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9

The Legal Architecture of Intergovernmental Transfers: A Comparative Examination

SUJIT CHOUDHRY AND BENJAMIN PERRIN

An enormous body of literature exists on intergovernmental transfers between central governments and federal subunits. This work focuses almost exclusively on the economic justifications for such transfers, their design, and the challenges they pose to democratic accountability, transparency, and the autonomy of federal subunits. The legal dimension of intergovernmental transfers has received comparatively little scholarly attention. This oversight may be deliberate, as it has been argued that "in the end intergovernmental transfers are the *instruments*, not the *determinants* of public policy" (Bird and Tarasov 2002, p. 23, emphasis in original).

Legal frameworks cannot be entirely neutral. Systems of intergovernmental transfers are constituted and governed by domestic constitutional law, intergovernmental agreements, and legislation. One cannot fully appreciate how these systems operate without studying the legal instruments through which intergovernmental transfers are provided as well as their interpretation and enforcement by the courts. Each legal framework involves crucial design choices that determine which level of government makes the rules governing intergovernmental transfers, who may modify those rules and under what conditions, and who resolves intergovernmental conflicts when they arise. Every design choice reflects policy preferences in favor of centralization versus decentralization, political decision making versus adjudication, fiscal autonomy versus fiscal restraint, and acceptance of economic disparity versus insistence on fiscal solidarity. Policy preferences are thus embedded in the legal structure of every intergovernmental transfer system.

This chapter examines the legal architecture of intergovernmental transfers through a series of case studies. The first section draws on the Canadian experience. It briefly reviews the political economy of intergovernmental transfers in federations. While both equity and efficiency concerns argue in favor of intergovernmental transfers, the Canadian experience illustrates how these transfers may pose challenges to democratic accountability, transparency, and the autonomy of federal subunits. A series of general design features are examined in order to assess and compare the legal arrangements of this aspect of fiscal federalism. The second section uses these design features to explore case studies of Belgium, Germany, India, and South Africa. The last section draws some tentative conclusions from the case studies about the impact of legal design on the legitimacy, effectiveness, and stability of systems of intergovernmental transfers.

Law and the Political Economy of Fiscal Federalism

The political economy of fiscal federalism illustrates the importance of the legal design of intergovernmental transfers. The principal economic argument for decentralized decision making (including federalism) is that it produces a better fit between citizens' preferences and public policies than would be the case in a unitary state, for two reasons (Tiebout 1956). First, the existence of federal arrangements allows a territorially concentrated minority to become a local majority, allowing it to vote for policies that would not win majorities at the national level. Second, through migration citizens presumably sort themselves into provincial populations that are much more homogeneous than the national population as a whole.

By contrast, unitary states are less sensitive to different preferences for publicly provided goods and services, which are averaged out by the national majority. Though these preferences may vary over time, unitary states are more likely to provide a single package, which citizens cannot opt out of (except through emigration). But as Boadway (2001) argues, intergovernmental fiscal transfers are necessary to ensure that the benefits of decentralization do not come at the expense of overarching objectives such as efficiency and equity.[1] Intergovernmental transfers help offset inefficient fiscally induced migration driven by differences in fiscal capacity across federal subunits. From the vantage point of equity, intergovernmental transfers guard against redistributive races to the bottom and promote horizontal equity by providing federal subunits of varying fiscal capacities with the ability to provide comparable levels of public services at comparable levels of taxation. Indeed, in Canada the importance of promoting horizontal equity is signaled by its inclusion in the constitution as a principle to which the federal government is committed, through the mechanism of equalization payments.

These standard arguments in favor of intergovernmental transfers have been widely discussed in academic and policy circles for more than 50 years. It is therefore of interest that they have generated a host of normative criticisms, which have been framed as a combination of arguments from federalism and democratic accountability (Petter 1989). To a considerable extent, these criticisms have been driven by the use of conditional grants by the federal government to ensure provincial compliance with national standards for health care and (earlier) social assistance (although there is some dispute as to whether these national standards are sufficiently detailed to qualify as conditions).

In Canada these debates over intergovernmental transfers have often involved legal arguments. Some political actors have challenged the constitutionality of transfers and conditional payments. Others have advanced a vast array of policy proposals regarding the legal architecture of transfer payments—that the rules governing transfer payments be constitutionally entrenched, that they require provincial consent to establish new federal transfer programs, that provinces be given the right to opt out of conditional programs with full compensation, that federal-provincial agreements be constitutionally entrenched, that the courts enforce such arrangements, and so on. The lesson from the Canadian experience is that law has infused the fiscal federalism discourse and has been a principal mechanism for addressing concerns about the design of intergovernmental transfer payments.

The Canadian experience suggests that the following general design features can be used to assess and compare the legal aspects of fiscal transfers in a federation:

1. *Legal basis of intergovernmental transfer system*. Does the central government have a legal duty to make intergovernmental transfers to subunits? To what extent is the system based on a combination of constitutional law, federal statutes (super-majority and simple majority), regulations,

ministerial decisions, and intergovernmental agreements? Does the central government have the legal power to directly make transfers to provinces to subsidize public expenditures in areas of provincial jurisdiction (that is, is there federal spending power)?

2. *Procedures for establishing and modifying intergovernmental transfers.* Does the central government have the power to unilaterally establish, modify, and terminate the terms of intergovernmental transfers (for example, level, conditions), or is subunit involvement legally required? If subunit involvement is legally required, what is the nature of participation—notice, consultation, or consent? May individual subunits and the central government enter into intergovernmental agreements for transfers?
3. *Conditional and unconditional transfers.* May the central government attach conditions to fiscal transfers, or must grants be unconditional? If grants may be conditional, are there any legal limits on the specificity of these conditions? If grants may be conditional, what are the legal consequences, if any, for subunits that violate these conditions? Do subunits have the right to opt out of conditional intergovernmental transfers? If so, do they have the right to compensation if certain conditions are met?
4. *Dispute resolution and adjudication.* How are disputes concerning intergovernmental fiscal transfers addressed? May intergovernmental transfers be judicially enforced, or are they nonjusticiable? To what extent does dispute resolution rely on constitutional principles (that is, federal loyalty), ad hoc political negotiations, mediation/conciliation, administrative proceedings, or constitutional adjudication? How have these mechanisms worked in practice?

Together these design features constitute the legal framework of fiscal federalism. Given that intergovernmental fiscal transfers play an important role in realizing the theoretical benefits of a federal system of government, they warrant particular attention.

Case Studies

These design features are used to explore case studies of Belgium, Germany, India, and South Africa. The cases include countries in which the scope of legislative authority matches the scope of executive authority (India) and those in which subunits administer federally enacted and designed policies (Germany). It includes developed countries (Belgium, Germany) and developing ones (India, South Africa); new (Germany, India) and very new

(Belgium, South Africa) federations; and federations from both the common law (India, South Africa) and civil law (Belgium, Germany) traditions.

Systems of Government in the Case Study Countries

Before describing and analyzing the legal architecture of intergovernmental transfers in the countries selected, it is necessary to identify the different levels of government involved and the powers attributed to them.

Belgium

Belgium embarked on its federal project in 1970. In 1993 its Constitution was substantially overhauled to create an innovative federal system of government, with two overlapping types of subunits: regions, which are geographically defined (Flemish, Walloon, and Brussels), and communities, which are based on language (Flemish, French, and German).[2]

Articles 127–130 of the Belgian Constitution grant jurisdiction to communities in the fields of cultural affairs, education, health, language policy, intercommunity cooperation, and international cooperation. Many of these areas, such as health, are the subject of shared jurisdiction with the federal government. The regions, however, are not explicitly granted legislative authority over certain areas of responsibility. Instead, these are defined in special legislation that requires a two-thirds majority vote by both the federal Chamber of Representatives and the Senate. The regions have assumed jurisdiction in areas such as economic policy, employment, transportation, public works, trade, agriculture, and energy. Since 1993 the federal government has formally enjoyed residual jurisdiction until its powers are more clearly delimited. The intergovernmental agreements discussed in detail below suggest that "the federal government is more decentralized at present and its fields of jurisdiction are diminishing for the benefit of the regions, not the communities" (Van der Stichele and Verdonck 2002, p. 40).

Germany

Federalism was not a new phenomenon in Germany after World War II, but it was solidified in the Basic Law of 1949.[3] It remained the structure of government after reunification with East Germany in 1990. The two main levels of government are the federal government (the *Bund*) and the (16) states (*Länder*).

The federal division of powers in Germany is set out in the Basic Law. The *Länder* exercise residual powers and are responsible for implementing and administering many federal laws. They also share jurisdiction with the *Bund* in several areas. In practice, the *Bund* "has widely eroded the legislative power of the states [*Länder*] and enacts the overwhelming majority of legislation today" (Larsen 1999, pp. 433–44). Germany does not have watertight compartments in its division of powers (Heun 1995).

An important institution in German fiscal federalism is the Council of State Governments (the *Bundesrat*), the upper house of the federal government. Specifically designed to represent the interests of the *Länder,* the *Bundesrat* is made up of members appointed (and recalled) by the *Land* governments. Each *Land* has a minimum of three and a maximum of six votes (depending on the size of its population), which must be voted as a block in the *Bundesrat*; the members of the *Bundesrat* do not act in their personal capacities but are agents of their *Land* government. While the *Bundesrat* is not as powerful as the *Bundestag*, the elected lower house, it does have "a suspensive veto over legislation generally and an absolute veto over all legislation affecting the vital interests of the *Länder*" (Kommers 1997, p. 97). It is well accepted that any law affecting the revenue of the *Länder* falls within the scope of an absolute veto and therefore requires the consent of the *Bundesrat*.

India

India has a system of government that is "basically federal, but with striking unitary features" (Vithal and Sastry 2001, p. 14). It comprises the union, 28 states, 7 union territories, and local governments. India's constitution defines the exclusive and concurrent powers of the states and the union. The union retains residual powers and may make any law imposing a tax not mentioned in the lists annexed to the Constitution. The exclusive powers of the union include defense, foreign affairs, banking, insurance, railways, currency, stock exchanges, and enumerated taxes. The exclusive powers of the states include health, unemployment, agriculture, and enumerated taxes. Concurrent areas of power include criminal law and procedure, forests, economic and social planning, competition law, and electricity, to name a few. The states determine the revenue that will be devolved to local governments through state finance commissions.

South Africa

The Constitution of South Africa, 1996 does not explicitly identify its system of government as federal.[4] Instead, it describes a government "constituted as national, provincial and local spheres of government which are distinctive, interdependent and interrelated" (Constitution of the Republic of South Africa). Schedule 4 of the Constitution sets out concurrent areas of responsibility of the national and provincial governments; Schedule 5 enumerates exclusive areas of provincial responsibility. The nine provinces are responsible for health, education, welfare, and roads. Nevertheless, the Constitutional Court of South Africa has ruled that the provinces enjoy limited autonomy and that they "are the recipients of power and not the source of power" (Constitutional Court of South Africa 1996, para. 14). Local governments, which have undergone consolidation, are responsible for urban infrastructure, including water, sanitation, traffic, and garbage collection. Municipal governments have the right to administer matters listed in Part B of Schedules 4 and 5.

Legal Basis of Intergovernmental Transfer System

The legal architecture of an intergovernmental transfer system may consist of constitutional law, federal statutes, regulations, ministerial decisions, and intergovernmental agreements. Every country relies on these legal instruments to varying degrees and in different ways. A given legal instrument may be mandatory (imposing a duty to transfer an "equitable share" of national revenue, as in South Africa, for example) or enabling (allowing grants to be made for "any public purpose," as in India, for example).

The extent to which each type of legal instrument is relied on has important implications for the legitimacy, transparency, political acceptance, justiciability, certainty, and flexibility of an intergovernmental transfer system. Designing an intergovernmental transfer system that will meet these short- and long-term objectives is a complex task, as each legal instrument offers its own advantages and disadvantages. A constitutional clause may help ensure legitimacy and certainty, for example, but it may be inflexible and lack political acceptance in the future. A unilateral ministerial decision may be flexible and politically expedient, but it may lack transparency and certainty.

Since no single legal instrument can optimize each of the objectives of an intergovernmental transfer system, most countries adopt a complex, interlocking set of legal instruments to suit the current and prospective needs of society. In addition to being economically and legally complex, these laws evolve over time, making them difficult to rationalize from a comparative perspective. Therefore, in considering the legal architecture of the intergovernmental transfer systems under review, emphasis is placed on their enduring and general qualities.

Belgium

The development of Belgium's intergovernmental fiscal transfer system is based on a series of political negotiations that have been codified in "special" federal legislation. This legislation requires a two-thirds majority in the federal legislature and a majority among each of the two linguistic groups in the federal parliament. The legislation is the culmination of negotiations and renegotiations among political actors. The first set of such laws came into existence in August 1980, when the regions received fiscal transfers based on three criteria of equal weight: population, personal income tax revenues, and territorial surface area. The communities were financed based on an approximate percentage of the population that was French and Flemish (Gérard 2001, pp. 12–13).

As new fields of jurisdiction were transferred to the regions and communities, special legislation was passed to provide appropriate levels of intergovernmental transfers. The Regionalization Law (August 8, 1988) established a federal transfer of 28 percent of income tax revenues to the regions. The Special Financing Act (1989) provided for a value added (VAT) and personal income tax transfer to the communities. Communities had complete financial autonomy in terms of the use of transferred funds, but they were unable to affect either the amounts or sources of these transfers (Van der Stichele and Verdonck 2002, p. 5).

This act was originally designed to function during a transitional phase between 1989 and 1999. However, after only four years, the French community faced serious difficulties in financing education. As a result, the Saint-Michel Agreement of 1993 was adopted, by a special law of July 16, 1993 (amending the Special Financing Act). Complementing this agreement, the Saint-Quentin Agreement of 1993 authorized the transfer of certain fields of its jurisdiction to the Commission Communautaire Française (in the Brussels region) and the Walloon region, without making sufficient transfers to cover the previous budgets of these areas of responsibility. This action was implemented through Decree II of the French-speaking community of July 19, 1993.[5] As the transitional phase came to a close, political negotiations encountered difficulties. It was not until May 23, 2000, that a new act was adopted, based on the Saint-Éloi Agreement of 1999, altering the allocation of the value added transfer between the communities.

A more permanent solution to the chronic community underfunding was the subject of the Saint-Polycarpe (or Lambermont) Agreement of January 2001, embodied in two pieces of special legislation passed July 13, 2001. The first regarded the refinancing of the communities and the broadening of the tax jurisdiction of the regions. The second concerned the transfer of various fields of jurisdiction to the regions and communities.

In contrast to the French- and Flemish-speaking communities, the German-speaking community relies largely on structural grants not connected to any tax base (OECD 2002). In practice, the transfers, which are unique to this community, are based on the number of German-speaking students (Van der Stichele and Verdonck 2002, p. 15).

The Belgian Constitution is vague regarding the existence of a federal spending power, but it has been "progressively gaining ground" (Commission sur le Déséquilibre Fiscal 2002). Generally speaking, "spending power" does not find a constitutional basis in Belgium, and federated entities may "in principle be freely assigned to their expenditures" (Van der Stichele and Verdonck 2002, p. 29). Braun (2003, p. 55) has gone as far as to state that "one can contend that in the Belgian system there is no unilateral action on the part of the federal government in fiscal policy making because the federal government is composed of regional actors."

The legal basis for intergovernmental transfers in Belgium relies less on constitutional law and more on ad hoc political negotiations that are then codified in special legislation at the national level. As practice has confirmed, this design feature has privileged flexibility over certainty.

Germany

The federal Constitutional Court of Germany has ruled that the fiscal provisions of the Basic Law are the cornerstone of German federalism (Macdonald 1996). These provisions are interlocked with several pieces of legislation. In 1949 and again in 1990, Germany was faced with vast regional disparity, which meant that "balanced regional development and uniformity of living conditions throughout the nation became attractive features for policy making and institution building" (Spahn 2001, p. 2).[6] While intergovernmental fiscal transfers have always been important in German federalism, they surged after major reforms in 1969 and again with reunification.

Chapter X of Germany's Basic Law sets out the complex intergovernmental transfer system. The *Bund* provides the *Länder* with funding when they implement and administer federal law, based on the principle of fair compensation, which promotes vertical fiscal balance. The *Bundestag*, which is composed of *Länder* appointees, maintains oversight over most federal laws dealing with intergovernmental finance in Germany.

Revenues from various taxes are allocated to the *Bund*, the *Länder*, or jointly. In determining the allocation of joint taxes (income taxes, corporation taxes, and VAT, which account for about 75 percent of tax revenue

[Larsen 1999]), the Basic Law provides that the *Bund* and *Länder* share revenues from income taxes and corporate taxes equally. Income tax allocated to the *Länder* is distributed among them based on the residence of the taxpayer (not the *Land* in which the taxpayer works). Corporate taxes are distributed based on a formula that deals with firms with operations in more than one *Länder*. The distribution of the VAT is more complex and involves indirect equalization.

The horizontal fiscal equalization system in Germany is made up of three constitutionally mandated elements, all of which require federal legislation to implement: VAT sharing, *Länder* financial adjustment, and federal auxiliary assignments. The Basic Law mandates a federal statute, requiring the approval of the *Bundesrat*, to determine how the VAT is to be divided between the *Bund* and *Länder* and among the *Länder*. This is guided by Article 106(3)(2) of the Basic Law, which requires that federal legislation comply with the principle that uniformity of living conditions in the federal territory be ensured.[7]

At least three-quarters of the VAT revenues transferred from the *Bund* to the *Länder* are distributed among the *Länder* based on their per capita share of national VAT revenues (Larsen 1999). The remaining quarter is distributed to *Länder* in which the per capita revenue from *Land* taxes, income taxes, and corporate taxes is below the national average of all the *Länder* combined. The federal Constitutional Court has criticized the distribution of the VAT in this fashion, since equalization can be achieved in a better and simpler manner through other mechanisms, discussed below (Larsen 1999).

Since the premise of German fiscal federalism is vertical balance, a system of direct horizontal transfers is required for any effective equalization scheme. The constitutional basis for direct equalization is set out in the Basic Law, which requires "that a reasonable equalization between financially strong and financially weak *Länder* is achieved." The *Bundesrat* must consent to the equalization formula.

This wording is given effect in the equalization law. The formula for the law is extremely complex. It includes four distinct processes: assessing the financial capacity of each *Land,* determining the demographics of each *Land*, applying an equalization index, and collecting contributions from *Länder* with surpluses and making contributions to *Länder* with deficits (Wilkins 2001).

This system has given rise to several constitutional showdowns between the *Bund* and certain *Länder* before the federal Constitutional Court. These cases demonstrate the significance of the constitutionalization of principles and mechanisms of intergovernmental fiscal transfers when combined with a strong adjudicative body.

In the Finance Equalization Case I (1952), the federal Constitutional Court ruled that horizontal financial adjustments from an economically stronger *Land* in favor of a poorer *Land* was consistent with the Basic Law but that this would not be the case "if it would weaken the [financial] capacity of the contributing states or lead to a financial leveling of the states" (cited in Kommers 1997, p. 91). The Court relied on Article 109 of the Basic Law, which states that the *Länder* are "autonomous and independent of each other with regard to their respective budgets," but it tempered its judgment based on the language of solidarity, holding that "the states have duties as well as rights. . . . [Strong states are] to assist, within limits, the financially poorer states"(cited in Kommers 1997, p. 91).

In the Finance Equalization Case II (1986), the Court invalidated various parts of the equalization law for "excessive leveling" and for miscalculating the economic strength of the *Länder* (Currie 1994). In particular, it found that the law violated Article 107(2) of the Basic Law, which requires that financial equalization be "reasonable." By way of a remedy, the Court instructed the legislature to change the basis for allocating tax revenues among the *Länder* by 1998 (Kommers 1997).

In 1999 Bavaria, Baden-Württemberg, and Hesse challenged the equalization law before the federal Constitutional Court. They argued that horizontal equalization transfers had become excessive and that better incentives for economic performance were needed. The Court recognized the need for a "degree of competition among the individual states as secured by the federal principle [that is also] innovation-fostering" (Spahn 2001, p. 15). It not only required revision of the existing equalization law, it also mandated that it be based on a new law on general standards. This law would have quasi-constitutional status and "define in an abstract and general way the objectives of adjustments as well as the factors underlying an adjustment in vertical and horizontal equalization on the basis of the regulations laid down in the constitution" (Beierl 2001, p. 8). It appears that the new law restricts transfers to neutral assessments and excludes pork barreling.

The 1999 federal Constitutional Court ruling on the equalization law found that equalization of the *Länder* at 95 percent of the national average is sufficient to conform to the Basic Law. The new equalization legislation, which decreases contributions by some *Länder,* provides for corresponding increases in supplementary grants by the *Bund*.

Supplementary grants from the *Bund* in favor of certain *Länder* are a third aspect of equalization transfers in Germany (vertical asymmetric transfers). Article 107(2) of the Basic Law permits these intergovernmental transfers to be made through a federal statute. Based on this nonmandatory language, it is not surprising that these supplementary grants were insignificant in the early years of German federalism. Only after reunification have they come to play an important role in the intergovernmental transfer regime. Solidarity Pact I and Solidarity Pact II, discussed below in the section on conditional and unconditional transfers, are the most notable forms of supplementary grants.

The federal Constitutional Court has upheld the asymmetric nature of supplementary grants. However, based on the doctrine of federal equal treatment, similarly situated *Länder* are entitled to receive the same supplementary grants according to their financial need.

Applying this doctrine in the Finance Equalization Case III (1992), the federal Constitutional Court rejected the claim of Hamburg that it was entitled to receive a grant given to Bremen and Saarland, on the grounds that Hamburg was not as heavily indebted as they were. The Court found that "Bremen had been the victim of constitutional discrimination because the city[-state] had received no transfer payments for several years and later received less financial aid than Saarland, even though Bremen had substantially higher debts than Saarland. Finally, the court ruled that the federal government's vertical payments to Bremen and Saarland had been too low in view of the serious budgetary problems of both states" (Kommers 1997, p. 91). The remedy was for the *Bund* and other *Länder* to provide additional financial assistance to both Bremen and Saarland.

The federal Constitutional Court has also held that there is a direct relationship between the level of equalization achieved through the equalization law and supplementary grants. According to the Court, "the lower the financial equalization law sets the equalization level for the horizontal equalization, the more the providing of general supplemental grants becomes a virtual duty of the Federation" (Larsen 1999, p. 459).

Germany does not have unrestrained spending power, because the *Länder* have a direct voice in authorizing federal spending in their areas of jurisdiction through the *Bundesrat*. This rule was applied by the federal Constitutional Court in 1976, when it invalidated a federal program that directly gave funds to local governments for, inter alia, the construction of waste disposal facilities, on the grounds that it infringed *Länder* autonomy because the *Länder* had not given their formal agreement to the program and the *Bundesrat* had not approved it.

The legal basis for intergovernmental transfers in Germany is archetypically constitutional in nature. The shortcomings of such heavy reliance on constitutional provisions, such as inflexibility, have been felt, but these provisions have simply been the subject of more-frequent amendment than other constitutional articles.

India

India's system of intergovernmental transfers is a "complicated mix of constitutional assignments, institutional precedents, discretion and negotiation" (Rao and Singh 2000, p. 2).[8] The Constitution "recognizes that the assignment of tax powers creates vertical imbalances and provides principles for the sharing of resources between the center and states" (Purfield 2004, p. 27). An additional underlying consideration of the framers was that horizontal imbalances would need to be addressed "for an even and equitable development of all regions of the country" (Vithal and Sastry 2001, p. 24). To accomplish these goals, the Constitution includes mandatory and enabling provisions for intergovernmental transfers.

India's intergovernmental transfer system is best understood when deconstructed into the three main federal institutions that constitute it: the Finance Commission (central tax revenue distribution and grants), the Planning Commission (grants and loans for development), and various central ministries (shared cost programs). The notion of a neutral and expert advisory commission to deal with intergovernmental transfers was based on the early success of the Commonwealth Grants Commission, created in 1933 for Australia. In 1949 the Constitution of India established a finance commission to make recommendations to the president, which are placed before Parliament, on the distribution of net tax revenues to be divided between the union and the states as well as on the allocation among the states; to establish principles to govern the grants-in-aid to states from the consolidated fund; to set up measures to augment the needs of local governments, as recommended by state finance commissions; and to handle other matters of finance referred by the president. These recommendations are usually accepted by the central government.[9]

The Constitution of India requires the president to appoint a finance commission every five years, or earlier as necessary.[10] The Finance Commission (Miscellaneous Provisions) Act, 1951 specifies the qualifications and manner of selection of members of the Finance Commission as well as their powers. Section 3 of the act requires the chairman to have "experience in public affairs"; the other four members of the Finance Commission must meet more-specific criteria. The presence of a judicial member on the Finance Commission is "supposed to give it an independent, semi-judicial status" (Rao and Singh 2000, p. 90). This is buttressed by Section 8(1) of the act, under which the Finance Commission is given all the powers of a civil court. Individual members of a given Finance Commission are able to append a "Minute of Dissent or Minute expressing an individual member's thoughts on the subject under review" (Vithal and Sastry 2001, p. 91).

The 80th Amendment to the Constitution (2000) fundamentally altered the union tax revenues subject to distribution among the states. Before this amendment, only specific taxes were subject to intergovernmental transfer. The new distribution of tax revenues is believed to provide greater certainty and stability of state revenue and increased flexibility in tax reform. Article 270 of the Constitution provides that all taxes and duties of the union (with a few minor exceptions) shall be distributed between the union and the states based on a percentage recommended by the Finance Commission and prescribed by the president.[11] Each Finance Commission will review the percentage of net union tax revenue (tax proceeds less the cost of collection) to be distributed to the states and between them. From 1996 to 2000, 29 percent of gross union tax revenue proceeds were transferred to the states.

Under Article 275 of the Constitution, the Finance Commission also makes recommendations for grants-in-aid to be made from the union to specific states that are "in need of assistance." These grants can be adopted only on the recommendation of the Finance Commission (Vithal and Sastry 2001). These are typically gap-filling transfers based on projected shortfalls between a state's revenues (after the above transfers are made) and its non–development plan expenditures.[12]

The Planning Commission is a political body, established by an executive order of the central government in March 1950. It has a smaller but increasingly important role in recommending a combination of grants and loans from central ministry programs to states for their development plans. Transfers made on the recommendation of the Planning Commission are nonstatutory transfers.

The constitutional basis of Planning Commission transfers is said to be Article 282 of the Constitution, which provides that "the Union or a state may make any grants for any public purpose." Grants under this article are controversial for two reasons. First, they circumvent the oversight of the Finance Commission. Second, they were originally intended for emergencies such as natural disasters or famine but have been used much more broadly (Sury 1999). As a result, some Indian constitutional experts question the legitimacy and constitutionality of these grants (Rao and Singh 2000).

The Planning Commission provides some indirect equalization. With some modifications, the prevailing approach has been the "Gadgil formula," under which the ratio of grants to loans provided to a state depends on whether it is classified as being in financial need. The formula was created by consensus of the National Development Council, an informal intergovernmental body established in 1952 that is chaired by the prime minister and includes members of the Planning Commission, central government cabinet ministers, and state chief ministers.

Central government ministries in India make fiscal transfers that states are required to match (to various degrees, depending on the project) to implement policies of the center. These programs are recommended by the Planning Commission. Since the programs usually concern powers vested in the states, they can be seen as a manifestation of a spending power. Patil (1995) suggests that in some state areas of responsibility, spending by the center may even outstrip state spending. States have also complained of heightened spending by the center in concurrent areas of responsibility.

A mélange of legal instruments serve as the legal basis for intergovernmental transfers in India. This has resulted in some uncertainty and concerns over the legitimacy of some transfers, including Planning Commission grants, which have been without a strong basis in constitutional law or statute.

South Africa

With the end of apartheid, South Africa faced the "special challenge of redressing enormous disparities—both political and economic—among jurisdictions that had long been subject to strict racial segregation and very different types and levels of public services and revenues" (Smoke 2001, p. 15). As a result, intergovernmental transfers took on an important role in this period. One of the founding constitutional principles applied by the Constitutional Court in certifying the 1996 Constitution was whether it made "adequate provision for fiscal and financial allocations to the provincial and local levels of government from revenue collected nationally" (Certification Case, Constitutional Court of South Africa, para. 45(k)).

Chapter 13 of the Constitution deals with intergovernmental fiscal transfers. Section 227(1)(a) enshrines the principle that provincial and local governments are "entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it." This fiscal transfer is to take place "promptly and without deduction." Section 214(1) mandates that an act of Parliament must provide for the system of intergovernmental transfers, including:

- The equitable division of revenue raised nationally by the national, provincial, and local spheres of government.

- The determination of each province's equitable share of the provincial share of that revenue.
- Any other allocations to provinces, local governments, or municipalities from the national government's share of that revenue and any conditions on which those allocations may be made.

The Constitutional Court has stated that there are both "substantive and procedural safeguards in determining the actual amount of the equitable share" (Certification Case, Constitutional Court of South Africa). Procedurally, provincial and organized local governments must be consulted and the recommendations of the Financial and Fiscal Commission considered before this "equitable share" law may be adopted. The Constitution requires that the following factors be taken into account:

- The national interest.
- Any provision that must be made in respect of the national debt or other national obligations.
- The needs and interests of the national government, determined by objective criteria.
- The need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them.
- The fiscal capacity and efficiency of the provinces and municipalities.
- Developmental and other needs of provinces, local governments, and municipalities.
- Economic disparities within and among the provinces.
- The obligations of the provinces and municipalities in terms of national legislation.
- The desirability of stable and predictable allocations of revenue shares.
- The need for flexibility in responding to emergencies or other temporary needs.
- Other factors based on similar objective criteria.

Since 1998 the framework legislation giving effect to these constitutional provisions has been the Intergovernmental Fiscal Relations Act, 1997. Section 10 of this act states that a division of revenue bill must be adopted annually to specify the "equitable share" transfer to be made. The Financial and Fiscal Commission makes recommendations to Parliament on each such bill.

The Division of Revenue Act, 2004 provides a typical example of the straightforward nature of these annual statutory allocations. Schedule 1 identifies the monetary amount of revenue that is divided among the three levels of government for the year. Schedule 2 divides the provincial share among the nine provinces; Schedule 3 does the same for municipal governments. Schedule 4 provides for general nationally assigned functional transfers to the provinces. Schedule 5 identifies specific conditional grants, and Schedule 6 identifies recurrent conditional grants.

The Financial and Fiscal Commission is a permanent expert commission that plays a major advisory role in South Africa's intergovernmental fiscal transfer system, with primarily "consultative and investigative powers but not lawmaking or enforcement powers" (Motala and Ramaphosa 2002, p. 97). Sections 220–222 of the Constitution created the Financial and Fiscal Commission, tasked with making independent and impartial recommendations pertaining to fiscal matters. The Financial and Fiscal Commission Act, 1997 provides a more thorough elaboration of the functions and procedures of the commission. A constitutional amendment and the Financial and Fiscal Commission Amendment Act, 2003 reduced the membership of the commission from 22 to 9 members, effective January 2004.

Before 1998 South Africa's national government made direct expenditures on health, social services, and roads—all areas of provincial responsibility. Since 1998 a new system of largely unconditional transfer has become the rule, diminishing federal spending power (Bahl 2001).

Given the relatively recent adoption of South Africa's Constitution and passage of the Intergovernmental Fiscal Relations Act, it remains to be seen whether the legal basis for intergovernmental transfers will serve South Africa well in the long run. But the relatively straightforward architecture of constitutional provisions that mandate an annual statute, based on input from an expert commission, holds much promise.

Procedures for Establishing and Modifying Intergovernmental Transfers

Two main approaches to establishing and modifying intergovernmental fiscal transfers prevail in the countries examined here. The first, and more straightforward approach, is negotiation between the federal government and subunits in which final agreement is subject to subunit consent (most often in the upper house of the federal government). This approach is used in developed countries, such as Belgium and Germany. The second, and more complex approach, is consultation of the subunits combined with the involvement of a specialized, independent commission that makes recommendations on the operation of the intergovernmental transfer system. This approach is used in developing countries, such as India and South Africa.

Belgium

Belgium's intergovernmental transfer system relies on special legislation that includes the requirement that the French and Flemish communities consent. Since this effectively gives these communities veto power, negotiation and consensus building is a necessary part of any initiative to create or modify the intergovernmental transfer system. The existing order can be overturned rapidly to reflect political or economic exigencies. The Saint-Polycarpe (or Lambermont) Agreement of January 2001, for example, enhanced the fiscal autonomy of the regions and assisted communities by increasing federal transfers after the French community's education program faced financial difficulties.

Another player in Belgium's fiscal landscape is the Conseil Supérier des Finances, which is made up of 12 members, with an equal number of French- and Flemish-speaking members and equal representation from federal and subunit governments. The Conseil Supérier des Finances makes annual recommendations on the financial requirements of the federal and subunit governments. Its recommendations have strong moral force and to date have been largely followed.

Germany

An intergovernmental committee and the *Bundesrat* establish and modify Germany's intergovernmental transfer system, within the confines of the relevant constitutional provisions. Simply put, "all federal financial legislation that allocates revenue that accrues to the states requires *Bundesrat* consent" (Larsen 1999, p. 433). Therefore, the intergovernmental transfer system can be modified only with the consent of the *Länder*. These negotiations include incentives for the *Länder* to "team up" against the *Bund*, casting aside political party affiliations in the interest of obtaining the best share for the *Länder* possible. The *Bund* may use asymmetric supplementary grants to try to break this coalition (Beierl 2001).

The *Länder* have legal standing to challenge intergovernmental fiscal transfer legislation before the federal Constitutional Court, which has played an activist role in setting the legislative agenda. The Court has held that the Basic Law creates entitlements for financially distressed *Länder* to claim financial assistance from the *Bund*. In one case, the Court agreed that Bremen and Saarland were entitled to financial assistance but did not prescribe a specific remedy, instead suggesting options, including additional transfer payments to the poor *Länder* or even a redrawing of the territory to create economically sustainable subunits. The *Bund* opted to make DM3.4 billion in additional transfers to the two *Länder* through an amendment to the equalization law.

India

The central government maintains wide discretion in creating and modifying India's system of intergovernmental transfers. While the recommendation of the Finance Commission must be sought on such changes, the Commission does not include members nominated by the states and its recommendations are not binding. With respect to Planning Commission transfers, the states play an influential consultative role, through the National Development Council, an intergovernmental body chaired by the prime minister that includes members of the Planning Council, center cabinet ministers, and state chief ministers.

South Africa

South Africa's Constitution allows the "equitable share" intergovernmental transfer to be "calculated based on cabinet judgments" (Bahl 2001, p. 28). But it requires that provincial and organized local governments be consulted. In practice, this involves a "complex bargaining process between distinct layers of government to determine the total amount of centrally provided unconditional transfers" (Brosio 2000, p. 25). Fiscal transfers to local governments in South Africa are generally based on annual decisions of the central government, although some involve multiyear commitments.

Unlike in India, provincial nominees are appointed to the Financial and Fiscal Commission in South Africa. However, despite the ability of the provinces and local governments to nominate certain members, the Constitutional Court has cautioned that "the Commission is hardly a vehicle for the exercise of power by individual provinces" (Certification Case, Constitutional Court of South Africa).

The provinces have a formal consultative role in intergovernmental fiscal transfers in South Africa through the Budget Council, an intergovernmental political body with a general consultative mandate concerning fiscal and financial matters. A representative of the Financial and Fiscal Commission attends the Budget Council's meetings, which take place at least twice a year. The Local Government Budget Forum is a similar body for municipal government issues. It is through these bodies that consultation of the provinces and local government is achieved each year before passage of the division of revenue bill.

The nature of provincial consultation has been clarified by the Constitutional Court based on the fact that the "equitable share" of a South African province is a "direct charge" from the National Revenue Fund. The Court has considered the importance of this terminology and concluded that it does not contemplate a money bill but "necessitates additional and direct consultation with provincial interests rather than a mere indirect engagement through the second House."[13] The Constitution of the Republic of South Africa Second Amendment Act, 2001 made it explicit that a money bill does not include equitable share transfers under Section 214 of the Constitution, affirming the consultative role of the provinces in modifying the system of intergovernmental transfers.

Conditional and Unconditional Transfers

Most intergovernmental transfer systems include a mix of conditional and unconditional transfers. The legal basis for these transfers and the consequences of violating the conditions may be clear and explicit or ambiguous. In most countries, conditional grants are controversial but continue to be relied on.

Conditional transfers are rare in Belgium's system of intergovernmental transfers and have been criticized as having a weak constitutional basis. In Germany unconditional grants are generally the rule, with the notable exception of some supplementary grants and shared-cost programs. The trend in India has been toward increased use of conditional transfers to the states in a vast array of centrally designed programs, including shared-cost programs. South Africa relies on unconditional and conditional fiscal transfers, both of which have an explicit constitutional basis.

Belgium

Conditional transfers are an exception to the norm in Belgium that federated entities maintain fiscal discretion to manage their own resources. Conditional transfers have been made, however, for measures for developing the international role of Brussels and for regional programs to help the unemployed find work. A nominal conditional transfer to communities also exists for employment programs and programs for foreign students. Conditional transfers have been characterized as being "on the borderline of the Constitution" in Belgium (Commission sur le Déséquilibre Fiscal 2002, p. 41).

Germany

Federal authorities in Germany must essentially convince a majority of the *Länder* in the *Bundesrat* in order to make conditional transfers, and such transfers have been criticized by the federal Constitutional Court. This has meant that intergovernmental transfers are generally unconditional, notwithstanding important exceptions that involve supplementary grants and shared-cost programs (see Bird and Tarasov 2002). In a 1975 case, the federal Constitutional Court held that providing grants for urban renewal "creates the risk that the *Länder* may become dependent upon the Federation and thus endangers their constitutionally guaranteed autonomy . . . [Therefore federal grants] remain the exception, and they must be so structured as not to become the means of influencing decisions of the constituent states in fulfilling their own responsibilities" (cited in Currie 1994, p. 58). On the facts of the case, the transfer was allowed, since it preserved the autonomy of the *Länder* by allowing them to determine where and how to spend the funds and was expected to significantly enhance economic growth.

The conditionality of supplementary grants is more complex. Generally speaking, "because they are meant to cover general financial need, the supplementary grants may not be in the form of grants tied to particular projects or tasks" (Larsen 1999, n. 51). An exception appears to relate to the previous system of supplementary grants to the new *Länder.* Solidarity Pact I consisted of an unconditional fiscal transfer (two-thirds) and a conditional fiscal transfer (one-third) for specific investments under the Investment Promotion Law Recovery East. Under Solidarity Pact II the grant is no longer conditional in any way, but annual reports to the intergovernmental Financial Planning Council are required on the use of funds.

India

Both the Finance Commission and the Planning Commission make general-purpose transfers to the states to use at their discretion. However, since the First Finance Commission, conditional grants have been considered permissible under Article 275 of the Constitution, and these grants have recently grown in importance in Indian fiscal federalism.[14] In some cases, "poorer states are unable to provide counterpart funds and are unable to receive even the allocations made to them" (Rao n.d., p. 19).

Historically, conditional grants-in-aid that were recommended by the Finance Commission were not scrutinized to determine whether their conditions were satisfied. Since the Seventh Finance Commission, however, the terms of reference have often sought recommendations on "the manner in which such expenditure could be monitored" (Vithal and Sastry 2001, p. 156).

Planning Commission grants may be awarded based on certain conditions, but the Constitution "does not provide principles governing such grants" (Patil 1995, p. 59). The Planning Commission also monitors specific earmarked grants for central sponsored schemes. These central ministry programs may include conditions related to staffing, infrastructure, and implementation, with quarterly disbursements to promote compliance.

South Africa

The Constitution of South Africa expressly authorizes the provincial and local government to "receive other allocations from national government revenue, either conditionally or unconditionally." Until 1998 fiscal transfers to local governments in South Africa were a combination of general and conditional transfers. It was widely held that this meant that "each province was thus then at the mercy of the central government" (Brosio 2000, p. 27). A major policy shift took place in 1998 to a formula-based system of largely unconditional intergovernmental transfers, known as the equitable shares program (Bahl 2001).[15] The total transfer is itself unconditional.

There has been a "differential capacity and willingness of provinces to supplement conditional grant funding with their unconditional equitable share funds" (Submissions to Parliament 2004/05). This and other reasons have led the Financial and Fiscal Commission to recommend "a negotiated relationship between transferring and recipient authorities in respect of conditional grants and a restraint on the use of conditional grants" (Submissions to Parliament 2004/05).

The legal framework for conditional grants in South Africa is further defined in the Division of Revenue Act. The act "assigns the role of compliance monitoring to transferring national departments, but the monitoring capacity of some of the departments is weak" (Financial and Fiscal Commission 2004). Where a province or municipal government does not comply with the conditions of a fiscal transfer, the transferring entity (national or provincial spheres) may delay, in full or in part, the payment of the allocations, after consulting with the national treasury and relevant provincial treasuries. If there is a "serious and persistent material breach" of the conditions, the transfer may be withheld by a decision of the national treasury (Financial and Fiscal Commission 2004).

Dispute Resolution and Adjudication

Disputes over intergovernmental fiscal transfers are resolved through a combination of mechanisms and proceedings, including constitutional principles, ad hoc political negotiations, mediation/conciliation at intergovernmental forums, administrative proceedings, and litigation, including constitutional adjudication. While most countries examined in this chapter initially rely on political negotiations between the governments in disputes, a range of possibilities exist.

In Belgium the federal loyalty principle places emphasis on political negotiations or mediation/conciliation. A recent trend has been for certain disputes over intergovernmental fiscal transfers to escalate to administrative proceedings before the Cour d'Arbitrage and ultimately the Conseil d'État.

While the existence of a federal loyalty principle in Germany's constitution has encouraged mediation, constitutional litigation has played a significant role in disputes over the intergovernmental transfer system. The federal Constitutional Court has developed important jurisprudence in this field that has been the basis for successful challenges to the equalization law.

The dispute resolution process governing India's intergovernmental fiscal transfers is not discussed in any detail in the literature reviewed. This is likely due to the high degree of federal discretion involved in the system of grants and the lack of a substantial provincial role in their creation or modification.

In South Africa the constitutional principle of cooperation places a strong emphasis on extrajudicial dispute resolution to resolve conflicts over intergovernmental fiscal transfers, including resort to mediation. Disputes over conditional grants are determined initially by a unilateral decision of the transferring entity and more permanently by a decision of the national treasury. While the Constitutional Court has not been very active in adjudicating specific disputes over intergovernmental transfers, it has made important pronouncements that provide a basis for such claims.

Constitutional Principles

The constitutions of several of the countries examined enshrine principles related to the emergence of conflict between levels of government. These principles serve as a starting point in these countries when disputes concerning intergovernmental transfers arise.

Belgium and Germany recognize the federal loyalty principle, or doctrine of federal comity (*Bundesrüe*). This doctrine essentially mandates the mutual respect and cooperation of subunits and the federal government such that they "act in such a way as to avoid all conflict of interest among themselves, the objective being to ensure that the various institutions function as a balanced whole" (OECD 1997, p. 27). In Germany the federal Constitutional Court has held that the *Bundesrüe* is an important constitutional principle with respect to fiscal equalization.

Section 41 of the Constitution of South Africa enshrines a similar principle of cooperation in intergovernmental relations, mandating an act of Parliament to "establish or provide for structures and institutions to promote and facilitate intergovernmental relations . . . and provide for appropriate mechanisms and procedures to facilitate settlement of intergovernmental disputes." The South African Division of Revenue Act, 2004 has as one of its purposes "to ensure that legal proceedings between organs of state [sic] in the three spheres of government are avoided as far as is possible."

Ad Hoc Political Negotiations

In most countries ad hoc political negotiations are the first avenue for resolving a dispute over intergovernmental fiscal transfers. Belgium's system has been described as based on compulsory negotiation, which includes the dispute resolution role of the Senate and fiscal coordination through the Conseil Supérier des Finances (Braun 2003). Despite the existence of these formal mechanisms of conflict resolution, "most coordination or conflict resolution takes place within or between political parties" (Braun 2003, p. 43).

In South Africa, Section 31(1) of the Division of Revenue Act, 2004 provides that litigation is the absolute last resort in resolving any intergovernmental fiscal dispute between state organs, after negotiated settlement and the procedures in the Intergovernmental Fiscal Relations Act have been exhausted. In theory, these procedures could include referral of the dispute to the Budget Council, a statutory intergovernmental body with consultative powers. Individuals responsible for prematurely resorting to litigation risk liability for costs.

In Germany the Conference of the Finance Ministers of the *Länder*, composed of the *Land* ministers of finance, negotiates common positions of the *Länder* governments on fiscal matters with the *Bund*. Party affiliations, however, play an important role in this process.

Mediation/Conciliation

Mediation/conciliation is an important step that is taken when ad hoc political negotiations fail to reach a compromise. Belgium's Coordination Committee is an intergovernmental political body to which the federated entities or federal government may refer a dispute to be resolved on the basis of consensus. In Germany conflicts surrounding intergovernmental fiscal transfers often involve the Mediation Committee of the *Bundesrat*, considered part of a "compulsory negotiation system." In South Africa the Mediation Committee deals with bills related to the functions of the Financial and Fiscal Commission as well as bills affecting the finances of provincial governments. Where mediation fails to resolve a dispute, the National Assembly may still pass the bill if it can muster a two-thirds majority.

Administrative Proceedings

In Belgium the Cour d'Arbitrage "is empowered to settle jurisdictional disputes between the federal government, the Communities and the Regions stemming from legislative measures" (Commission sur le Déséquilibre Fiscal 2001, p. 33). However, it is not considered to be part of the judiciary. The chair of the Court alternates each year between a native French speaker and a native Flemish speaker. The Cour d'Arbitrage has been asked to intervene to enforce the legislative provisions of the intergovernmental transfer system in Belgium.

The Conseil d'État has administrative jurisdiction to review legislation to ensure that authorities do not exceed their powers. It held that it was by no means clear that the Cour d'Arbitrage would be able to apply a purported jurisdictional limit on regional taxation autonomy included in the Sainte-Thérése agreement.

In South Africa the Division of Revenue Act calls for an administrative process when a conflict arises over the conditions of a conditional fiscal transfer. The first stage is a unilateral decision of the transferring entity (national or provincial government), after consulting with the national treasury and relevant provincial treasuries. The second stage involves a decision of the national treasury.

Judicial Review and Adjudication

Constitutional adjudication of disputes over intergovernmental fiscal transfers is most developed in Germany, where multiple cases on the matter have been decided since 1952. The federal Constitutional Court has jurisdiction to interpret the Basic Law and to adjudicate disputes between the *Bund* and the *Länder* and among the *Länder*. Half of the judges of the Court are elected by the *Bundesrat* and half are elected by the *Bundestag*. Wealthier *Länder* have launched several constitutional challenges to the equalization law, based in large part on the constitutional prohibition against leveling, which was developed by the Court. Based on this doctrine, "financial equalization may not reduce the wealthier states' per capita tax income level all the way down to that of the poorer states" (Larsen 1999, p. 446).

The Constitutional Court of South Africa has not been as involved in adjudicating disputes as the federal Constitutional Court in Germany. However, in the Certification of the Constitution of the Republic of South Africa, 1996, it made important pronouncements in describing the constitutional principles related to the system of intergovernmental transfers that may provide a basis for future constitutional litigation.

Conclusions

Of the range of factors involved in making an intergovernmental transfer system work, its legal architecture is but one. Political, economic, social, geographic, and other influences contribute substantially to the success or failure of aspects of each of the regimes described in this chapter.

This chapter focused on the practical benefits and shortcomings of these systems that are connected to their legal frameworks. From this assessment, some preliminary lessons can be drawn.

Belgium

Federal transfers are a vital aspect of fiscal federalism in Belgium. An eight-country study by Bird and Tarasov (2002) finds that Belgium has had a consistently high vertical fiscal imbalance, demonstrating the importance of intergovernmental transfers in financing regional expenditures.

The ability of special legislation to accommodate innovative economic design concepts for intergovernmental transfers demonstrates its main strength: its flexibility. Despite the difficulties faced during periods of political renegotiation, the use of special legislation rather than regular legislation or fully entrenched constitutional rules appears to have provided the best compromise in Belgium's unique form of federalism. During the negotiations over the so-called "permanent phase" of the intergovernmental transfer system in Belgium, "tension between the federal government and the communities overall was palpable. No entity wanted to renegotiate the matter each year. However, the establishment of a fixed criterion risked proving unfavorable to one level of government or the other" (Van der Stichele and Verdonck 2002, p. 14). Special legislation has demonstrated itself flexible enough to accommodate midterm entrenchment of a political compromise in a way that annual arrangements and long-term constitutional provisions do not.

In contrast, the political renegotiation process in Belgium has been criticized as favoring the subunits at the expense of the federal government and taxpayers generally. The creation of political agreements, followed by special legislation, has been the subject of judicial scrutiny in Belgium, to the extent that these agreements present difficulties in adjudication.

Germany

Germany has had a consistently low vertical fiscal imbalance, indicating that intergovernmental transfers are less important in financing regional expenditures there than in some other countries (Bird and Tarasov 2002). Even *Länder* that criticize the intergovernmental transfer system in Germany, such as Bavaria, recognize the benefits of having constitutional authorization and principles for these transfers. With respect to vertical transfers, this prevents transfers from becoming "subject to the free interplay of political forces" (Beierl 2001, p. 3). The federal Constitutional Court has interpreted the constitutional provisions in a way that has "shaped the political process within certain parameters" (Heun 1995, p. 182).

While it has faced challenges and tensions, the legal architecture of Germany's system of intergovernmental transfers has proven to be a remarkably versatile and stable vehicle through which the social consensus of the country has manifested itself. Its constitutional framework, with principles governing fiscal transfers; implementing laws, which require subunit consent; and a neutral process for adjudicating disputes represent a powerful combination.

Shah (2004, p. 11) applauds Germany's fiscal capacity equalization scheme to address regional fiscal disparities as an example of better practice. In contrast, Spahn (2001, p. 11) argues that the intergovernmental transfer system in Germany "has clearly been pushed beyond limits," particularly with respect to postunification interregional equalization. He illustrates the enormity of these equalization transfers by noting that they amount to "more than twice the official development aid of all industrialized countries to all developing countries in the world" (Spahn 2001, p. 13). Germany's equalization transfers have been criticized for "discouraging entrepreneurial spirit, and by inducing moral hazard" (Spahn 2001, p. 13); limiting the flexibility and responsiveness of the *Länder*; and reducing accountability of politicians.

Not surprisingly, the power of the *Bundestag* (made up of representatives appointed by the *Länder*) to approve the federal statute that governs vertical fiscal transfers (such as the VAT) has led to progressive increases in the percentage allotted to the *Länder* at the expense of the *Bund*; a similar phenomenon occurred in Belgium. The complexity and lack of transparency in Germany's intergovernmental fiscal transfer regime are also problems in and of themselves.

India

Serious concerns have been raised about the effectiveness of the intergovernmental transfer system in India, and studies have linked some of these problems to the way in which its legal architecture has evolved. The involvement of several agencies in the intergovernmental transfer system has been criticized as inefficient and wasteful.

In a leading study of Indian fiscal federalism, Rao and Singh (2000, p. 2) find "some evidence to support the hypothesis that states with greater political and economic influence or importance receive higher per capita transfers." This has been facilitated by a reduction in the percentage of fiscal transfers determined based on objective factors in favor of increased discretion. Khemani (2003) confirms that political bodies without constitutional authority, such as the Planning Commission, have a tendency to award funds based on political considerations (such as party affiliation of the state government and the number of seats from a given state in the central government's ruling party or coalition). With respect to central ministry grants, Khemani (2003, p. 5) finds that "national politicians indeed pursue disaggregated targeting of individual districts to serve particular political objectives." Constitutional rules that determine intergovernmental transfers, it is concluded, do indeed make a difference.

Indian fiscal federalism has also been criticized on the grounds that the multiple central government agencies that are involved lack coordination. Rao (n.d.) recommends that the Finance Commission focus on fiscal transfers while the Planning Commission focuses on loans for infrastructure projects. The criticism of the central ministry schemes, of which there are now more than 250, is that they are highly susceptible to political manipulation. Not surprisingly, an investigative report commissioned by the National Development Committee recommended that these grants be scaled down. Shah (2004, p. 6) has gone so far as to label these as "pork barrel transfers or political bribes." He also criticizes India's transfers to address regional fiscal disparities as a practice to avoid, given that it involves general revenue sharing based on multiple factors. At the municipal level, the result has been that "as state governments themselves are faced with several resource constraints, the local bodies are unable to deliver the required standards of public services" (Rao n.d., p. 6).[16]

States also appear to have suffered from federal control over intergovernmental fiscal transfers—the opposite of the pattern seen in Germany and Belgium. The result is that the average state deficit in India increased from 3 percent of GDP in the 1980s to 4.4 percent in the 1990s. The relationship between state fiscal transfers and indebtedness is particularly troubling. On the one hand, fiscal transfers increase borrowing capacity. On the other hand, borrowing increases dependence on the fiscal transfers. Rao (n.d.) concludes that the state indebtedness that has resulted from this situation is unsustainable for both those states that receive extra assistance from the Planning Commission and those that do not. Khemani (2002) casts some doubt on this conclusion.

Purfield (2004, p. 4) concludes that the financial decline of Indian states is the result of the institutions of fiscal federalism, which promote "transfer dependence, common-revenue pools, moral hazard, and soft budget constraints." State responsibilities are not met by their revenue-generating capacity, so that transfers account for some 40 percent of state revenues. Purfield also claims that the Tenth and Eleventh Finance Commissions actually increased the financial disparity between states.

Conflict between the Finance Commission and the Planning Commission has also arisen. Rao and Singh (2000) charge this has led to numerous problems, including a decrease in equalization, poor coordination, and incentives for states to offer different projections to the two commissions. The five-year tenure of the Finance Commission has also been criticized as denying the body the institutional memory necessary to fulfill its functions.

South Africa

South Africa has one of the highest fiscal imbalances in the world, at least with respect to provinces. Provincial governments are highly dependent on their unconditional equitable share transfers, with such funds constituting 87 percent of provincial budgets on average between 1999 and 2004. The opposite is true in municipalities, transfers to which have been growing faster than the national equitable share. Provincial deficits are projected to reemerge as a result of higher social security costs in the coming years.

Shah (2004) has criticized South Africa's transfers to address regional fiscal disparities, because they involve general revenue sharing based on multiple factors. Smoke (2001) also argues the need to improve the transfer system, given the vertical fiscal imbalance and prevalence of conditional transfers. Since the provinces do not have any independent sources of revenue, they must rely entirely on central grants (Brosio 2000).

Common Findings

Some lessons can be drawn from this analysis. First, some important conclusions can be drawn about the general legal framework of intergovernmental fiscal transfers. The transfers should be objectively and transparently determined, usually based on a recognized formula that is not the subject of ongoing political negotiations. These arrangements should be established by the central government, an expert commission, or an intergovernmental committee (World Bank 2001).

Second, the menu of procedures available for adopting and modifying intergovernmental fiscal transfers involves tradeoffs. While some theorists argue for nonnegotiable rules, in practice rules are almost always negotiable. Every country resolves the tension between flexibility (for economic or political reasons) and certainty (for planning public policy agendas) differently, and the equilibrium between these two goals has shifted over time. The traditional view of intergovernmental finance, prevailing in the 1970s, suggested that virtually everything to do with intergovernmental fiscal transfers should be decided unilaterally by the federal government. This view still prevails in developing countries such as India and South Africa. The emerging model is one in which "jurisdictional boundaries and the assignment of functions and finances have to be taken as determined at some earlier (constitutional) stage and not open to further discussion in normal circumstances" (Bird and Smart 2001, p. 12).

Third, conditional transfers remain a prevalent but troubling aspect of intergovernmental fiscal finance. Indeed, "both theory and experience suggest strongly that it is important to state expenditure responsibilities as clearly as possible in order to enhance accountability and reduce unproductive overlap, duplication of authority, and legal challenges" (World Bank 2001, p. 267).

Fourth, the limits of law in optimizing an intergovernmental fiscal transfer system are greatest when problems arise and dispute resolution or adjudication is required. This is so because a well-considered legal framework is a necessary condition for any effective intergovernmental transfer system, but it is not in itself a sufficient safeguard. As Smoke (2001, p. 3) notes, "no matter what a constitution or enabling law says, central agencies rarely have a desire to decentralize services, thereby losing prestige and resources."

This chapter began by observing that it has been argued that "in the end intergovernmental transfers are the *instruments*, not the *determinants* of public policy" (Bird and Tarasov 2002, p. 23, emphasis in original). The findings presented here demonstrate that legal frameworks are not simply empty vessels to be filled. Each legal framework has its own internal biases, based on who makes the intergovernmental transfer rules, who modifies them and under what conditions, and who resolves conflicts when they arise. Each of these "neutral" decisions carries intrinsic biases in favor of centralization versus decentralization, political decision making versus more objective assessment, fiscal autonomy versus fiscal prudence, and acceptance of economic disparity versus insistence on fiscal solidarity. These preferences are embedded in every intergovernmental transfer system and should be deliberately considered at the moment their legal frameworks are conceived and reformed.

Notes

1. The seminal work is Oates (1972).
2. In Flanders the Flemish region and community have become essentially the same unit, through a series of close cooperative agreements.
3. For a discussion of the earlier roots of German federalism and fiscal federalism, see May (1969) and Bird (1986).
4. For a discussion of the constitutional debates surrounding this issue, see Haysom (2001).
5. See Decree II of the French-speaking community of July 19, 1993, regarding the transfer of certain fields of jurisdiction from the French-speaking community to the Walloon region and the Commission Communautaire Française (Van der Stichele and Verdonck 2002).
6. Citizens of the former German Democratic Republic represented about 20 percent of Germany's population in 1990 but contributed less than 6 percent of value added (Spahn 2001).
7. Legislation provides that "the tax receipts of financially weak states are raised to up to 92 percent of the average tax receipts of all states per inhabitant" (Beierl 2001, p. 6). See also Spahn (2001).
8. For an overview of intergovernmental finance in India before independence, see Vithal and Sastry (2001).
9. For a discussion of the early Finance Commissions, see Vithal and Sastry (2001), Rao (1992), and May (1969).
10. Several Finance Commissions have considered whether there should be a permanent Finance Commission, but the idea has been rejected on the grounds that a freshly constituted set of members can be expected to be unbiased and treated differently from full-time government employees (Vithal and Sastry 2001).
11. Parliament may increase any union custom or duty by a surcharge whose proceeds go entirely to the union. It is too early to tell whether this will allow the union to circumvent the general spirit of Article 270, which presumes that union taxes are shared.
12. For a discussion of the controversy of the gap-filling approach, see Sury (1999).
13. All bills from the National Assembly are considered by the National Council of Provinces, which is composed of 10 delegates from each province. If a bill does not affect the provinces, the National Assembly may pass it regardless of the concerns of the National Council of Provinces. If a bill does affect the provinces and the National Council of Provinces rejects it, the matter is referred to a mediation committee, made up of an equal number of National Assembly and National Council of Provinces members. If the committee cannot resolve the issue, the National Assembly may still pass the bill if it has at least a two-thirds majority.
14. Conditional transfers accounted for about 15 percent of state expenditures in the 1990s, up from just 7 percent in the 1980s (Rao and Singh 2000).
15. The provincial equitable sharing formula includes seven weighted components: education (41 percent), health care (19 percent), social development/welfare (18 percent), economic activity (7 percent), "basic" (7 percent), institutional (5 percent), and capital "backlogs" (3 percent) (Financial and Fiscal Commission 2004).

16. In the 1980s total state revenue grew 15.3 percent and total transfers 15.8 percent, while expenditures grew 15.5 percent. In the 1990s fiscal imbalance emerged, as total state revenue grew 12.8 percent and total transfers just 11.5 percent, while total expenditures grew 14.3 percent (Rao n.d.).

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