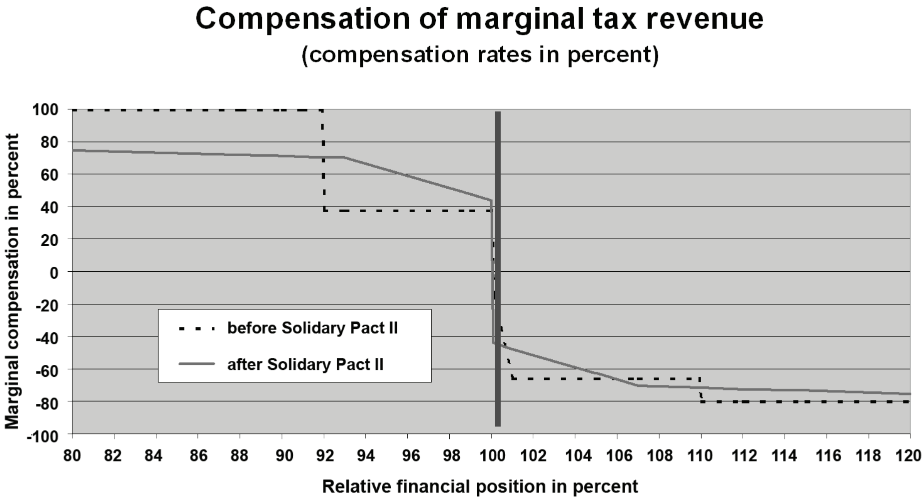
When assessing the real tax strength of the municipalities in the individual states, which until 2005 had been determined on the basis of uniform assessment rates regarding the trade tax and the real property tax, these fictitious assessment rates will no longer be applied under Germany's Solidarity Pact II.

Another aspect to consider in the horizontal equalization is the increase from 50 percent to 64 percent when taking into account the revenues from the municipality tax. This step allows for a stronger consideration of the financial strength of the municipalities and hence takes more into account the fact that in financially strong states, there are usually also financially strong municipalities. From a financial viewpoint, it would be right to take into account 100 percent of the municipal taxes (see SVR [2001:5]); however, a reduction of 36 percent as an exemption has been stipulated in the law on measures (*Maßstäbegesetz*).

The increase from 50 percent to 64 percent constitutes the biggest change within the horizontal fiscal equalization. Yet the preference given to federal states with financially strong municipalities, which was inherent in the previous system, has only been reduced and not completely abolished.

A so-called premium model will be introduced from 2005 onward, which is meant to provide positive incentives both to the donor states and the recipient states under the fiscal equalization system. By disregarding a flat percentage of 12 percent of above-average tax receipts and below-average tax shortfalls, the respective federal states are to be rewarded for positive developments regarding their tax revenues.

The rates governing the horizontal equalization figures among the federal states have also been modified, and from 2005 onward there will be a change from the graduated tariff to a steady and linear tariff with considerably lower siphoning-off rates as far as the donor states are concerned. Consequently, the donor states no longer have to expect a siphoning-off rate of up to 80 percent, but only a rate of 75 percent at the most. Figure 4 deals with the marginal rates of compensation before the framework of Solidarity Pact II (continuous line) and from 2005 onward (broken line).




Source: Spahn and Werner [2007:103].

**Figure 4. Marginal rates of compensation before and after the Solidarity Pact II**

There are also a number of new regulations concerning the vertical allocation of additional funds from the central government. For example, the vertical allocation of additional funds from the central government of EUR 770 million in total per year, which go toward the costs of political administration and are paid to the thinly populated states, will be lowered to EUR 520 million annually from 2005 onward. Besides, in addition to the nine federal states, which already receive this money, the federal state of Saxony will also receive these vertically allocated funds from 2005 onward.

The vertical grants for budgetary crises, which the federal states of Bremen and Saarland receive, as well as the central government funds for the integration of the new federal states into the fiscal equalization system, which the federal states of Bremen, Saarland, Rhineland-Palatinate, Lower Saxony, and Schleswig-Holstein receive will last be granted in 2004 and discontinued in 2005 onward.

The allocation of central government funds for the burden placed on the states by the division of Germany, which the East German states receive, will be set at €10.5 billion in 2005 and will gradually be reduced over the period of the Solidarity Pact II to €2 billion annually in 2019.[10]

The tariffs relating to the deficit-coverage funds allocated by the central government have also been reviewed and will provide positive incentives,

[10] A detailed apportionment is located in the appendix.

due to their lower replenishment level combined with an increased number of federal states entitled to receive these funds.

In addition to the above-mentioned new regulations, Germany's central government will also take over all annual debt repayments of the "German Unity" fund, thus relieving the West German states of this burden.

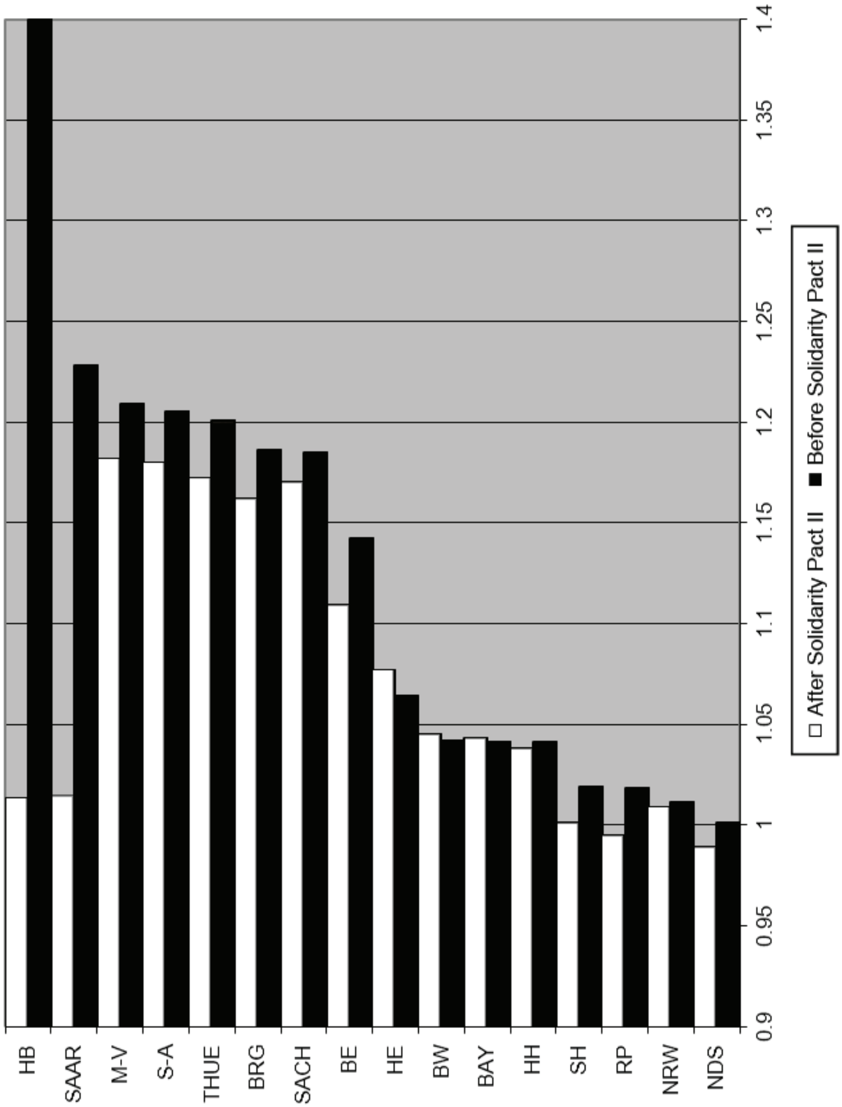
All in all, the new regulations mentioned above constitute an additional financial burden on the central government, and for this reason the central government and the federal states have agreed on a yearly compensation of about EUR 1.32 billion to be paid to the central government from the VAT revenues.

Figure 5 illustrates both the impact of the horizontal as well as the vertical equalization among the federal states up to 2005 (before the Solidarity Pact II) and from 2005 onward (after the Solidarity Pact II) and is based on the tax receipts of 2001. It is easy to see that particularly the removal of the vertical allocation of funds for budgetary crises to Bremen and Saarland, and the first-time consideration of Saxony as a recipient of vertical funds toward the costs of its political administration have an enormous effect.

The lesson the Philippines can learn from the German experience is that a high equalization volume can lead to an "equalization overdose". Basically, in Germany neither the donor states nor the recipient states within the equalization system have a high incentive to attract additional tax revenues. The German equalization systems punish every extra tax administration effort of the states due to extreme high siphon-off rates. For this reason, some the states have decided to thin out their tax administration. As matter of course, they do not confirm this behavior officially and the states' finance ministers react mostly quite nervously on this "political minefield".[11] For this reason, a principle of solidarity without any competitive element within the equalization system can provoke a situation in which the subnational entities in the Philippines have fewer incentives to mobilize resources.

In Switzerland all three tiers of government can levy their tax rates independently on the direct taxes, but since 2001 the tax base of the direct taxes and the tax year have been completely harmonized. Therefore the tax "jungle" [Duss and Bird 1979:62] has now dwindled a bit, but it has not yet been fully cut back especially regarding the PIT and the wealth tax.

[11] In the appendix is a table that points out the different "audit probability" in German states for the years 1997 and 1999. The "audit probability" in this table is measured as the number of tax clerks per 1,000 taxpayers.




Source: Werner [2003:92].

**Figure 5. Effects of the Solidarity Pact II, based on the tax revenues of 2001**

On the other hand, all revenues from indirect taxes like the VAT or all excises belong to the central government, and only a small tax sharing between the central government and cantons exists for the stamp taxes and the withholding taxes.[12]

In the context of the educational cost in Switzerland, a very smart solution for the financing of the universities exists. In Switzerland, 12 universities exist and two of these—the Swiss Federal Institutes of Technology (Eidgenössische Technische Hochschule, ETH) in Lausanne and Zurich—are institutions of the central government. The remaining ten universities are located in ten cantons; therefore, 16 of 26 Swiss cantons do not have to finance a university directly. However, it happens very often in Switzerland that a student has his residence in one canton but he attends the university of a neighboring canton. This situation can be used as a classical example of spillovers, and a possible solution could be the concept of functional, overlapping, and competing jurisdictions (FOCJ) developed by Frey and Eichenberger [1995].

Nevertheless, the cantons do not use the FOCJ concept to solve this problem, but the canton where a university is placed receives funds from the other cantons where the commuting students have their residence. The calculation of the funds is very detailed, which means that the different costs a university incurred for a faculty as well as the respective duration of every student have to be borne in mind for the calculation.

The total expenditure cost of 12 universities amounted to €6.611 billion in 2010, while over 20 percent originated at the ETH Zurich and 50 percent was generated by the ETH Zurich, the University of Zurich, and the University of Geneva. Moreover, the impact of the intercantonal university equalization differs from university to university and has its highest influence at the University of Freiburg and the University of Luzern.[13] A detailed overview of the financial structure of the 12 universities can be observed in Figure 6.

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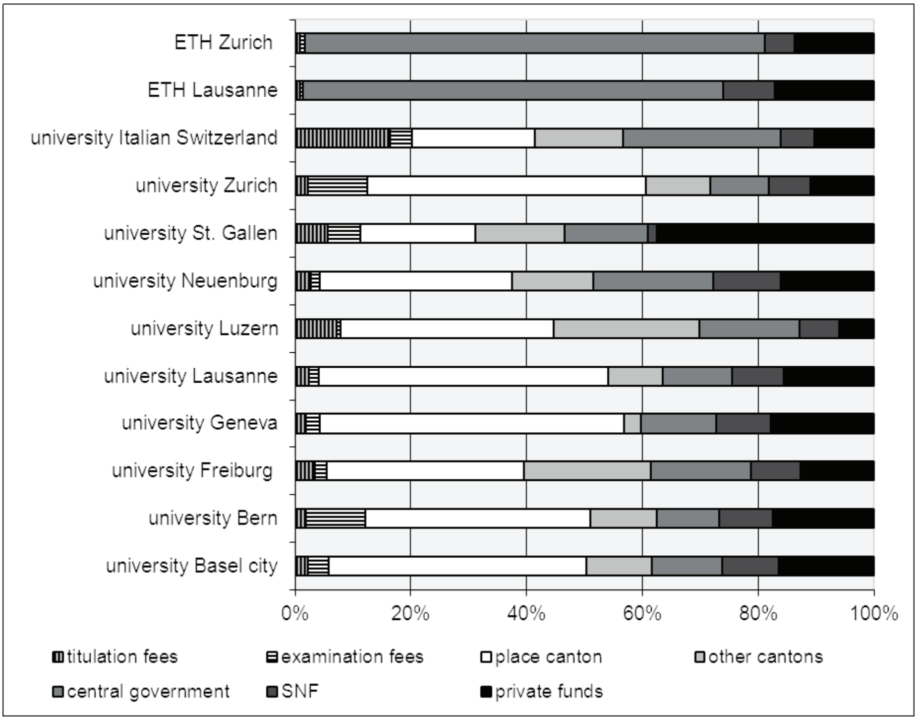
[12] The new Section 132 of the Swiss constitution introduces a tax sharing at the withholding tax, in which the cantons are receiving 10 percent of the whole tax yield (5 percent based on the population number and 5 percent for equalization purpose between the cantons). Moreover, Switzerland has recently approved a new intercantonal fiscal equalization system (Neuer Finanzausgleich, NFA), and this equalization system will be fully implemented in 2008 (see Schaltegger and Frey [2003] as well as Dafflon [2004]).

[13] In 2004, the impact of the intercantonal university equalization had it highest influence at the University of Basle City and the University of Italian Switzerland (see Werner [2009a, 2009c]).




Source: Author's calculation based on various data from Statistik Schweiz.

**Figure 6. Financing structure of the 12 Swiss universities in 2010**

While the German system mainly equalizes revenue disparities between the Länder, the Swiss university education equalization system considers the different expenditure needs of each canton.

The advantages of an equalization system, which is based on revenue equalization, is that it is easier to administer and more transparent. However, revenue equalization systems are generally unable to consider spillover. For this reason revenue equalization should be used solely for regions or provinces, while a local equalization system should be based on cost equalization.[14]

However, if the Philippines want to revise its intergovernmental system, or more especially the national internal revenue allotments (IRA), a formula-based system with a fixed sunset clause should be given preference over ad hoc decisions.

[14] A general description of a local equalization system based on revenues and local needs (see Werner [2006]).

In terms of accountability, unconditional block grants make more sense than earmarked grants. If, on the other hand, the central government of the Philippines wants to ensure national minimum standards of public goods, earmarked grants are preferable. The distinction between unconditional block grants and earmarked grants automatically becomes a political hot potato, because the national Ministry of Finance or rather the central government loses power to the subnational entities if the equalization system is formula-based and mainly unconditional.

Furthermore, matching grants to local and regional authorities can lead to the desired investment decision and at the same time give central government the ability to render subnational governments politically docile.

Both the standard opinion in public finance literature and the suggestion put forward by the donor community toward developing countries is that performance-oriented grants are an innovative instrument for a transfer system and may lead to results-based accountability in the subnational units. However, the author would adamantly reject such an instrument for the Philippines because a huge amount of data has to be checked and controlled for such a performance-oriented grant system. Certainly, one good feature of the Philippine intergovernmental system is that the distribution of the vertical grant system in the Philippines is mainly based on population and size only. Even if area size and the "amazing population increase" in some parts of the Philippines occasionally create some tension between the central Ministry of Finance and the subnational entities, such an indicator system is definitely more transparent than the number of enrolled schools. Moreover, designing the assessment methodology for such a system—the indicators and the scoring system—is quite tricky, and the majority of such ivory-tower ideas come to grief as soon as they try to define the indicators of poverty reduction.

A huge negative effect of the Philippine grant system, or rather IRA, which was mentioned by Prof. Dr. Benjamin E. Diokno, is the rapid conversion of municipalities into cities or changing political subdivisions. From the international perspective, one suggestion for mitigating this conflict could be to use the German "readjusted" system of population numbers instead of a fixed distribution ratio between provinces, cities, municipalities, and barangays. Consequently, 57 percent of 40 percent of all internal taxes that belongs to the cities and municipalities should be divided purely on the basis of population numbers, but the population of local units with more than 100,000 inhabitants have a higher per capita value than a local unit with fewer than 50,000 residents.

## 3. Pros and cons of independent grant commissions for the Philippines

The institutional arrangements and the responsibility for fiscal transfer and their respective equalization differ between the countries and can be classified as follows:[15]

- central government agency ("It's sink or swim.")
  - Ministry of Finance as in Poland, France,[16] Italy, and China
- national legislature ("A cobbler should stick to his last.")
  - The Brazilian constitution has fixed the Senate of Brazil
- intergovernmental forum ("Avoid a toothless paper tiger.")
  - Canada and Indonesia and, with some minor flaws, Germany and Montenegro
- independent agency / grant commission ("political outsourcing")
  - Australia, India, South Africa, and Uganda

In the following paragraphs the different concepts of an independent agency and an intergovernmental forum are explained using the examples of Australia and Canada.

Australia has a strong, vertical fiscal imbalance in favor of the central government. It corrects this imbalance by using asymmetric vertical grants (based on the goods and services tax) with an implicit equalizing effect. The Australian Commonwealth Grants Commission (CGC), set up in 1933, advises the central government and the Australian states. As an advisory body, the CGC is asked to calculate appropriate ratios of per capita grants for the distribution of general revenue assistance from the Australian government to the states and territories. The central government as well as states and territories accept the suggested distribution of the grants to the states, even though, de jure, the right to make the final decision belongs to Commonwealth Minister for Finance and Administration.

The Australian system of fiscal equalization is one of or even the most complex and thorough of all federations worldwide. Australia has put in place an explicit and ambitious equalization scheme that aims at full, standardized budget equalization. In establishing a point of reference for such a scheme, Australia attempts to evaluate not only the standardized

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[15] This classification has benefited from discussions with Anwar Shah (see Shah [2005] as well as Shah [2007]) and Paul Bernd Spahn.

[16] See Werner [2011].

taxing capacity of its states but also the standardized expenditures adjusted for needs and cost differentials among jurisdictions.

This all-embracing approach to equalization in Australia is often criticized for its complexity and lack of transparency. Even the CGC itself observes that "the simplification of methods should be a priority going forward" (see CGC [2004:84]).

The Canadian equalization system is embedded in a heterogeneity of different forms of cultural heritage with the major French-speaking province of Quebec, the bilingual-mixed province of New Brunswick, and the eight English-speaking Anglo-Saxon Provinces. On the one hand, Canada has one of the highest forms of subnational tax sovereignty in the world,[17] but on the other hand, the economically weak provinces, which are mostly located on the Atlantic Ocean coastline, are heavily influenced by the vertical equalization grants of the central government in Ottawa.

The Canadian transfer system consists of three[18] pillars:

1. Canada Health Transfer (CHT), with a volume of CAD 25.4 billion in 2010-2011
2. Canada Social Transfer (CST), with a volume of CAD 11.2 billion in 2010-2011
3. Canadian equalization system

The CHT and CST are funded by the central government, which transfers 13.5 percentage points of its personal income tax and 1 percentage point of its corporate income tax to the provinces and territories. CHT and CST are earmarked for health and education expenditures of the provinces. The distribution factor is generally the population of a province.

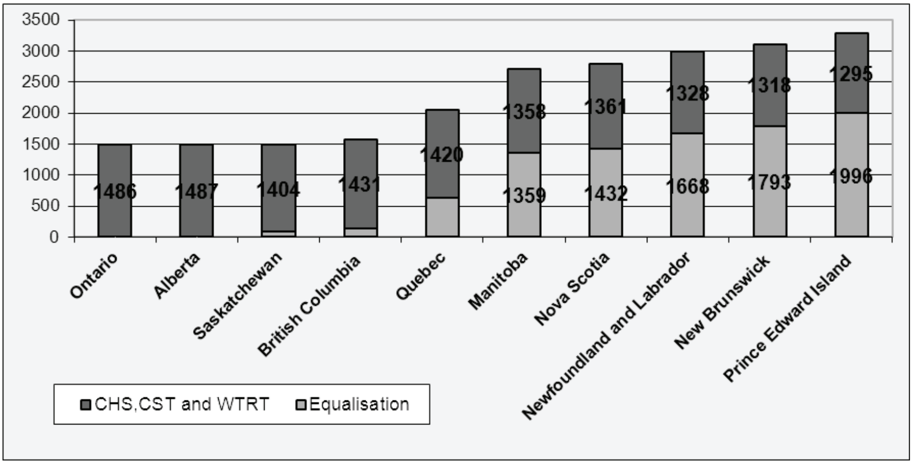
The Canadian equalization system (3) is based on the fiscal capacity of every province. Fiscal capacity is measured using 33 provincial tax bases.

The calculation of the tax base uses nationwide average tax rates. Until 2007, the standard Canadian measures used the average fiscal capacity of the five "middle-income" provinces. Following the 2007 changes, however, the national standard is now based on the average incomes of all ten provinces.

[17] See Hayashi and Boadway [2001]; Esteller-Moré and Solé-Ollé [2002].

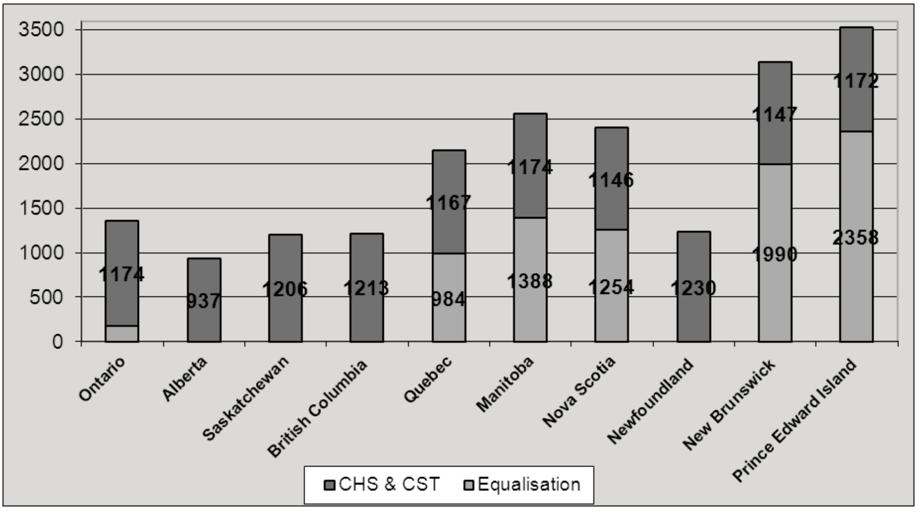
[18] Before, the Canadian transfer system consisted of four pillars: the Canadian Health Transfer (CHT), the Canadian Social Transfer (CST), the Territorial Formula Financing (TFF), and the Canadian equalization. Moreover, the Health Reform Transfer was used for some fiscal years; therefore, five pillars of the Canadian transfer system are sometimes mentioned.

Figure 7 demonstrates the fiscal impact of all four pillars in fiscal year 2005-2006, while Figure 8 highlights the effect of the transfer system in Canadian dollar per capita in fiscal year 2011-2012.




Source: Werner, Guihéry, and Djukic [2006].

**Figure 7. Transfer from the Canadian central government to the provinces in fiscal year 2005-2006 (measured in CAD per capita)**




Source: Author

**Figure 8. The effect of the transfer system in CAD per capita in fiscal year 2011-2012**

With clear transparency and low administration cost, the Canadian system has similar advantages as the German equalization system, compared to their counterparts in other federal or unitary countries. In contrast to the German equalization system, the Canadian equalization allows the reflection of different subnational tax rates.

Legal responsibility for the Canadian equalization system falls within the scope of the federal government, which proposes the volume and the formula, and the national parliament, which finally approves the proposal of the central government. However, the central government and the provinces cultivate intergovernmental discussion through the Fiscal Arrangements Committee. The provinces and the central government consequently share information, consider technical issues involved in the equalization process, and discuss problems with less political rivalry.

The level of the marginal rates of compensation, the equalization model, and the institutional arrangements for intergovernmental fiscal transfers are always the subject of a fundamental political decision, which could be a hard row to hoe if we consider the lengthy political reform discussions in Germany and Switzerland, for example. The only way of avoiding this political "hot potato" is to delegate the whole equalization measurement to an independent Council of Economic Experts such as the Australian Commonwealth Grant Commission. On the other hand, however, such "political outsourcing" always leads to a lack of democratic control and boosts the complexity of the system because bureaucratic experts have to consider other principles than those of an elected representative.

For the Philippines, the Australian model with an independent grant commission does not make sense because, on the one hand, so-called independent commissions are never independent and, on the other hand, even the supporters of this idea are still not able to explain how the selection process of the members of such a committee could fail to be influenced by political pork barreling.

## 4. Conclusion

The reasons for fiscal equalization are manifold and are influenced by political and economic views. Fiscal equalization can be used to solve or ease fiscal conflicts between the different tiers of government. However, if the political stakeholders do not possess a common interest such as the continuance of a country and would prefer to see the secession of a region, even a well-designed equalization system would not be able to prevent such a situation. The case of Bosnia and Herzegovina is quite unique (see Werner, Guihéry, and Djukic [2006]) because, on the one hand, the respective ethnic groups in this country use the distribution of tax revenues to heat up national tension and, on the other hand, the international community is working to avert a separation through external political pressure as well as an internal control institution called the Office of the High Representative (OHR).

In some countries like Spain, fiscal conflicts are the result of an unfulfilled wish for independence by the regions, and if one erroneous trend in the intergovernmental system is rectified, the political leaders of the Autonomous Communities bring up another painful subject instead of considering their huge autonomy and the successful development of Spanish democracy over the last decades.[19]

Another dimension of fiscal conflicts is natural resources; therefore, Spahn's [2007:197] suggestion that "such conflicts are best avoided a priori through a clear tax and revenue assignments rules" is more than reasonable.

An additional aspect of fiscal equalization is the fact that it can raise serious problems for central budget stability if the topic of the bailout problem is underestimated. Besides the famous bailout by the United States for New York City in December 1975 or the debt behavior of the Argentine provinces during the currency board period (un peso = un dollar), there are various other examples where subnational bailouts have a huge effect for the whole country, such as the regional health insurance system of

[19] The 17 Spanish regions, called Autonomous Communities, can be characterized as two different groups. The two Autonomous Communities of Navarre and the Basque county possess a special status called "foral" and therefore their independence from the central government in Madrid was extremely high—for example, they had their own tax administration and a huge tax sovereignty, which was quite similar to that of an independent state. The residual 15 regions, which are called regions of the common rights (Comunidades Autónomas de Régimen Común) can influence their tax revenues from the personal income tax by different tax rates or by the arrangement of the tax exemptions (see Werner [2009b]). This concept is not similar to the Nordic local surcharges on the personal income tax, where the municipalities add a proportional surcharge to the national tax rate. The Spanish concept could be compared more with the Swiss solution, where cantons and municipalities can levy their own tax rates and tax exemption for every citizen and only the taxable income is fixed by national laws. If a region uses the same tax rates and exemptions like the central government, the region will receive 33 percent of the total personal income tax, which is paid by their respective citizens. A huge difference between Switzerland and Spain is that in Spain an upper and lower limit exists for the tax rate.

the southern part of Italy or the two small federal states of Saarland and Bremen. Fortunately, the Philippine debt level is not comparable to that of Greece or California, but a sound debt management is one of the most neglected components of public finance management in every country around the world.

Sometimes fiscal conflicts are brought to an end by external shocks, as in Indonesia. Since the central government of Indonesia mandates funds to the regions destroyed by the tsunami, the wish for independence in the region of Aceh has decreased enormously.

However, the question as to whether fiscal equalization or fiscal conflicts came first cannot be clearly answered. Rather, every federal and unitary country has to design its own junction between solidarity and subsidiarity.

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# Appendices

**Table A1. Abbreviations of the German federal states**

| | German | English |
|---|---|---|
| S-A | Sachsen-Anhalt | Saxony-Anhalt |
| MV | Mecklenburg-Vorpommern | Mecklenburg-Western Pomerania |
| THUE | Thüringen | Thuringia |
| SACH | Sachsen | Saxony |
| BRG | Brandenburg | Brandenburg |
| SAAR | Saarland | Saarland |
| NDS | Niedersachsen | Lower Saxony |
| RP | Rheinland-Pfalz | Rhineland-Palatinate |
| SH | Schleswig-Holdstein | Schleswig-Holstein |
| NRW | Nordrhein-Westfalen | North Rhine-Westphalia |
| BW | Baden-Württemberg | Baden-Wuerttemberg |
| BAY | Bayern | Bavaria |
| HE | Hessen | Hesse |
| BE | Berlin | Berlin |
| HH | (Hansestadt) Hamburg | (Hanseatic city) Hamburg |
| HB | (Hansestadt) Bremen | (Hanseatic city) Bremen |

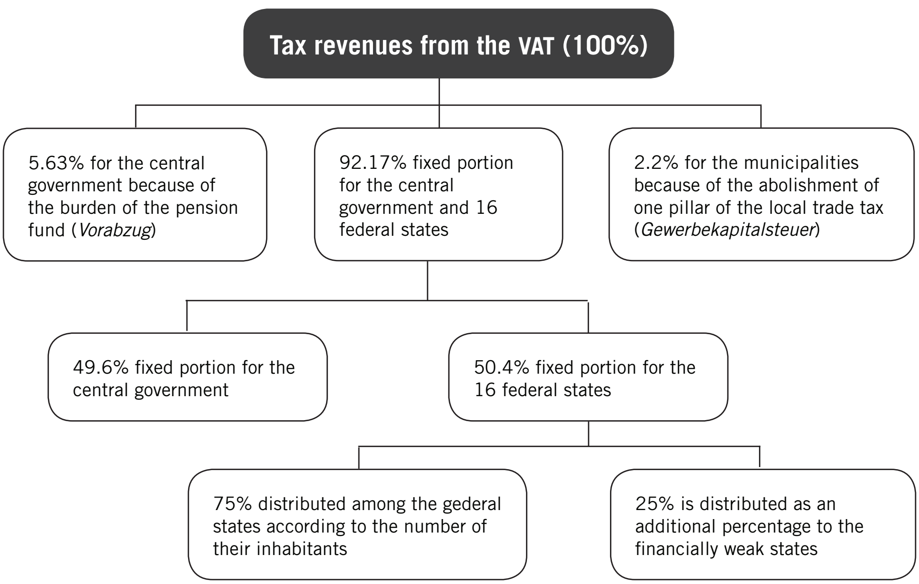


**Figure A1. The VAT-distribution between the central government, the 16 states, and the municipalities in fiscal year 2004**

**Table A2. Types and criteria of the different vertical grants from central government toward the states in fiscal year 2004**

| Type | Criteria | Volume in € Mio. | Recipient states |
|---|---|---|---|
| Deficit-coverage funds (*Fehlbetragsbundes-ergänzungszuweisung*) | Enable the financially weak "recipient states" to reach 99.5 percent of the average financial strength of the federal states | 3.040 | Saxony-Anhalt, Thuringia, Saxony, Brandenburg, Mecklenburg-Western Pomerania, Lower Saxony, Saarland, Rhineland-Palatinate, Schleswig-Holstein, Berlin, Bremen |
| Special requirement funds for political administration costs (*Sonderbedarfszuweisungen für überdurchschnittliche Kosten der politischen Führung)* | States with less than four million inhabitants | 790 | Saxony-Anhalt, Thuringia, Brandenburg, Mecklenburg-Western Pomerania, Saarland, Rhineland-Palatinate, Schleswig-Holstein, Berlin, Bremen, but not Hamburg |
| Special requirement funds for the burden by the division of Germany (*Sonderbedarfsbundes-ergänzungszuweisungen aufgrund teilungsbedingter Sonderlasten*) | All states that were newly formed by the German reunification | 10.530 | Saxony-Anhalt, Thuringia, Saxony, Brandenburg, Mecklenburg-Western Pomerania, Berlin |
| Special requirement funds for the integration of the new federal states into the fiscal equalization system (*Überganszuweisungen aufgrund der Integration der neuen Bundesländer in den Länderfinanzausgleich und den daraus resultierenden Belastungen für finanzschwache westdeutsche Flächenbundesländer*) | All western states that received relatively lower transfers from the donor states due to the integration of the eastern states into the fiscal equalization system | 69 | Lower Saxony, Saarland, Rhineland-Palatinate, Schleswig-Holstein, Bremen |
| Special requirement funds for budget crisis | High ratio of the debt revenue ratio | 614 | Bremen, Saarland |
| Total | --- | 15.043 | --- |

**Table A3. Development of vertical grants for the states burden by the division of Germany until fiscal year 2020**

| Year | Amount |
|---|---|
| 2005 | €10.53 billion |
| 2006 | €10.48 billion |
| 2007 | €10.38 billion |
| 2008 | €10.23 billion |
| 2009 | €9.51 billion |
| 2010 | €8.74 billion |
| 2011 | €8.03 billion |
| 2012 | €7.26 billion |
| 2013 | €6.54 billion |
| 2014 | €5.78 billion |
| 2015 | €5.06 billion |
| 2016 | €4.29 billion |
| 2017 | €3.58 billion |
| 2018 | €2.81 billion |
| 2019 | €2.10 billion |
| 2020 | €0.00 billion |

**Table A4. Audit probability in German states for the years 1997 and 1999**

| | 1997 | 1999 |
|---|---|---|
| NRW | 4.71255 | 4.4731515 |
| BAY | 3.85792 | 3.7885001 |
| BW | 4.39388 | 4.1519066 |
| NDS | 4.37292 | 4.4472924 |
| HE | 4.73701 | 4.6529072 |
| SACH | 4.89705 | 4.8849013 |
| RP | 4.81786 | 4.7529658 |
| S-A | 5.41163 | 5.2080417 |
| SH | 4.27887 | 4.2064463 |
| THUE | 5.0373 | 4.8945202 |
| BRG | 5.27095 | 4.8932231 |
| M-V | 5.71429 | 5.4771242 |
| SAAR | 4.8601 | 4.7840633 |
| BE | 8.27718 | 8.5805896 |
| HH | 7.09002 | 6.7643208 |
| HB | 7.31852 | 6.4148148 |

Source:Torgler and Werner [2005:87].