Special issue: Cuadernos Manuel Giménez Abad


Editors: Mikel Erkoreka and Mario Kölling
INDEX

by Mikel Erkoreka and Mario Kölling

6 FISCAL FEDERALISM AND SUBNATIONAL FINANCE IN ARGENTINA BEFORE AND AFTER THE PANDEMIC STORM
by Miguel Ángel Asensio and Florencia Martino

33 BORROWING TO COMPETE OR SURVIVE A PANDEMIC? - NEW DIRECTIONS IN AUSTRALIAN FISCAL FEDERALISM
by Tracy Beck Fenwick

54 FISCAL DECENTRALIZATION AFTER SYSTEMIC CRISES: AN ANALYSIS OF THE BRAZILIAN EXPERIENCE
by Silvana Gomes

76 FROM SAFE SAVINGS TO BIG BANGS – GERMAN FISCAL FEDERALISM DURING AND BETWEEN ECONOMIC CRISIS
by Christian Bender and Fabio Botta

98 FISCAL FEDERALISM AND SUBNATIONAL FINANCE IN INDIA AFTER THE 2008 FINANCIAL CRISES AND COVID-19 PANDEMIC
by V N Alok

127 FISCAL FEDERALISM IN ITALY TWENTY YEARS AFTER THE CONSTITUTIONAL REFORM: AN APPRAISAL
by Andrea Filippetti, Costanza Giannantoni, Sandro Rondinella and Fabrizio Tuzi

148 NIGERIA: FEDERALISM IN THE COVID-19 PERIOD AND BEYOND
by Dele Babalola

by Mikel Erkoreka, Mario Kölling and Mireia Grau

185 THE FISCAL EQUIVALENCE TRAP – DON’T DECIDE, DON’T PAY - HOW A PRINCIPLE OF FISCAL FEDERALISM MOTIVATES STATE INACTION
by Eva Maria Belser and Géraldine Cattilaz

204 LARGE SCALE BUT TEMPORARY: HOW THE FEDERAL GOVERNMENT’S RESPONSES TO THE GREAT RECESSION AND COVID-19 (MOSTLY) MAINTAINED CONTINUITY IN AMERICAN FEDERALISM
by John Kincaid and J. Wesley Leckrone

Two deep economic crises have had a major impact on public finances in the first two decades of the 21st century. On the one hand, the 2008 financial crisis exercised an intense pressure on public accounts and led to an increase in public debt across federations, with a specific impact on subnational governments. On the other hand, with the consequences of the 2008 crisis still present, the COVID-19 pandemic hit governments’ financial sustainability for the second time.

Once the initial impact of the COVID-19 crisis has been overcome, the recovery of long-term fiscal sustainability and public debt management will be one of the main challenges facing governments in the coming years. In the systems of fiscal federalism, the post-crisis management of public finances and debt also affects subnational governments. Subnational governments are usually responsible for providing public basic services and managing welfare policies, such as healthcare or education, a stronger focus on sound public finances will have a severe impact on their capacity to deliver these public policies.

In general, the subnational level of government has received less attention from academia than the federal level. That is why this special issue puts the focus on the subnational finance.

The purpose of this special issue is to study how both crises affected multilevel governance systems and the institutional dynamics of federal and decentralised countries, focusing on the impact on subnational finance. The periods of crisis provide an ultimate testing ground for evaluating the resistance of the systems of governance and historically have played an important role in transforming the functioning and intergovernmental dynamics of federal countries.

The special issue has achieved a geographical balance, encompassing federal or decentralised countries over the five continents: Argentina, Australia, Brazil, Germany, India, Italy, Nigeria, Spain, Switzerland and United States. In this way, the special issue aims to facilitate research on trends within the framework of comparative federalism and allows to compare and contrast the evolution and behaviour of subnational finances and indebtedness between different federal realities. For example, the special issue evidences a trend towards re/centralisation in most of the studied cases.

Some of the articles published in this special issue were presented at the Conference of the International Association of Centers for Federal Studies (IACFS) held in Bilbao on 27 and 28 October 2022. The conference was organised by the Ituna Center for Basque Economic Agreement and Fiscal Federalism Studies (UPV/EHU - University of the Basque Country). The IACFS (www.iacfs.org) is an interdisciplinary association of centers and institutes throughout the world with interests in independent research and publication about political, constitutional, legal, administrative, fiscal, economic, historical and philosophical issues relevant to political systems which have federal features. On behalf of the Ituna Center, we would like to take this opportunity to thank the speakers and participants of the IACFS Conference, as well as the Basque institutions for their support during the organisation (especially, the government of Bizkaia and the Basque government).
This special issue is the result of the collaboration between the Ituna Center and the Manuel Giménez Abad Foundation. In addition to the papers presented at the IACFS Conference, the special issue has been complemented by the articles received in response to the call for papers opened by both institutions.

We hope that this special issue will be of interest to you and that it will contribute advancing on fiscal federalism and subnational finances research.

**Mikel Erkoreka**  
UPV/EHU - Ituna Center for Basque Economic Agreement and Fiscal Federalism Studies

**Mario Kölling**  
UNED and Manuel Giménez Abad Foundation
FISCAL FEDERALISM AND SUBNATIONAL FINANCE IN ARGENTINA BEFORE AND AFTER THE PANDEMIC STORM

by Miguel Ángel Asensio
IFNALSC & Universidad Nacional del Litoral

by Florencia Martino
Universidad Catolica Argentina & Consejo Nacional de Investigaciones Científicas y Técnicas

To cite this article:
Ángel Asensio, Miguel; Martino, Florencia (2023):
Fiscal federalism and subnational finance in Argentina before and after the pandemic storm,
Cuadernos Manuel Giménez Abad, Special Issue 9.
DOI: 10.47919/FMGA.CM23.0111

ABSTRACT

The paper is addressed to examine the general framework of fiscal federalism and subnational finances in Argentina and its behaviour considering the structural scenario and incidence of modern crises, not omitting the very important one of 2001 but emphasizing in particular the caused for the international slowdown (2008) and the great pandemic cycle (2020-2022). Crises affected subnational finances but not transformed essentially its structure. In the fiscal-federal scheme the financial power is retained clearly by the central government which is also the main public debtor.

Keywords: Fiscal federalism, Subnational finance, Argentina, Crises, Pandemic.
I. INTRODUCTION

As is known, the fiscal federalism of each country recognizes a certain allocation of resources, functions and transfers that define its structure, according to an evolutionary historical process, usually specified in its constitutional charters or other statutes or laws.

The taxation of the provinces and municipalities has gained significant interest in the country for a considerable time and numerous investigations have been carried out to determine the role of subnational resources in relation to the financing of the expenses of these levels of government.

This corresponds to the intensive development of research on federalism and fiscal decentralization in the international and Latin American arena (Brosio and Jiménez, 2013). This implies moving beyond the problems of central governments, to extend to “intermediate” and local governments (World Bank, 2001; Martínez Vázquez, 2014), which make up the “subnational” or “non-national” space.

Addressing the analysis of the fiscal importance of the subnational space in the Argentine case implies considering its existence in an institutional context made up of a federal or national government, 23 provinces, an Autonomous City and around 2,300 local governments (Hernández, 2020).

Analyze specifically the evolution and nature of the tax powers of said levels of government in Argentina is important to describe the historical and empirical facts that marked their evolution up to the present, within the respective constitutional and legal framework. Essentially, such subnational fiscal powers and functions must be considered to fully explain the structure of the nation’s federal financial system.

This work will seek to expose some of the fundamental aspects that frame the evolution of the system in well over a “long decade”, encompassing from the environment of the 2008 crisis to the 2020-22 pandemic cycle, exploring the structural, institutional and conjunctural profiles derived from the changes and adaptations of the scenario of “multilevel finance” (King, 1988), the fiscal rules involved and, where appropriate, the incidence in the observable framework of the use of credit and indebtedness.

In such an orientation, after this Introduction, the general framework of Argentine fiscal federalism is initially addressed. Next and within it, the level of provincial and municipal governments, namely its subnational component. Subsequently, we delve into specific aspects of such a “non-national” conglomerate, considering the observable issues about its fiscal autonomy and its evolutionary cycle in general and the recent crisis and pandemic processes, in particular, those that, having visibly impacted the economy, did so, also in the fiscal variables of the central and subnational governments, as well as in the monetary flank.

II. HISTORICAL FRAMEWORK: ASSIGNMENT OF REVENUES AND EXPENDITURES BETWEEN THE DIFFERENT LEVELS OF GOVERNMENT

In Argentina, as is generally the case of countries organized on federal bases and norms, analyzing the financial arrangements between different levels of government implies considering the design of the country’s federal fiscal constitution. In it, in addition to the guidelines emanating from the National Constitution itself, different laws and norms are involved, coming from different levels of political and territorial authority.
Coming from the origins in the 19th Century, fiscal evolution at the national and sub-national level in Argentina has obeyed to its own peculiarities. The financial constitutional framework began when the Constitution of 1853 was approved, later reformed in the years 1860 and 1866. The first of these was representative of a “dual” federalism, insofar as it recognized the existence of municipalities but as part of the provinces, these being the ones in charge of assuring the regime that regulated them, and, on the other hand, all customs incomes were granted to the national government in formation. While the 1860 Constitution temporarily limited the central government’s taxing power over exports, the third Constitution reassigned them to the national level of government. The latter put the collection of both import and export taxes in the hands of the central government. In this tax separation scenario, direct taxes were assigned to the provinces.

The country, in its formative independent stage signed by different conflicts and circumstances (Prados de la Escosura, 2005), was backward and not yet fully integrated into the world. In such a context, within the Constitution, taxes that were difficult to collect were assigned to the subnational level of government, while those from foreign trade were assigned to the central government. In exchange, over the federal government was imposed the obligation to assist the provinces when their budgets are insufficient to cover their ordinary expenses. This configured a system of concentration of resources at the highest level of government, which we called “concentration and patronage scheme” (Asensio, 2015).

In the following decades and especially in the last of the 19th century, important divergences emerged regarding the powers to apply indirect taxes. After important debates in the parliamentary sphere that ended in favor of the national government, which since the 1890s operated concurrently with the provinces in this field (Núñez Miñana and Porto, 1992; Asensio, 2015). On the other hand, four decades later, an initially transitory imposition was created through the income tax already in the middle of the first half of the 20th century, accompanied a little later by a tax on sales.

In this way, during the 1930s, the national government formulated a system that included important taxes due to their revenue significance. These, together with the indirect taxes known as “internal taxes” were distributed between the Nation and the provinces according to a set of established proportions, through what was known as “national revenue sharing”. In addition, the provinces administered other direct property taxes and minor indirect taxes.

To specify the chronology of the changes mentioned, we will mention that the federal tax system has gone through different stages. In the first, the principle of “separation of tax sources” established in the Constitution of 1853 was settled. In the second stage, from 1890, the “concurrence of sources” was implemented -limited to internal taxes on consumption-, and in the third stage from the beginning of the 1930s, a wide use of the system of division of income products called tax co-participation, or simply “participation” (revenue-sharing) was applied (Jarach, 2013).

1. In spite of this, the Argentine Federation emerged in the early second half of the XIX Century in better condition than a majority of Latin American post-independence economies, thanks to its “Atlantic link” (Gelman, 2008, 2014).
Table 1: Stages in the Assignment of Tax Powers in Argentina.

<table>
<thead>
<tr>
<th>Taxes</th>
<th>(I) Separation of Sources: 1853-1890</th>
<th>(II) Concurrence of Sources: 1890-1930</th>
<th>(III) Revenue Sharing: 1930-Present*</th>
</tr>
</thead>
<tbody>
<tr>
<td>External</td>
<td>Nation</td>
<td>Nation</td>
<td>Nation</td>
</tr>
<tr>
<td>Direct</td>
<td>Provincial</td>
<td>Provincial</td>
<td>Common</td>
</tr>
<tr>
<td>Internal consumption</td>
<td>Not specified</td>
<td>Nation/provincial</td>
<td>Common</td>
</tr>
</tbody>
</table>


Regarding the expenditure assignment, in an epoch when some functions like pensions or social protection were unknown, the Constitution of 1853 established a strong central government, endowed with internationally usual powers at that level (defence, external relations), and explicitly granted the functions of primary education, administration of justice and the regime of municipalities to the provinces that at the same time retained those powers that were not delegated to the national government.

So, in the original Constitution an income separation system was implemented that was later altered with the intervention of the national government in indirect taxes in the last decade of the 19th century and transformed again in 1934 through the creation of a revenue sharing or co-participation system, supported by rulings of the Supreme Court of Justice of the Nation.

It was not until 1994 that the revenue sharing or co-participation system was incorporated into the reformed National Constitution, in its article 73. Such “revenue sharing” implies two types of distribution of the co-participating mass; one is the primary distribution that in turn consists of two parts, one for the national government and another for the provincial governments, while the second distribution is the so-called secondary, being a distribution between provinces of the mass assigned in the first, based on proportions established by law, which originally responded to formulas, but which have subsequently responded to a less specific and casuistic determination process.

Considering the levels of government involved, the revenues of the federative actors -central and sub-central governments- were configured as a mixed pattern system that combines taxes from national and subnational sources (own taxes), on the one hand, with from a shared source, on the other, concentrating high-collection taxes in the national government, with an automatic proportion of said resources collected that must be transferred to the different parties, both the Nation and the Provinces.

2. Here we follow Núñez Miñana, Porto (1990) and Asensio (2015). More strictly, as we will see, this period could be divided in the previous to the 1990's and after. From the 1990's it is open the “era of the pacts” (when revenue-sharing is partially modified with some clauses of such agreements) (Asensio, 2006).
### Table 2: Phases or Steps in the Co-participation Process

<table>
<thead>
<tr>
<th>Phases</th>
<th>Concepts</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gross Taxation Mass</td>
<td>“Pool” from National Collection</td>
</tr>
<tr>
<td>2</td>
<td>Deduction of certain taxes</td>
<td>Deduction of customs and others</td>
</tr>
<tr>
<td>3</td>
<td>Shareable Mass</td>
<td>Amount ready for sharing</td>
</tr>
<tr>
<td>4</td>
<td>Primary distribution</td>
<td>Division Nation-Provinces</td>
</tr>
<tr>
<td>5</td>
<td>Secondary distribution</td>
<td>Division among Provinces</td>
</tr>
</tbody>
</table>

*Source: Own elaboration.*

In this model, the provinces, as the first component of the subnational stratum, legislate and collect indirect and direct taxes. Some of the first are gross income and stamps while the direct ones are taxes on real estate and motor vehicles. The municipalities, the second component of the subnational stratum, essentially apply the taxes known as *rates*.

Since the 1950s and throughout the rest of the 20th century, the taxes collected by the provinces included the tax on lucrative or economic activities, currently called tax on gross income, the property tax on real estate, the stamp tax, and the tax on motor vehicles, and other taxes, including an inheritance tax. This last tribute was not very productive in relation to the generation of resources, but it contributed at the time to the finances of the second level of government.

In 1974, the Value Added Tax (VAT) collected by the national state was introduced, with which it was intended to eliminate the gross income tax at the provincial level as a harmonization measure. This idea failed when collection insufficiencies occurred, and soon the taxpayers had to pay both taxes.

In subnational terms, the main horizontal tax agreement in force in Argentina, sanctioned in 1977, is the one related to the aforementioned tax on gross income, called the Multilateral Agreement, which regulates interjurisdictional transactions and organizes the distribution of tax bases, and not revenue, which continues enforced to this day.

Given the fact that a systemic situation has been configured where the main tax revenues are reserved at the national level, which therefore obtains the highest tax yields, through the collection of value added tax and income tax, among others, the powers of expenditure exhibit their own profile. Beyond the original constitutional provisions outlined in the key formula of the 19th century, the provinces concentrate functions with high manpower requirements such as primary and secondary education, health and the police. Moreover, through joint organisms there exists a separation between regulation and provision in the effective functional scheme for the execution of public functions in the three levels.

In addition, since the late 1970s and early 1980s, provincial functions have expanded as some public services have been privatized, decentralizing them, and others have also been transferred to the provinces. This occurred especially in the case of the provision of electrical energy as well as in the supply of running water, where national public companies did so towards their provincial counterparts.
In the 1980s, a modification was introduced to the rate structure of the tax on gross incomes, which was set at rates of 1% for the primary sector, 1.5% for the manufacturing industry and 2.5% for the tertiary sector. At the same time, the inheritance tax, which had a low fiscal yield and was no longer part of the tax structure, was eliminated. Another tax was imposed, such as the stamp tax that sought to cover the loss of income, with better results than the old tribute.

Broadly speaking, this system was in force until the early 1990s, a period in which Argentina entered the decade of Fiscal Pacts, making government agreements between the national and provincial governments. These pacts introduced important changes in the fiscal-federal framework and in the fiscal relationship between both levels of government. Although just after the beginning of such a cycle of intergovernmental agreements, the New Constitution of 1994 can be understood as the main Fiscal Pact.

In the scheme essentially emerging from one of those agreements, the Fiscal Pact of 1993, distortionary taxes should be abandoned or significantly reduced, such as the tax on gross incomes on the productive sectors, among others. This affected the delicate and imperfect tax structures of the provinces, with a high dependence on their oversales taxation and sealing taxes, which could generate an insufficient level of tax collection. Despite the initial attempts to promote said reforms, this risk explains the conservative position of the provinces in the face of such large changes in the tax structure. This became more visible from the year 2001 when several jurisdictions reverted the previous measures reinforcing the previous tax system, and in particular the tax on gross incomes.

In the aforesaid decade (1990’s), as mentioned, public utilities privatization processes took place and, in the cases in which said processes have been extensive or regular, supervision was essential to guarantee satisfaction and accountability in the effective provision of such services to citizens. In this sense, although functions such as education or health are carried out in some important municipalities, most frequently these functions are reserved for the provinces. Of course, there are gray areas that make it difficult to achieve efficiency in the provision of public services at both the provincial and municipal levels.

Furthermore, in the assumed field of competence (expenditure assignment) new functions are developed as local governments gradually become involved in areas formerly served at the regional level, as occurs in local economic development and the environment, and in areas such as housing and welfare.

The significance of local governments in the Argentine public sector, which as a whole is modest within the total expenditures of all levels of government, suggests that there is a feasible space for the expansion of decentralization towards the third of such levels.

The previously mentioned tax sharing is the main instrument of interlevel fiscal relations and the transfers that typify it are made unconditionally without prejudice to minor transfers. In the provinces, when replicated (province-municipal participation), it usually has constitutional status.

They provide that the shared funds be integrated by national and provincial fiscal resources, establishing the distribution of national or provincial income and also other resources such as provincial royalties on natural resources and income from privatized services. Tax sharing, more strictly, is also done in some provinces where the income from each tax is shared individually on a “tax by tax” basis and not under the “tax union” option.
The quantification criteria of the “primary allocation” are derived from the laws that regulate each province. The growth of this allocation has been raised based on an approach that looks at overall fiscal necessity rather than strict considerations of the cost of divisible services provided by local governments. On the other hand, the “secondary allocation” takes into account various apportionment elements, such as population or own resources.

Then, the funds destined to be co-participated are formed with a mixture of shared funds and from their own sources from the national or provincial orbit, given that the latter -as the first subnational jurisdictional level- must also transfer part of the taxes they collect to the municipalities under its jurisdiction.

During the 1990s, a new federal tax co-participation law was not approved (that is, the law regulating the Nation-Provinces distribution and between them) as it should be done since the constitutional reform of 1994 required it, but rather the Law National No 23,548 of Federal Co-participation of the year 1988 was modified through Fiscal Pacts between the national government and the provinces. These were intergovernmental “vertical” coordination agreements established between the two levels of government.

In this regard, we attach below a synthetic table that states the principles of such Nation-Provinces Agreements. They can be divided into “Agreements” and “Consensus”, the latter in the “contemporary phase”, to which we refer in more depth later.

**Table 3: Nation-Provinces tax agreements in Argentina.**

<table>
<thead>
<tr>
<th>Order</th>
<th>Main Characteristics of the New Agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>Revenue-sharing regime, regulation of the structure of GIT (Gross Incomes Tax) and “similarity” prohibited.</td>
</tr>
<tr>
<td>1991</td>
<td>Distribution of tax income from gasoline, VAT and others.</td>
</tr>
<tr>
<td>1992</td>
<td>Deduction of 15% of the resources of the “common fund” for social security.</td>
</tr>
<tr>
<td>1993</td>
<td>Invades subnational fiscal powers (GIT, property, etc.). It proposes progressively abandoning the GIT and imposing fiscal behavior in terms of property taxes in the provinces. Elimination of the turnover tax on manufacturing activities, with the aim of reaching minimum levels for the rates that tax the taxable value of real estate.</td>
</tr>
<tr>
<td>1994</td>
<td>Enact concurrent constitutional faculty of the Nation in matters of indirect taxes and power over natural resources granted to the Provinces.</td>
</tr>
<tr>
<td>1999/02</td>
<td>It ratifies the previous ones and contemplates norms for the reorganization of the retirement system, providing for the transfer to the Nation of provincial funds and a system of contributions for its maintenance.</td>
</tr>
<tr>
<td>2017</td>
<td>Aim for improvement of the fiscal situation of the country, reduction in fiscal deficit and increase competitiveness of the Argentine economy. Retake objective of gradual elimination of the tax on Gross Income and the simplification of the tax system. Measures to improve fiscal transparency and the publication of information on the budgets of the provincial governments.</td>
</tr>
</tbody>
</table>
2018

Looks for the elimination of income taxes for workers and retirees who earn less than certain amount. The gradual reduction of the income tax rate for companies, so that in 2022 the rate reaches 25%. Elimination of provincial taxes on exports of industrial products. The unification of the tax on Gross Income among the provinces, establishing a maximum rate of 1.5%. Creation of a compensation fund for provinces affected by the elimination of taxes, with the aim of maintaining its fiscal revenue. Elimination of the Buenos Aires Conurbano Fund.

2019

Fiscal commitments for provinces, including reduction of the fiscal deficit and elimination of distortionary taxes. Commitments to improve efficiency of public spending and to reduce public employee payroll spending. This Consensus was seen important to address Argentina’s economic and fiscal challenges. However, since then, the country has faced a series of serious challenges, the COVID-19 pandemic and political instability, which have affected the fulfillment of the agreement’s commitments.

2020

Establishes the suspension for two years of lawsuits for tax debts between Nation and Provinces and reduction of tax rates such as the tax on Gross Income and the tax on Stamps. Elimination of certain tax collection, collection and withholding regimes to facilitate business operations. Contains province commitment for not to increase their tax burden during the next two years and creation of a Federal Council of Fiscal Responsibility to monitor compliance of the accord. The Consensus seeks to generate a framework of stability and predictability for taxpayers and provinces, encourage investment and employment and improve the financial situation of the Nation and provinces.

Source: Own elaboration.

In accordance with the new legal framework (post-1994), it was possible for royalties to appear in the provincial fiscal structure and, in some of them, to significantly increase budgetary resources, due in part to the additional economic activity generated by the development of mineral resources. However, recent national legislation, previously agreed with the provinces of Patagonia, has introduced what has been called a “regulatory profile” in the decentralized scenario provided for in the 1994 Constitution for the oil and gas sector.

The 2001 crisis accelerated some contradictory changes with previous Pacts, including the taxability of the manufacturing industry on gross income, the reappearance of the death duties or inheritance tax, particularly in the Province of Buenos Aires, as well as circulation taxes in some other jurisdiction, for maintenance and repair of regional and local roads.

III. DEEPENING THE ANALYSIS: THE EARLY 21ST CENTURY, CRISSES, FEDERAL FISCAL SCHEME AND SUBNATIONAL AUTONOMY

As we have mentioned before, the strong vertical fiscal imbalance is the structural characteristic of the fiscal scheme in Argentina, in favor of the national government with respect to other levels. In times of crisis, this is sharply evidenced by additional disputes over existing resources. The “subnational fiscal space” evolves in such a context.

3. The 1994’s Constitution, in Article 124, 2nd paragraph, granted the power on natural resources (minerals, hydrocarbons, etc.) to the provincial jurisdictions, changing the fiscal map of the country, enhancing provincial revenues mainly in Patagonia, Cuyo and Northwest, besides some specific cases. It involves the municipalities also, as in the case of the gold deposit of “Bajo La Alumbrera” (Di Paola, 2019).
To examine this, we will remember what was previously mentioned, regarding the fact that in relation to revenues, from the country's first constitution to the present, the system evolved towards the strong accumulation of the same by the national government, leaving a small proportion of resources for subnational governments, both provincial and municipal. In other words, the revenue system as a whole was centralized. In turn, it was legislated through the basic federal regulations framing to a large extent the provinces and municipalities for the exercise of the tax powers that they have retained.

So, under this regulation that we have called “umbrella legislation” (Asensio, 2015), provincial and municipal governments cannot establish taxes similar to those distributed through the co-participation regime, which are VAT and income tax of individuals and companies, among others. Therefore, complying with regulations to apply one’s own tax policy is a condition for accessing the common cake of participation (the so-called tax “co-participation” of national taxes).

Regarding spending, the new century inherited a previous interjurisdictional redistribution of functions, after carrying out a great decentralization of expenditures through the transfer of public services from the national government to the provinces. The same happened in the 1970s, 1980s, and mostly in the 1990s. The transfers were mainly from the secondary education and health sectors, and they expanded the scope of provincial spending.

It is important to mention that this system would face two major crises, one right at the beginning of the century in 2001 and the other in 2008-2009. The first was an internal crisis, with an explosive end to the currency convertibility regime in force since 1991, and abandoned at the beginning of 2002. The second was a crisis resulting from the international recession that began in that year.

Regarding the 2001 crisis, it generated a strong growth in social assistance by the State to combat the poverty that was unleashed as a result of it. In addition, two new taxes were introduced, which are the tax on financial transactions, that is, on the check; and the export tax, collected by the national government.

After the economic recovery in 2002, the main beneficiary of the application of these taxes was the central level, further accentuating the existing vertical fiscal imbalance. Later, the fiscal institutions of Argentina were transformed by the Fiscal Responsibility Law enacted in 2004, and by the approval of the Educational Financing Law. The first Law established guidelines to expand public spending, linking it to the Gross Domestic Product, and the maximum level of debt for the provinces. In addition, it created the Federal Council of Fiscal Responsibility, the body for supervising such Regime. The Educational Financing Law established an additional spending scheme for its implementation.

The aforementioned evolution is related to the national and subnational tax structure. Any tax structure, which includes the different levels of government, is affected by the economic situation, evidenced in the flexibility of the taxes that are related to the economic cycle, the structure of direct and indirect taxes and other facts.

As we know, it is possible, in turn, to show the federal revenue system as a whole and within it the weight of the subnational sector, showing the tax burden measured from the ratio between the tax revenue received by governments and the level of economic activity, in the following figure for the period 2004-2021.
It expresses the manifest difference in one’s own fiscal capacities. The national or federal level is decisive in the scheme. Said national and subnational fiscal capacities are exercised through constitutionally and legally assigned taxes, the primary consideration of which we have already made in preceding paragraphs.

Returning now to the subnational level, it should be noted that the provinces and municipalities rest on tax bases linked mainly to gross income, on the one hand, and on real estate, on the other, either for their taxes in the first case or to apply rates, in the second, without prejudice to other encumbrances as indicated. In property taxation, progressive rates are expressed in the specific regulations.

Likewise, the real estate tax is divided into a tax on urban real estate and a tax on rural real estate. Both have traditionally been affected by a fiscal policy mistake based on a kind of “political failure” in order to avoid taxpayer dissent. There has been great opposition to raising this tax, due to its visibility, unlike indirect taxes, with the additional effect that if its base is increased, the national tax on personal property increases. Consequently, if the value of the cadastral base of the provinces is modified, taxpayers must face a double increase in taxes, one paid to the provincial government and another to the national government.

It is necessary to return to the issue of withholdings or deductions for exports collected by the national government. Whatever the tax base, all taxes affect income. This is how a phenomenon of “occupation of tax room” arose (Bird, 1986; Asensio, 2015), due to which provincial tax incomes began to shrink. The national government additionally affected agricultural income with such withholdings on agricultural exports, and this diminished the opportunities for the provinces to increase the rates or valuation of their taxes on rural real estate. This generated a fiscal shift in favor of the central government, which, as the constitutional holder of the power to tax foreign trade, absorbed the total income from this tax. This then conditioned subnational finances.

The evolution of the tax system was again put in check for the second crisis of the decade in 2008-2009, with the impact of the drop in aggregate demand on income. It was
observed that although there was a slowdown in tax collection in the year mentioned and in the preceding year, this was attributable to export taxes. However, the results in 2008 and 2009 are strongly influenced in a compensatory way by taxes on wages used to finance social security. The result was that once social security taxes were discounted from total tax income, taxes collected by the national government decreased by 1.18% of GDP, while provincial taxes increased by 0.25%.

<table>
<thead>
<tr>
<th>Table 4: Tax Structure (main taxes in percentages).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provincial taxes</td>
</tr>
<tr>
<td>National taxes</td>
</tr>
<tr>
<td>Main National Taxes</td>
</tr>
<tr>
<td>On Property</td>
</tr>
<tr>
<td>Trade &amp; foreign transactions</td>
</tr>
<tr>
<td>Income &amp; Profits</td>
</tr>
<tr>
<td>Contributions to Social Security</td>
</tr>
<tr>
<td>VAT</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance of the Argentine Nation.

An important aspect in the evolution of provincial finances, as the most relevant level within the subnational stratum that also incorporates local governments or municipalities, is the authentic existing tax autonomy for the use of their fiscal capacities. In the context of international studies on the subject, it is known that there are technical alternatives to regulate the exercise of legal powers in this regard (Blochliger and King, 2006; Blochliger and Rabesonna, 2009). Strictly speaking, in the Argentine case, for decades the same laws that approved the operation of the federal tax system incorporated regulations and limitations on the unrestricted use of provincial powers in its main taxes, as already indicated. Emblematic examples have been the National Co-participation Law of 1988 itself and the Fiscal Pact of 1993, an aspect that we have discussed in detail in other contributions (Asensio, 2018).

An example is the establishment of an evolutionary cycle tending to limit, the tax rates of the main provincial tax already mentioned, namely the Tax on Gross Income, which as such is transferable in various stages of incidence (Turnover). Without mentioning the Pact of 1993 that partially respected, a new temporary course was established in the 2017 Fiscal Consensus, modified also in the middle of the pandemic, and again in 2021-2022.

4. Actually, they are earmarked for financing the pension plans but frequently the federal government borrows from them to afford certain objectives.
The table below, once again exposes the character of “regulated tax autonomy” with which it is possible to characterize the one enjoyed by provinces, without ignoring that without its existence it would be difficult to ensure fiscal policy behaviors fully compatible with stability.

Table 5: Gross Income Tax Rates in Consensus of 2017 and Modified in 2021.

<table>
<thead>
<tr>
<th>Concepts according to Years</th>
<th>Established in 2017</th>
<th>Established in 2017</th>
<th>Established in 2017</th>
<th>Established in 2021</th>
<th>Established in 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activities taxed/ Years</td>
<td>2018</td>
<td>2019</td>
<td>2020</td>
<td>2021</td>
<td>2021</td>
</tr>
<tr>
<td>Agriculture, fishing, mining and forestry</td>
<td>1.5</td>
<td>0.75</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Agriculture, mining and forestry</td>
<td>1.5</td>
<td>0.75</td>
<td>0.0</td>
<td>0.0</td>
<td>0.75</td>
</tr>
<tr>
<td>Fishing</td>
<td>1.5</td>
<td>0.75</td>
<td>0.0</td>
<td>0.0</td>
<td>0.75</td>
</tr>
<tr>
<td>Mining and Quarrying</td>
<td>1.5</td>
<td>0.75</td>
<td>0.0</td>
<td>0.0</td>
<td>0.75</td>
</tr>
<tr>
<td>Total Manufactures</td>
<td>2.0</td>
<td>1.5</td>
<td>1.0</td>
<td>0.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Paper industry</td>
<td>7.0</td>
<td>6.0</td>
<td>5.0</td>
<td>4.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Electricity, gas, water</td>
<td>5.0</td>
<td>3.75</td>
<td>2.5</td>
<td>1.25</td>
<td>3.75</td>
</tr>
<tr>
<td>Electricity, gas, water (except residential)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4.0</td>
</tr>
<tr>
<td>Construction</td>
<td>3.0</td>
<td>2.5</td>
<td>2.0</td>
<td>2.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Trade</td>
<td>WM</td>
<td>5.0</td>
<td>5.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Restaurants</td>
<td>5.0</td>
<td>4.5</td>
<td>4.0</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>Transport</td>
<td>3.0</td>
<td>2.0</td>
<td>1.0</td>
<td>0.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Communications</td>
<td>3.0</td>
<td>4.0</td>
<td>3.0</td>
<td>3.0</td>
<td>5.50</td>
</tr>
<tr>
<td>Total Financial intermediation</td>
<td>WM</td>
<td>5.5</td>
<td>5.0</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>Financial services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>9.0</td>
</tr>
<tr>
<td>Real estate, business, rental</td>
<td>6.0</td>
<td>5.0</td>
<td>4.0</td>
<td>4.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Social and Health Services</td>
<td>5.0</td>
<td>4.75</td>
<td>4.5</td>
<td>4.25</td>
<td>4.75</td>
</tr>
</tbody>
</table>

WM= without maximum.

Source: own elaboration based on the Fiscal Consensus 2017 to 2021.

5. Regarding the 2017 Fiscal Consensus, the changes established for the year 2021, mentioned in this table, were sanctioned.
With the foregoing, it should be added that in the Fiscal Consensus of 2018, the reduction of national subsidies for public services was established, starting in January 2019, depending on the possibilities of the provinces, regarding the consumption water service, sewage, electricity and public transport.

In the 2019 Fiscal Consensus, in relation to Gross Income, the suspension of income tax relief on the export of goods was established, with the exception of mining or hydrocarbon activities and their complementary services. In relation to the Real Estate Tax, the fixing of rates of the same between a range of 0.5% and 2% of the fiscal value of the property was suspended. Regarding the stamp tax, the non-increase of rates of this tax on real estate, automobiles and hydrocarbon activities and complementary services is suspended, and suspension of this tax for acts and contracts.

The 2020 Fiscal Consensus determines, in relation to Gross Income, the maintenance in the suspension of income tax relief on the export of goods. In relation to the Real Estate Tax, the fixing of rates of the same between a range of 0.5% and 2% of the fiscal value of the property was suspended. Regarding the stamp tax, the non-increase of rates of this tax on real estate, automobiles and hydrocarbon activities and complementary services was suspended, as well as suspension of this tax for acts and contracts. In particular, in the Fiscal Consensus for 2021/22 was banned again the taxability in the GIT (Gross Incomes Tax) of the exportation of goods.

IV. FISCAL RESOURCES AT THE THIRD LEVEL, OWN SOURCE AND SHARED ONE’S

Local governments are the third level of the scheme but the second as a member of the subnational stratum. Argentine municipalities are financed with three types of resources: their own taxes collected in accordance with constitutional and legal powers, these being fines, rates and fees required for providing services to the people in their jurisdiction; transfers from other levels of government; and participation (sharing) of national and provincial taxes.

These sources of income can also be grouped into: taxes and other rights collected as part of specific functions; and resources received via transfers or grants from the central or provincial level of government. In the first group, rates (“tasas”) prevail, while in the second, higher level tax sharing stands out, being almost two thirds of local income.

When describing tax income at the local level, the particular form of taxation that they use to exercise their taxing power, rates, is pointed out as “disguised taxes”. “Rates” are the main collection item, followed by the rest of the fees, fines and user charges that produce a third of local tax income.

In the constitutional reform of 1994, municipal autonomy was recognized, the character of which would have to be defined in the provincial constitutions. Therefore, although the development of the statute of local governments is undeniable, the scope of such autonomy continues to be the province’s power. Additionally, with said reform, the Autonomous City of Buenos Aires was granted a particular status, which resembles an “urban province”.  

6. “Tasa” is the Spanish denomination for such contributions.
There is a determining and limiting factor so that municipal governments can exercise full tax authority, that is, the legislation, collection, modification and reduction of taxes, which is established by intergovernmental tax agreements and ratifying laws concluded between the national government and the provinces, like the Coparticipation Law No. 23,548, enacted in 1988, and the Federal Pact of 1993 and similar and subsequent ones.

These laws force the provinces to set limits to local tax powers, because the provincial governments cannot collect taxes similar to what is distributed at the national level through the co-participation mechanism. The link between the three levels of government is completed in the 1988 Law, which establishes that the provinces must agree for their local governments a co-participation regime to be applied in their jurisdiction. If it was not implemented, they could not receive their participation in the national taxes established in said Law.

According to traditional constitutional interpretations, local governments were prohibited from collecting taxes when they were not in harmony with those collected by the provincial and central governments. Likewise, the municipalities had to comply with the “principle of not analogy” established in the Coparticipation Law. So, in practice, many provinces have regulated the autonomy of the municipalities, and they use the tax powers that such autonomy implies in a limited way as a consequence of the restrictions.

In this way, the most important forms of municipal taxation continue to be taxes on property (real estate taxes), which finance typical services such as lighting; and rates based on inspection, safety and sanitation (rate on gross incomes from economic activities). Both taxes reached almost 70% of the total own income.

The tax bases of these taxes make them, as previously mentioned, “masked taxes”. For the property tax, it falls on the cadastral value of the property, whose base is equivalent to that of the provincial real estate tax, while for the income-based right, the base depends on the gross income of the taxpayers, according to the economic activity to which they are engaged, being the same as the provincial tax on gross incomes or sales.

This generated a deviation from the principle of correspondence between the amount collected from the “tasa” (rate) and the costs of providing local government services. This problem was supposed to have been resolved with the 1993 Fiscal Pact, which established that provinces should induce their local governments to set rates on services that are no greater than the costs of providing those services, with meagre results.

In some cases, local governments used redistributive principles when regulating security and sanitation rates, applying them differentially on certain luxury activities. The same happened when applying higher rates in the local property tax according to the socioeconomic standards of the different urban areas, being an opposite criteria from normative fiscal federalism that reserves the distributive part to the federal government, suggesting that local governments focus on the efficient provision of local public goods.

As stated, the legal regime of Argentine municipalities is contemplated in the provincial constitutions. However, as mentioned, the national constitution makes explicit that the central government must ensure provincial autonomy, provided that they guarantee primary education, the administration of justice and the “municipal regime”. And in this third level the financial need also plays.

7. The so called “betterment contribution tax” has a revenue signification minor to its potential.
We know of a national tax sharing system that transfers resources to the provinces and through them to the municipalities. In addition, such a system obliges the provinces to reproduce a co-participation scheme with local governments in their jurisdictions. These laws establish the manner of distributing revenue from the central and provincial levels and other specific and particular resources of some intermediate governments, as well as royalties collected from the exploitation of natural resources within provincial limits, including resources from privatizations.

Although the principle established in article 121 of the 1944 Constitution is applied to subnational jurisdictions, which mentions that the provinces “keep all powers and functions not delegated to the nation”, many times the provincial constitutions detail the functions of that level of government and do not describe in parallel the functions of local governments in as much depth.

The organic laws that regulate the operation of local governments try to correct these deficiencies, establishing very broad functional restrictions and details that, according to when they were approved, show strong aspirations for deeper decentralization. City governments typically play many roles, often focusing on services on behalf of residents, such as public lighting, street cleaning, waste treatment, vehicular traffic management, urban planning and building regulations. There is no uniformity in the provision of other services, such as drinking water supply, given that in some cases they are provided by municipalities and in others by provincial governments.

Beyond the norms generated by the Federal Pact of 1993, the autonomous impulse created by the Constitution of 1994 trigger a fluid framework. Recent interpretations suggest that local governments were not prohibited from collecting taxes, as long as they complied with the requirement of being in line with those collected by the nation and the provinces, and complied with the key “principle of not analogy”, sanctioned in Coparticipation Law No. 23,548.

In the Table below, we can see the magnitude of the total income of the municipalities in relation to the GDP and in parallel the dimension of the total expenses of the local levels of government in function of the GDP, for three selected moments.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total incomes/GDP (in %)</th>
<th>Index</th>
<th>Total expenses/GDP (in %)</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>2.68</td>
<td>100.00</td>
<td>2.70</td>
<td>100.00</td>
</tr>
<tr>
<td>2013</td>
<td>3.32</td>
<td>123.88</td>
<td>3.33</td>
<td>123.33</td>
</tr>
<tr>
<td>2019</td>
<td>3.43</td>
<td>127.99</td>
<td>3.36</td>
<td>124.44</td>
</tr>
</tbody>
</table>

Source: Own elaboration based on data from the National Directorate of Provincial Affairs, Secretary of Finance, Ministry of Economy of the Argentine Nation.

This table shows that the income of the municipalities has increased along with the expenses, which is why it is difficult for them to make large-scale expenditures, given that, as mentioned, they do not have as much facility to increase their revenue as the other levels of government.
V. THE LONG TERM AND THE “CENTRAL ROLE OF THE CENTRAL GOVERNMENT”

From a general perspective, it is worth noting a relevant characteristic in the Argentine case. The country has a federal organization, but the evolution from its old original system of “separation of sources” to the contemporary co-participation regime, as well as the correlative conformation of functions that deposited in the federal government the majority of social security benefits, payments by pensions and assistance to specific groups, even acknowledging a moderate decentralization of expenses with the subnational levels, poses a lasting predominance of the same in the federative finance scheme. Although differing from a highly centralized federation like Mexico, it dominates in the field of resources and recognizes greater importance to the subnational space in terms of spending.

The table that we accompany shows this in the “twenty long years” since the beginning of the 21st century. These data show a long-term evolution of sustained growth in spending in relation to GDP, both at the national level and at the two subnational levels of government. Then, total consolidated public spending increased very significantly in that period.

And what about the central role and centralization in the scheme? We have pointed out some time ago that if “full” bilateral centralizations can be recognized, this is not the Argentine case. The data clearly shows that Argentina exhibits a very important unilateral centralization, while operating essentially on the resource side, recognizing a moderate margin for subnational finance on the expenditure side (Asensio, 2000). However, given the decisively determining character of the “power of the stock market”, centralization, in a generic sense, is an emergent consequence.

However, the national government is the one that has the broadest powers to resort to indebtedness, on the one hand, and to the monetary requirements for insufficiencies of the Treasury towards the Central Bank. In addition, in the field of genuine income, access to export taxes enhanced their capacity with respect to the subnational level.
### Table 7: Structure and trend in public spending.

<table>
<thead>
<tr>
<th>Year</th>
<th>National</th>
<th>Provincial</th>
<th>Municipal</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>17.45</td>
<td>13.54</td>
<td>2.84</td>
<td>33.83</td>
</tr>
<tr>
<td>2001</td>
<td>18.14</td>
<td>14.54</td>
<td>2.92</td>
<td>35.60</td>
</tr>
<tr>
<td>2002</td>
<td>15.00</td>
<td>11.74</td>
<td>2.37</td>
<td>29.11</td>
</tr>
<tr>
<td>2003</td>
<td>15.51</td>
<td>11.53</td>
<td>2.41</td>
<td>29.45</td>
</tr>
<tr>
<td>2004</td>
<td>13.20</td>
<td>11.03</td>
<td>2.38</td>
<td>26.60</td>
</tr>
<tr>
<td>2005</td>
<td>14.48</td>
<td>11.98</td>
<td>2.59</td>
<td>29.06</td>
</tr>
<tr>
<td>2006</td>
<td>14.45</td>
<td>12.48</td>
<td>2.71</td>
<td>29.65</td>
</tr>
<tr>
<td>2007</td>
<td>16.86</td>
<td>12.92</td>
<td>2.70</td>
<td>32.48</td>
</tr>
<tr>
<td>2008</td>
<td>18.23</td>
<td>13.47</td>
<td>2.60</td>
<td>34.30</td>
</tr>
<tr>
<td>2009</td>
<td>21.61</td>
<td>15.08</td>
<td>3.20</td>
<td>39.89</td>
</tr>
<tr>
<td>2010</td>
<td>21.05</td>
<td>14.03</td>
<td>3.19</td>
<td>38.27</td>
</tr>
<tr>
<td>2011</td>
<td>22.18</td>
<td>14.74</td>
<td>3.09</td>
<td>40.01</td>
</tr>
<tr>
<td>2012</td>
<td>23.22</td>
<td>15.00</td>
<td>3.06</td>
<td>41.28</td>
</tr>
<tr>
<td>2013</td>
<td>24.05</td>
<td>15.48</td>
<td>3.33</td>
<td>42.86</td>
</tr>
<tr>
<td>2014</td>
<td>25.11</td>
<td>15.57</td>
<td>3.32</td>
<td>44.99</td>
</tr>
<tr>
<td>2015</td>
<td>25.92</td>
<td>16.83</td>
<td>3.55</td>
<td>46.30</td>
</tr>
<tr>
<td>2016</td>
<td>27.36</td>
<td>16.66</td>
<td>3.29</td>
<td>47.31</td>
</tr>
<tr>
<td>2017</td>
<td>25.71</td>
<td>17.14</td>
<td>3.40</td>
<td>46.25</td>
</tr>
<tr>
<td>2018</td>
<td>24.37</td>
<td>15.93</td>
<td>3.36</td>
<td>43.67</td>
</tr>
<tr>
<td>2019</td>
<td>24.17</td>
<td>15.95</td>
<td>3.12</td>
<td>43.24</td>
</tr>
<tr>
<td>2020</td>
<td>27.52</td>
<td>16.50</td>
<td>3.48</td>
<td>47.50</td>
</tr>
<tr>
<td>2021</td>
<td>24.28</td>
<td>15.12</td>
<td>3.44</td>
<td>42.84</td>
</tr>
</tbody>
</table>

Source: Fiscal Policy and Income Analysis Directorate belonging to the National Directorate of Macroeconomic Policy – Under secretariat of Macroeconomic Programming - Secretariat of Economic Policy, based on the Ministry of Finance, public information from the provinces, social works and INDEC.

In summary, the preceding Table shows that, within a generalized growth of consolidated spending in more than twenty years, the weight reached by the central government with respect to the subnational orbit is accentuated. In the second decade, its participation reached more than once a phenomenal range of almost 58% of the total, leaving around 42% for the aggregate of provinces and municipalities.
VI. FOCUSING AGAIN IN THE CRISES

1. Two crises in the first decade of the XXI Century.

As we anticipated slightly above, during the first decade of the 21st century, the Argentine economy was affected by two substantial economic crises. For this reason, we have previously called it “the decade of double crisis” (Asensio, 2011). We refer to the one of internal origin that began in 2001 and was very evident during 2002, on the one hand, and to the one that originated as a result of the international crisis of 2008 and that was more evident in 2009.

Both crises, however, occurred at very different conjunctural moments. The first, of great depth, was accompanied by the monetary collapse, the default of its external debt and the forced restructuring of its banking system, being strictly speaking the end point for a previous period of negative evolution linked to a fixed exchange rate between the Argentine peso and the US dollar. Almost immediately the country began to experience a significant recovery based on favorable international conditions, particularly in the commodity market, reaching what was known as “twin surpluses”: fiscal and external.

The second, on the other hand, of a much smaller magnitude and duration, emerged in the middle of the aforementioned expansion cycle, which was lasting as such and lasted beyond the aforementioned decade. Consequently, the decline in 2008-2009 was moderate in relation to the previous one, being an episode that did not alter the recovery trend that began at the end of 2002. On the other hand, the country achieved a renegotiation or long-term arrangement with bondholders of its external debt and the banking system was strengthened.

Within the general scheme of fiscal federalism, the national government was consolidated through the very important income from export duties accrued during such a “revolution of commodities”, also taking advantage of the income from the resources of the retirement system, privatized after averaging. In such a context, subnational finance received a minority share of the fiscal improvement in the national sphere but also benefited from the general bonanza of that decade, given the procyclicality of its own tax system.

The reserved access to the national government of the recently mentioned export rights derives from the provisions of the Constitution that date back to the 19th century. This placed this sphere of government in an asymmetrical position with respect to subnational levels and endowed it with a concomitant additional spending capacity, being a resource that is easier to perceive than the traditional VAT and Income Tax, on the other hand not shared with the provinces and municipalities given the exclusive character granted by the Constitution to the Nation, except for the moderate participation that it granted as its own power to said levels of such collected mass, as indicated.

The illustration of such a decade of “double crisis” or decade of “fall and recovery” through relevant variables is the one that we expose in the following figure within the “twenty long years” mentioned above, in order to also visualize the collapse comparatively pandemic that we consider next.

---

8. This alludes to the result in the Treasury balance, on the one hand, and to the balance of international payments, on the other.
2. Economy, fiscal federalism, subnational finance and the pandemic phenomenon.

The COVID 19 pandemic that struck the world and mainly covered the years 2020 to 2022 despite its continuing incidence and some of its effects in various regions of the planet, had obvious negative repercussions on the economies of advanced and less developed countries.

This was necessarily reflected to a different extent in the evolution of fiscal systems, both in income and expenditure and, accordingly, with difficulties and readaptations at different levels of government, both at the central and subnational levels, and in the latter case, both at the level of states, cantons or provinces, as well as municipalities or communes at the local level.

The economic magnitude of such a crisis in Argentina can be compared with the data of the two major crises showed in the Graphic above. In the one of 2001-2002 the abrupt GDP downfall was around -12% and in per cápita terms -12.5%, aggravated for two previous downfalls. In 2008-2009 the GDP drop reached -6% and the GDP per cápita fall reached -7%, coming, however, from positive years. In the pandemic crisis the shrinking of GDP was close to the one of 2001-02, being -10% in global terms and -11% per inhabitant. Here, also, the previous years were negative ones. Fortunately, the rebound was positive in 2021. Comparatively, the first and the last ones were of the acute “V” type, while in 2008-9 recognized also a V format but relatively less violent and surrounded by positive years, previously and in the recovery9.

In the Argentine case, a country in which its position of high external indebtedness conditions its access to international credit markets10 and a situation of tightness in its public accounts, the adoption of emergency measures implied a new global budgetary challenge that, in addition to readjustments and readaptations of expenditure items, implied the recurrence of monetary support from its Central Bank.

10. At the time of concluding this work, the country maintains a Specific program with the International Monetary Fund, given its high level of indebtedness, aggravated by the conditions generated by the war in Ukraine and a catastrophic drought, unprecedented in several decades.
The establishment of different aid programs aimed at alleviating the collapse of the private economy corresponded in different ways to all levels of government but predominantly at the federal level, with emphasis on actions aimed at protecting employment within what was the toughest attack of the so-called preventive and mandatory isolation, aimed as in other countries at reducing contagion. The federal share of expenditures increased in three points of GDP from 2019 to 2020 with public health and social security clearly pushing it.

In this context, during the years 2020 and 2021 these actions evolved, in some cases enhanced for seasonal reasons or due to the difficulty in accessing vaccines in sufficient quantity, until the moment in which this process (vaccination) was showing positive to reduce the transmission and death rates.

It should be noted, however, that the operation and rationality of a federal system was subjected to difficult circumstances. Considering dramatic examples of national-state differences in large federations on specific health decisions (United States or Brazil, for example), the Argentine case was seen as much less conflictive in terms of inter-jurisdictional disagreements, despite important divergences with at least one relevant jurisdiction, such as the Autonomous City of Buenos Aires (CABA), in relation to the specific criteria adopted on pandemic protection within the educational system.

In tax matters, various questions are raised in terms of the incidence and impact or observable impacts due to the pandemic. Among the several, it is worth asking whether there was an alteration in the general trend of tax flows, on the one hand; on its manifestation at various levels and in particular the subnational, on the other, and regarding alterations in the interlevel fiscal structure, finally.

In this sense, based on the existence of a predominant role of the federal government that had an impact on its indebtedness with the central bank, from a strictly tax perspective, a decrease in the volume of both central and subnational budget incomes can be seen, compatible with the predominant procyclicality in the total tax revenue of federative actors, central and subcentral.

**Figure 3: Collection of tax revenues in millions of pesos (base year 2004).**

Source: Own elaboration based on data from the Undersecretary of Public Revenue of the Ministry of Economy of the Argentine Nation.
The manifestation of such a drop was then visible in the income of the federal and subnational public sectors, the latter comprising the intermediate or provincial stratum and that of local governments. In cases of crisis, the private resort to a financing mechanism that rests on the relaxation of compliance with tax obligations is known, which is reflected in the effective collections of the Treasury.

Given this picture, it is important to answer the question: how did the federal tax income structure affect such a phenomenon? The answer is that within a hardly avoidable drop in the size of fiscal flows, due to the aforementioned procyclicality, there was no a manifest but small alteration in the structure or proportions in which the three federal levels participate within the dualism of national resources-subnational resources, given a soft backsliding in the central share as can be seen in the preceding graph and the following Table. This, largely produced as a consequence of the almost parallel behavior of the corresponding tax flows. In the expenditure side, the maintenance of the relative participations remain similar in average, except for the unique acute jump in 2020, whose level had reached the proportion of 58% already mentioned.

Table 8: Participation in revenues and expenditures by level of government. Selected periods.

<table>
<thead>
<tr>
<th>Period</th>
<th>Tax Revenue</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996-2000</td>
<td>19.2</td>
<td>4.2</td>
</tr>
<tr>
<td>2001-2005</td>
<td>21.1</td>
<td>4.1</td>
</tr>
<tr>
<td>2006-2010</td>
<td>25.7</td>
<td>4.4</td>
</tr>
<tr>
<td>2011-2015</td>
<td>28.2</td>
<td>5.5</td>
</tr>
<tr>
<td>2016-2020</td>
<td>24.5</td>
<td>5.1</td>
</tr>
</tbody>
</table>

Source: Own elaboration based on data from Asensio (2020, in press), AFIP, DNCFP, INDEC and MECON.

There remained, of course, monetary consequences that are still trying to be mitigated in such a system, and that must be resolved through the use of the absorption mechanisms that, within its organic regulations, correspond to the Central Bank, regarding the use of such instruments at the request of the national health system and the emerging deficit situation in the Treasury of the Nation.

VII. INDEBTEDNESS AND THE CRISES

Access to the use of credit has had alternatives concomitant with various circumstances. It is subject to regulations both in the Argentine National Constitution and in the Provincial Constitutions, as well as in national and subnational regulations.

Indebtedness in the subnational level can be originated in diverse aspects and objectives. At the provincial and local level there exists norms which must be considered in connection with its constitution and statutes linked in turn with national laws and, of course the National Constitution, in particular with reference to external debts. The complexity of the issue suggested to a main expert indicate that “it is needed a sanction of a law...given the Article 27 of National Constitution establishing the great frameworks
or guidelines „to be respected by the subnational states [for] the agreements to subscribe” in the matter (Dalla Vía, A., 2016).

Given that, financing through the use of credit enables national, provincial and local governments to increase their income beyond what is allowed by their tax powers, the resources derived from other levels of government and their administrative capacity to collect and manage them. It is worth considering here whether or not the so-called “golden rule” is respected, in which the level of local indebtedness must be limited to its use to make medium and long-term investments or increase social capital.

The National Constitution establishes that the federal government is responsible for agreements on foreign debt. The provinces can contract debt obligations, always within the limits established by the constitutions. Since 1980, when these obligations are contracted abroad, the intervention of the central government is necessary, embodied in norms, laws and federal statutes and of the monetary authority that as such imply and regulate the intervention of the Ministry of Economy of the Nation and the Central Bank in access to the external credit market.

The external debt, in particular, played a determining role in the so-called “lost decade” of the 1980’s of the last century. The inability to meet international commitments was reflected in the notorious default of 2002, with a renegotiation of bonds reached in 2005.

**Figure 4: Public Debt Services in percent of GDP.**

![Figure 4: Public Debt Services in percent of GDP.](source)

Source: Own elaboration based on Argentinian Ministry of Finance, and public information from the provinces, social works and INDEC.

More studies remain to differentiate the evolution of the national consolidated debt, including its various facets. In the previous Graph, which refers to its services, it is possible to perceive the very high level that they represented in 2001, as well as their much smaller dimension in the period 2008-2009. In both pre-pandemic reference moments, it is visible that the first implied a peak in incidence, while the second was clearly less violent in perspective.

Subsequently, adverse expectations related to “country risk” and a fragile balance of payments situation led to a new appeal to the IMF whose evolution has affected the level of such services. Although their magnitude includes those that refer to national and subnational debt, the data shown allows us to appreciate an overwhelming participation of the credit contracted by the central government in relation to that originated in the
Within this framework, the role of the provinces being visible, the corresponding payments are meager in the case of the municipalities.

Interestingly, both at the national and subnational level, the last years for which there is official information coverage (2020-2021), which are the most significant in terms of pandemic, show a significant reduction in the weight of national and subnational debt services, and it must be understood in this field that such contradictory evidence is linked to the ordering nature of the already mentioned agreement with that Multilateral Organization.

Figure 5: Public Debt Services (% Quinquennial Averages GDP).

Source: Own elaboration based on Argentinean Ministry of Finance, and public information from the provinces, social works and INDEC.

The Graph presented above brings together the incidence of the aforementioned services, this time grouped into five-year periods. Once again, the aforementioned differences in size are observable, between the Nation and the provinces and municipalities.

VIII. CONCLUSIONS

Subnational finances are important in the federal or decentralized schemes, including those of unitary states. Both at the level of intermediate governments (states, departments, Lander, cantons, provinces) and local (municipalities, districts, prefectures, communes) particularities are observed as a result of different evolutions in their formation processes, which do not always yield similar patterns (Bird, 1986; Bird, 2011, McLure, 2000).

In the Argentine case, a historical review has been carried out, of the distribution of powers and obligations between the nation and subnational governments. As in other cases, subnational tax powers in Argentina cannot be considered without evaluating the federal finance system. Likewise, some historical changes do not originate at the subnational level, but at the central level, so that in the design of subnational taxes, attention to the principle of not analogy established in federal legislation should be the “iron rule”.

Provincial and local governments can be considered as minority partners of the national state in terms of revenue. The same does not occur with spending, where said
governments provide important services with high labor demands, such as security, primary and secondary education, and health institutions.

A critical aspect to highlight is coordination with higher levels of government. The overlapping of activity and the lack of precision in the delimitation of certain functional responsibilities are characteristics of the intergovernmental scenario in Argentina. Although this is typical of certain overlaps in federal countries, it should be stressed that it is important to promote and improve the consultation and coordination procedures.

A significant and highly necessary step would be to adapt the application and improvement of the rules and procedures adjusted to the new legislation on fiscal responsibility, as occurred in federal and non-federal spheres.

Given the high interconnection generated by the Nation-Provinces and Provinces-Municipalities tax participation regimes, which also imply a strong procyclicality, during the COVID-19 pandemic process there was a similar decrease in subnational incomes in relation to those of the federal government, which, however, assumed a greater proportion of the financial burden of the health emergency then unleashed. The data and quantitative indications examined show the same for the 2008-09 crisis and the same can be deduced for the 2001-02 crisis. In 2020 centralization increased but in a range that had already been previously reached.

In structural terms towards the interior of the consolidated public sector, a relative weight of the sub-national levels in average is maintained with respect to the national level, a circumstance that does not hide a soft tendency towards expansion in the area of the municipalities, as shown by the indicators presented. At the Latin American level, however, given its federal nature, the subnational sector in Argentina (provinces plus municipalities) is superior to other cases of decentralization, although inferior to that of Brazil, where the weight of states and local governments is more visible\textsuperscript{11}.

With respect to debt the availability of data is not conclusive in relation to the pandemic situation, until further research could show in specific discrimination the weight of it. Recent national data mainly shows flows for services and not always for stocks. Of course central amounts are bigger than the provincial ones and more information is needed for getting information on local level, which affect the jointly evaluation of the subnational aggregate.

\textsuperscript{11} The Appendix to this article includes comparative data from moments just before the start of the COVID-19 pandemic, with respect to five important countries in Latin America.
REFERENCES

INTRODUCTION

APPENDIX I

Comparative Subnational Data (alternative sources)\textsuperscript{12}.

Table 1: Relation Taxes/GDP with Subnational Aggregate.

<table>
<thead>
<tr>
<th>Level</th>
<th>Brazil</th>
<th>Mexico</th>
<th>Argentina</th>
<th>Colombia</th>
<th>Peru</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>27.1</td>
<td>23.2</td>
<td>28.2</td>
<td>16.1</td>
<td>22.1</td>
</tr>
<tr>
<td>Subnational</td>
<td>12.2</td>
<td>1.5</td>
<td>6.6</td>
<td>3.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Intermediate</td>
<td>9.8</td>
<td>1.0</td>
<td>5.5</td>
<td>1.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Municipal</td>
<td>2.4</td>
<td>0.4</td>
<td>1.1</td>
<td>2.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>39.3</td>
<td>24.7</td>
<td>34.8</td>
<td>19.6</td>
<td>23.3</td>
</tr>
</tbody>
</table>

Table 2: Relation Expenditures/GDP with Subnational Aggregate.

<table>
<thead>
<tr>
<th>Level</th>
<th>Brazil</th>
<th>Mexico</th>
<th>Argentina</th>
<th>Colombia</th>
<th>Peru</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>18.8</td>
<td>11.6</td>
<td>25.0</td>
<td>13.7</td>
<td>12.5</td>
</tr>
<tr>
<td>Subnational</td>
<td>20.1</td>
<td>11.8</td>
<td>19.2</td>
<td>8.7</td>
<td>9.1</td>
</tr>
<tr>
<td>Intermediate</td>
<td>11.1</td>
<td>9.9</td>
<td>15.8</td>
<td>2.7</td>
<td>4.5</td>
</tr>
<tr>
<td>Municipal</td>
<td>8.9</td>
<td>1.9</td>
<td>3.4</td>
<td>6.0</td>
<td>4.6</td>
</tr>
<tr>
<td>Total</td>
<td>38.9</td>
<td>23.3</td>
<td>44.2</td>
<td>22.5</td>
<td>21.6</td>
</tr>
</tbody>
</table>

\textsuperscript{12} Own elaboration by the Authors on data from ECLAC, CIAT, OEA, IADB and GTZ.
ABSTRACT

This paper shows that Australian net debt by government sector in 2021-22 was at an all-time high, higher than that experienced during the previous GFC crisis. It provides empirical evidence the contribution of the states and territories to all Australian public debt accumulation is currently higher relative to any other point in the history of Australian federalism. The percentage increase of the states’ net public sector debt since 2011-12, has considerably outpaced the Commonwealth’s. The key question, therefore, is whether these increases in public debt represent a critical juncture in Australian Fiscal Federalism, or, if they are simply pandemic related driven? Australian fiscal arrangements make the states and territories extremely fiscally inflexible during times of crisis. The paper establishes that Australia indeed does have the necessary conditions to pressure increasing state indebtedness in the future. These conditions, however, have not been sufficient to produce high levels of subnational debt accumulation in Australia, relative to other more decentralized federations.

Keywords: Fiscal Federalism, Australia, Subnational Public Debt Accumulation, Soft Budget Constraints.
I. INTRODUCTION

Two deep economic crises have impacted public finances in Australia, the Global Financial Crisis 2008-2009, and the more recent COVID19 Health Pandemic 2019-2022. These events are different, but they are similar in that they each have the potential to expose both the strengths and weaknesses of fiscal arrangements in a federation. In Australia, the most recent COVID19 pandemic, followed by its consequential expenditure shocks, then revenue and supply shocks, have impacted the levels of states and Commonwealth\(^1\) net public sector debts, and thus State-commonwealth fiscal relations. Relative to other federations, Australia historically maintains one of the highest levels of vertical imbalance in the world (VFI).\(^2\) The Commonwealth raises approximately 80 per cent of tax revenues and then redistributes these revenues as both tied and untied grants to the states and territories. As a percentage of GDP, all Australia net public sector debt has risen from a historical low of -6.4\% in 2007-2008, to a high of 33.8 \% in 2021-22 (ABS, GFS 2021-22). In comparison to other federal countries however, subnational debt remains relatively low, representing only 21\% of all Australian public sector debt and 8.6\% of total GDP as of June 30, 2021 (see Figure 1). This level of subnational public debt is in stark contrast to more fiscally decentralized federations like Canada, where subnational debt to GDP exceeds 40\% (Hanniman, 2020).

In fact, as is clear in figure 1 below, that Australia not only survived the Global Financial Crisis (GFC) of 2008-09 but emerged largely unscathed. Throughout the GFC, Australia maintained the lowest debt-to-GDP in the OECD and maintained its AAA credit ratings with global rating agencies—ratings that were extended to the states vis-à-vis the Commonwealth’s Guarantee of State and Territory Borrowing (Parliament of Australia, 2009). Therefore, vis-à-vis this mechanism during the GFC, the Commonwealth temporarily re-inserted itself as the guarantor of state loans to protect the states from rising global interest rates, protect state-based credit ratings, and ensure their continued access to the foreign debt market. In principle, because of Australia’s ability to engage in large countercyclical spending projects such as infrastructure spending to counter the recession and quickly finance federal economic stimulus plans, Australia did not go into economic recession during the GFC.

---

1. In Australia the “federal” or “central” government is referred to as the “Commonwealth”
2. VBI refers to a situation where subnational units in a federation spend more than they collect, making them dependent on the centre for fiscal resources.
Figure 1: All Australia general and state government sector net debt (L2) as a percentage of GDP


Beyond providing a new analysis of the extent and growth of public debt in Australia, the central goal of this paper is to explore why this most recent crisis (2019-2021), created an increasing need for states and territories to borrow—resulting in them running up their public sector debts to higher than historical levels. Moreover, the key theoretical question is whether this is a critical juncture in Australian fiscal federalism, or simply a short-term pandemic created problem? Empirically, the key question is whether increasing indebtedness is driven by a structural problem, whereby Australian states and territories have limited “fiscal flexibility” because of Australia’s high VFI forcing subnational units to borrow in times of crisis? Or, because other political, fiscal, and contingent factors are driving the increased contribution of the states and territories to all Australia net public sector debt since 2019, relative to both the Commonwealth and historical tendencies in Australian federalism?

The paper will proceed as follows: The next section will provide a brief overview of Australia’s federal system focusing primarily on its constitutional fiscal arrangements and the politics and impact of fiscal federalism in Australia during crises. Section three frames the key empirical research puzzle to be solved, the article’s central research question, followed by two theoretical propositions and an overview of the key determinant in the literature that explains increasing subnational indebtedness. Section four presents an analytical framework to examine the main hypothesis and to uncover if the key conditions to explain increasing subnational public debt are found in the Australian case. Lastly, the paper concludes with some political and policy implications.

II. BRIEF OVERVIEW OF AUSTRALIAN FEDERALISM

Relative to other federal systems, in particular the U.S. and Canada to which Australia is most often compared, Australia has a highly centralised federal system. In theory,
such high levels of fiscal centralisation can undermine the goals of federalism by blurring federalism’s accountability mechanisms and constraining the ability of the states to diversify their policy options. Federal systems have the dual challenge of having to provide safeguards against the threat of centralized exploitation, as well as decentralized opportunistic behaviour. Australia was federated in 1901, bringing together six (originally five) sovereign states and two territories. In part however, because of Australia’s original constitutional design and its high court’s subsequent judicial interpretations, fiscal federalism has been a core element of the Commonwealth’s growth since federation and its progressive centralization (Galligan, 2012). Fiscal federalism simply refers to how taxing, spending, and regulatory functions are allocated among governments and how intergovernmental transfers are structured.

Under Section 51 of the Australian National Constitution, the Commonwealth has broad taxation powers including personal income tax and the GST tax, customs duties, excises on fuel, alcohol, and tobacco, and petroleum resource rent tax. Currently for example, states and local governments collect less than 20 percent of tax revenue raised in Australia, raising just over half of the revenues they require to fund their expenditures. In 2020-21, the Australian government contributed 46.4 percent of states spending and approximately half of its revenues supplied by the Commonwealth were tied to national goals, priorities, and programs (Commonwealth of Australia, 2022). The size of discretionary transfers relative to non-discretionary transfers thereby provides the Commonwealth ample room to set the direction of policy priorities and policy directions while meanwhile credit-claiming for co-financed policy successes along the way. Moreover, the Commonwealth’s power to grant monies to the states on such terms and conditions as the (national) Parliament thinks fit is enshrined in Section 96 of the National Constitution. This implies that non-discretionary funding to the states is also de jure subject to federal discretion. An extensive discussion of untied transfers to the states which are primarily delivered through Australia’s Horizontal Fiscal Equalization System (HFE), is outside the goals of this paper.

The key point of this overview section is to underscore that the original Australian Constitution and Fiscal Constitutionalism (referring to subsequent judicial interpretations), makes the states and territories largely fiscally dependent on the centre to fund, to deliver, and to provide public services within their jurisdictional authority—primarily health, education, and infrastructure, among others. As Galligan succinctly asserts (2012, p. 327): “VFI was not precluded; indeed, it was there at the beginning, and only diminished as the states began levying their own income taxes, which they did up until the Commonwealth monopolised that field in 1942.” After the imposition of uniform income taxation that was deemed to be a temporary ‘crisis measure’ related to WWII war measures, but was never returned to the states, the Commonwealth was undisputedly de jure and de facto considered to be responsible for the state of the National Economy, and the primary borrower in the federation.

There have been some constitutional challenges to federal encroachment of income tax overtime, however, it was not opposed by most states, and when NSW and Victoria did challenge it in 1957, it became judicially clear that a state government could have rejected its federal grants under Section 96, and instead levied their own income tax, but history has shown us that no state was willing to take this decision (Stewart, M., n.d., pg. 13). For example, the idea was floated again in 1976 by Malcolm Fraser’s Coalition Government that passed the States (Personal Income Tax Sharing) Act (Fenna, 2018), and again in Tony Abbott’s short-lived White Paper on Federation Reform (2015), but the idea of the states levying their own income tax (on top of the existing Commonwealth income tax), has simply failed to receive much concrete traction or interest at the level of the states for reasons that will become apparent in the following section.
1. The Politics and Impact of Fiscal Federalism in Australia during Crises

Historically and globally, it is well known that crises—war, national disasters, global economic downturns, and more recently health pandemics, necessitate extraordinary fiscal responses. Moreover, although crises are often justified to necessitate moments of national control and leadership while often demanding public sacrifice, they also create unique political opportunities. Mentioned in the previous overview section, this opportunity was first seized upon in Australia by the central government during WWII to impose uniform taxation. As a former Senior member of the Australian parliament commented to the author recently, “the Commonwealth never misses the opportunity of a crisis”. The Commonwealth’s unlimited expenditure power however (Section 81), even during a crisis, was recently tested during the GFC when Mr. Pape challenged the then Labour government’s “Cash Splash”, a fiscal stimulus measure during the GFC designed to provide individual payments to families adding up to one per cent of GDP to stimulate the economy (Pape vs. Federal Commissioner of Taxation 2009, 238 CLR 1.). Pape’s argument in the High Court was to reject the various judges’ claims, that constitutional responsibility for the national economy, especially in times of crisis, might entail or imply extra or special spending powers (see Galligan, 2012, pgs. 334-337). In the end, the High Court allowed the Rudd—Australian Labour Party government (ALP) to make the GFC related stimulus payments as intended to individual taxpayers, but it denied de jure that the Commonwealth had unlimited expenditures powers. This federal spending power has been used again during the COVID19 crisis, but it has not been challenged again in the High Court.

The major parties of Australian federal democracy are the Australian Labour Party (ALP)— (currently in 2023, they are holding both the Commonwealth and all but one of the states, Tasmania), and the Liberal-National Party Coalition (that held power during the COVID19 pandemic and was defeated nationally in 2022). Some historical tendencies between Australia’s two major political parties’ biases regarding their tendencies towards centralisation (anti-federalist), versus decentralisation (pro-federalist) have been documented (Hollander and Patapan, 2007). Both national parties, however, have recently used the commonwealth’s expenditure powers under Section 81 of the Constitution, to spend at will during crises on countercyclical fiscal stimulus spending measures. The Labour government did so during the GFC vis-à-vis the Tax Bonus Act discussed above, and more recently the Liberal-National Coalition did during the COVID19 crisis vis-à-vis the Commonwealth’s JobKeeper and JobSeeker programs. The extraordinary power of the Australian federal government to both dominate taxation and exercise its expenditure power has meant that whichever national political party governs through a crisis has tended to play a central role in managing its economic consequences—even if this entails exercising expenditure power outside of its jurisdiction. It should be noted however, empirically, that the ability of Australia to provide direct fiscal responses during the acute phases of the COVID19 crisis was related to its lower pre-pandemic debt and a smaller fiscal deficit relative to other countries (Hudson et al., 2021).

Out of the six states and two territories that held elections during the acute and recovery phases of the pandemic, only two of six were defeated that of SA in 2022 and NSW in 2023. No incumbent state government that held elections during the acute phase of the pandemic was defeated. According to the results of the 2022 Australian Election Study (AES), respondents were much more negative about the federal government’s handling of the crisis than their own state governments, with just 30 percent saying the federal government had handled the pandemic well (Cameron et al., 2022, p. 32). This potentially indicates that although the Australian voter is cognizant that the federal government is responsible for managing the national economy, good management of the economy alone from 2019 to 2022, was not enough to secure the incumbent government’s re-election. According to the authors of the AES, “further analysis of the AES data shows
Notwithstanding, responsibility for the pandemic measures was assumed almost entirely by the states as it is the states that operate the public hospitals; the government school systems; and the police and emergency services agencies; regulate and licence business; and control the criminal and civil law (Lecours et al., 2021). It was also the decision of each state when to shut and when to reopen its borders. As former Prime Minister Scott Morrison said “We [the Commonwealth] never said there should be borders. That was never the health advice, it was never the agreement. That was something they [the premiers] came up with on their own” (Keen and Payne, 2020). Control by the states over border closure decisions had a tremendous impact on both trade, business, and tourism, resulting in significant lost payroll taxes which is a state-based tax. Although state premiers were re-elected during the pandemic for keeping their territories protected due to what they claimed was the success of their border restrictions, it was in fact precisely because as Fenna describes “the national income tax regime acts as a regional insurance regime” (2018, p. 137). The extent of fiscal centralization and extraordinary federal support offered during the pandemic blurred premiers’ accountability for the length of their border closures. Most small businesses that reported revenue declines because of COVID-19 were kept afloat because of the federal government’s direct fiscal response of the Commonwealth’s Jobkeeper program. Subnational delegation of taxation authority in Australia, during times of crisis, should be considered a marketable asset on behalf of states as it distances them from the direct economic impact of their emergency policy responses at the ballot box.

As can be observed with the case of states border closures during the pandemic, the actual distribution of authority does not preclude the fact that the Australian public often cannot discern who is responsible for which policy. Accountability is precisely blurred because of the extent of the VBI. The federal government, for example, supports 50 per cent of the states’ health expenditure, and 59 per cent of their education expenditure through Specific Purpose Payments designed to provide funds for state and territory governments tied to specific policy goals in areas for which the states have primary responsibility (Commonwealth Government of Australia, 2022). Therefore, as documented theoretically in other federations by Wlezian and Soroka (2011), a combination of federal conditional transfers and subnational policymaking makes it hard for individual survey respondents such as those recorded in the AES data to know which level of government did what. Moreover, unique to the Australian case, the extent of federal fiscal dominance provides a perpetual shirking mechanism for the states to blame their states’ policy responses on the lack of federal fiscal support.

Notwithstanding the status quo of fiscal federalism in Australia, the continued operating deficits at all levels of government during the recent health pandemic necessitated unprecedented levels of public debt accumulation in Australia. Commonwealth expenses increased considerably during the acute phases of the pandemic from 2019-2021 because of direct fiscal spending stimulus. Net public sector debt in Australia increased by 38% in 2020-21, since 2018-19. Although this was in part related to pandemic-related expenditure increases, net public sector debt in Australia has increased every year from a net lending position in 2007-08, which coincides with the GFC (ABS, 2021). Most interesting from a fiscal federalism perspective, however, is the fact that while Commonwealth net public sector debt increased 21.9 per cent in 2019-20, relative to the previous year, state net public sector debt increased 142.9 per cent in that same year, rising in all states and territories except W.A. (Ibid). Therefore, while the contribution of state debts to all Australia net public sector debt remains considerably low compared to other federations (only 25 per cent of total Australian debt in 2021-22), during the pandemic states contribution tripled from 8.2% in 2018-19. In
fact, the Commonwealth sector’s share of net public sector debt is at its lowest since 2013-14, while the state sector is at its highest (Ibid.) Does this imply the states were contributing to more of the heavy lifting during the pandemic? Is this evidence of a critical juncture in Australian fiscal federalism?

III. FRAMING THE PUZZLE: INCREASING PUBLIC SECTOR DEBT FROM THE 2008 GFC TO THE COVID19 PANDEMIC

As mentioned at the outset, Australia not only survived the Global Financial Crisis (GFC) of 2008-09 but emerged largely unscathed. Throughout the GFC, Australia maintained the lowest debt-to-GDP in the OECD. The GFC did not have a lasting impact on national or subnational finances, primarily for contextual reasons. Although the deterioration of global economic conditions and the need to introduce significant economic stimulus measures increased the net debt position of major OECD economies, Australia’s initial position in terms of the strength of its government finances was very different. Its strength relative to other OECD economies was primarily related to its first significant mining boom from 2004 to 2007, successive budget surpluses, and asset sales, all of which resulted in Australia achieving its historical lowest levels of net debt, -3.8% in 2007-08, prior to the onset of the GFC (Di Marco et al., 2009). Thus, even though state expenditure as a percentage of GDP did increase during the GFC (see figure 2), it was easily covered by the Commonwealth’s then surpluses and the successful reform of federal-states financial relations that were negotiated in the context of the 2008 crisis. Moreover, given the extent of government surpluses prior to the GFC, increases in government spending began in 2005. Compared to the COVID19 crisis therefore, the GFC did not have a significant impact on central government expenditure. Beyond the federal stimulus spending mentioned in the previous section, the Australian government also did not have to bail out major financial institutions, and its decision to keep interest rates low, further bolstered the economy and enabled it to avoid a recession.

Figure 2: Australia: Consolidated government expenditure as percentage of GDP

Source: OECD Fiscal Federalism Database.
The COVID-19 crisis however, plus other subsequent emergency disasters such as the 2019 bushfires and the 2022 flooding events in Queensland and New South Wales (NSW), have had a severe and lasting impact on national and subnational finances. Taxation revenue fell at most levels, specifically income tax and GST for the commonwealth, and stamp duties and land tax for the states and territories. On the revenue side however, the fall in taxation hurts the Commonwealth and necessitates absolute borrowing more than at the state level because of the VBI, which means the federal government alone collects 80 per cent of total revenues. Ironically decreases in state taxation revenues during the pandemic were partially offset by gambling taxes that are not factored in as a revenue source by the Commonwealth Grants Commission (CGC) when calculating state relativities for equalization payments, payments which are paid out of the nationally collected GST tax. On the expenditure side, the Australian Bureau of Statistics (ABS) reported in 2022, a 4.6 per cent decrease in total government expenditure from 2021 levels. Notwithstanding, total government expenditure remains higher compared to pre-pandemic levels.

Moreover, at the subnational level, the financial impact has been uneven despite Australia having one of the most egalitarian horizontal equalization systems (HFE) in the world. The larger Eastern States of NSW and Victoria improved upon their net operating balances during the acute phase of the pandemic indicating they are in economic recovery, while the smaller states of Tasmania and Northern Territory with lower revenue raising capacity have had no change, and the mining/resource endowed states of Queensland and Western Australia both recorded positive net operating balances in 2022 (ABS, 2022). In Western Australia (WA) for example, their surplus is the result of having secured a politically negotiated bilateral fiscal deal with the Commonwealth in 2018, that guarantees a minimum revenue floor coupled with strong mineral royalties emanating from its high levels of iron ore production. Taken together, these two factors are the main drivers of a net operating surplus (revenues-expenses) of 8.6% in WA (2020-21), compared to Victoria’s operating deficit of -19.7% (2020-21). Notwithstanding, aggregated state expenses surpassed revenues from 2019 to 2022 in a continuous fashion relative to previous years but are improving (see Figure 3).

Figure 3: Aggregate State Revenue and Expenses

Source: Author Elaborated, ABS, 2022

1. Why are the States/Territories contributions to All Australia Net Debt Increasing?

Given Australian fiscal federalism arrangements, the Commonwealth continues to be seen as the ultimate provider of subnational revenues and creditor of state debts. Therefore, because of Australia’s notoriously high VFI, the Commonwealth has largely absorbed the fiscal shock of COVID19. It remains evident in figure four below that the bulk of Australia’s net public sector debt is carried by the Commonwealth. The key point to be noted however, is the proportion of states contribution to total debt is increasing. Since 2018-19, aggregate state net debt relative to the commonwealth’s net debt has increased from 9% to 33% in 2021-22, and is expected based on Australian Parliament Office Budget Projections to continue growing to an all-time high of 38% of total national net debt by 2024-25, or stated otherwise, 14.6% of GDP.  

Figure 4: Main Contributors to All Australia Net Public Sector Debt

The Commonwealth’s operating deficit is also considerably higher than those of the states and this will continue necessitating central borrowing and increasing national net debt. However, when calculated as a share of its revenues for example, the state of Victoria’s net debt level in 2022 (the highest state debt in the federation), was higher than the Commonwealth’s (ABC, 2022). In fact, if we take 2011-12 as the base year to calculate the percentage change in the amount of borrowing undertaken by each level, the Commonwealth is borrowing 236% more than it did in 2011-12, which includes its debt accumulation after the GFC. This is compared to an increase change of 661% that states are now borrowing relative to their 2011-12 level. Therefore, the rate of the states’ debt accumulation relative to the Commonwealth’s over the past decade in Australia is increasing 2.8 times faster than the Commonwealth’s. This is therefore the key puzzle to solved herein: What are the conditions driving the increased contribution of the Australian states and territories to the accumulation of all Australia net public sector debt?

Source: Author Elaborated based on ABS (2021) and Commonwealth of Australia (2022).

2. Two Propositions

Theoretically, given that Australian federalism experienced a reinvigoration during the COVID19 pandemic as Premiers took primary leadership roles, it may be possible that new centrifugal forces in the post-pandemic context have increased the public's understanding and expectations regarding the public services and public responses that ought to emanate from the states and territories—especially expectations around making capital investments for future disaster relief and crisis management. Alternatively, from a public finance perspective, the recent pandemic may have simply increased expenditure pressures on the constituent units, while simultaneously decreasing states revenues sources (payroll tax, stamp duties, and property taxes all decreased during 2020-2022). The imbalances in state operating budgets would simply be short-term pandemic related budget deficits.

From the perspective of fiscal federalism and the politics of federalism however, we know that states and territories are not able to slash publicly provided services, cancel large scale pre-existing infrastructure projects, or raise taxes given their limited ability to utilise this mechanism in Australian federalism. Their most obvious option remaining option, if they can, is to borrow cash. Without increases to federal transfers, states must continue to find revenue to provide the services most Australians believe should be paid for by both levels of government, in particular housing, schooling, and childcare and prisons, plus roads and transport (a major infrastructure expense), which they believe should be paid for by the States/Territories exclusively (Biddle et al., 2019). Does the increased contribution of state public sector debt relative to decreasing Commonwealth contributions therefore, in the post-pandemic context, underscore new directions in Australian Federalism? Or do crises simply further accentuate a well-known structural problem in Australian Fiscal Federalism referred to by international credit risk agencies as the fiscal inflexibility of the states and territories?

3. The key Determinant: The Rules Regulating Subnation Finance in Australia

Subnational finances are an integral part of understanding the politics of federalism. Who does what, how, and who pays, basically equates to the distribution of power in a federal democracy. The rules regulating subnational finances can undermine the goals of federalism by limiting the ability of the subnational levels to respond to local demands and/or to respond quickly in times of crisis. Conversely, in more decentralized and robust federations where subnational levels have veto power, the fiscal autonomy of the constituent units can also constrain the ability of the central government to deliver upon national policy objectives and achieve nationally uniform outcomes. Political economists specialising in fiscal federalism have long been concerned with the relationship between federalism and economic outcomes, that is, the consequences for overall macroeconomic performance of a federation of how policies are financed and who finances them (Rodden, 2002). Less attention has been paid to how the rules governing subnational finances affect the political will of subnational levels to both innovate, diversify, and invest in the future. One of the principal debates on issues of fiscal decentralization (decentralization being one the public choice prescribed virtues of federalism), revolves around how to manage/regulate subnational spending and debt.

As observed by Makin and Pearce (2014), “there is a surprising dearth of academic literature examining subnational public debt in Australia”. In fact, it is only since the 1991 Premiers’ Conference and subsequently updated that the ABS provides disaggregate subnational fiscal data (Makin and Pearce, p. 4). Economists however have long been concerned with the sustainability of public debt. While such analysis is normally focused on the national level, there is an increasing interest in examining the fiscal positions at
the sub-national level. In developing federal countries for example, subnational fiscal performance has long been a major area of academic research based on the negative effect subnational units can have on macro-economic stability, particularly following on from times of crisis when countercyclical spending increases for both practical and political reasons.

Moreover, while there may be a dearth of academic interest in examining state level fiscal performance and public debt accumulation in Australia, the recent heightened visibility of the states and Premiers since the 2019 bushfires, and the following onset of the COVID19 pandemic in Australia, ought to result in an increased examination of state policy initiatives and their ability to pay for policy variations that ought to follow on from the leadership roles they are increasingly assuming in the eyes of both the public and the media..

Historically, the Australian states and territories have been subject to both de jure and de facto hard budget constraints. For federal scholars, a soft budget constraint, within the context of the rules regulating subnational finances, refers to the responsibility of the constituent units in a federation to cover their budget expenditure out of their allocated central government transfers and own source revenues. If it fails to cover the expenditure of its budget, it will require external fiscal intervention—this can either be in the form of central government bailouts or directly through borrowing. Beyond economic performance, the soft budget syndrome as Kornai et. al (2003) originally coined the concept, affects political behaviour and intergovernmental relations. This is because is well known in federalism studies that political motives often induce a federal government to extend fiscal support to certain states and regions. Kornai et al.'s (2003) theoretical propositions assumes that the supporting institution is hierarchically superior to the supported budget constraint organization. In our case the states.

In contrast, hard budget constraints refer to a situation where constituent units in a federation will not receive outside support to cover their excessive spending and will thus, be obliged to reduce or terminate an activity if the deficit persists. The threat from a hierarchically superior fiscal organization (i.e., the Commonwealth Government in Australia) is only credible when it is both enforceable (de jure), and in the vested interest of that same organization (de facto).

Unique to the history of Australian federalism is the fact that the states legally abdicated their right to autonomously borrow monies by inserting section 105(A) through a constitutional amendment in 1927. According to Saunders (1990), the transfer of significant levels of state debts was seen as attractive by the six original states at federation in 1901, however if it required Commonwealth control of future state borrowing, (a de jure hard budget constraint), it was considered first, unacceptable by the Premiers, and second, complicated as there were significant differences in the size of pre-federation state debts.

Notwithstanding, the issue created by the imbalance between Commonwealth revenue collections and surplus, and the extent of the states’ pre-federation debts plus their ability to pay them with limited revenue sources, remained on the early federation's agenda. This issue was finally resolved in 1927, after several years of economic competition and heavy borrowing on the London market by both levels of government. The Commonwealth would finally take over all state debts in exchange for coordinated future borrowing managed by the Australian Loan Council (ALC). All future borrowing would be taken out by the Commonwealth on behalf of the states and their programs for borrowing would have to be approved by the Loan Council—when and if they were allowed to borrow directly, was allowable, however the ALC which was dominated by the power of the Commonwealth would still set the global limits as to how much each state could borrow.
It is beyond the goals of this paper to document the entire history of the ALC (see Saunders 1990). Suffice is to say for the goal herein that several *de facto* modifications occurred so that by the 1990s, the states were borrowing on their own behalf, but within the *global limits* set by the ALC. In response to the GFC in 2008 however, when all Australia net debt was at a record low, -3.1 per cent of GDP (ABS, 2021-22), the government increased these global limits and the then Rudd Labour Party Government issued a time-limited voluntary guarantee over state government borrowing to assist the states who were incurring budget deficits by expanding infrastructure investment to help counter the recession (see Parliament of Australia 2009).

While the ALC has long since served its original purpose (*policy drift*), this author and other federal scholars consulted were surprised to discover during this research that the ALC has formally ceased to be operational and has not met since March 2017. According to Commonwealth of Australia's (2018) Final Budget Outcome:

> “Consistent with the 2018-19 Budget, the Commonwealth’s Loan Council Allocation is no longer reported. The ALC unanimously agreed to remove the Australian, State and Territory Governments’ reporting requirement form Uniform Presentation Framework (UF), [which previously required reporting and disclosures of net debt] and transfer the administration of the UPF to the Council on Federal Financial Relations [reporting to the National Cabinet formed in 2020]”

Therefore, beyond the *Council of Federal Financial Relations* (CFFR), comprising the Commonwealth Treasurer and all State and Territory Treasurers that is the gatekeeper of the *Federation Funding Agreements* (discretionary funding), Australian state and territories are no longer restricted by any statutory or constitutional rules on borrowing, and they are not required to achieve balanced budgets. This are thus under *de jure*, a soft budget constraint. According to the international credit risk agency *Standard & Poor* (S&P), several states have self-imposed fiscal targets and fiscal principals that call for their net debt to be “stabilized” or “sustainable” in the medium term, but are vague about timeframes for achieving this (S&P, 2022). Therefore, subnational public debt in Australia is currently regulated by the market and state electorates. However, given the high credit ratings enjoyed by Australian states and territories, this means in practice, the only identifiable fiscal constraint on excessive subnational borrowing in the context of recent international bond markets is political.

**IV. IS PUBLIC DEBT INCREASING BECAUSE THE STATES CAN BORROW FREELY?**

The key answer in the literature as to why subnational debt increases is because they can borrow freely, with limited fiscal, political, or institutional constraints. The following empirical section applies Hanniman’s (2020, pp. 279-280), analytical framework he developed to analyse the sources of Canadian provinces growing indebtedness. I have used Hanniman’s framework to see if in Australia, similar conditions are present, and if they lead to the same outcome—i.e., high levels of provincial/state indebtedness. As a caveat, the goal herein is not to compare Australian subnational to Canadian subnational debt, but rather to compare Australia across two crises (GFC and COVID19), to see if it is moving in the same direction—towards increasing levels of states/territories indebtedness—for similar reasons.

Based on my observations and data obtained from the ABS, I suggest the three key drivers of increasing indebtedness at the state level in Australia case are indeed, like the Canadian case, present, albeit at significantly lower levels because of the extent of fiscal centralization in Australia. As explained in the overview, the VFI is primarily
a product of the Commonwealth’s taxation power. In contrast with Canadian provinces, the centralized nature of fiscal federalism in Australia means that the states do not have large open-ended expenditures, they are however rigid. Most of the policy sectors the states in Australia are responsible for are funded in partnership with the Commonwealth through closed National and Federation Funding Agreements. The degree of indebtedness of the states, therefore, is driven by their fiscal inflexibility in periods of falling revenues sources and rising expenditure needs (Condition 1). It is however quantitatively less than in Canada, but it equates nevertheless in Australia as a driver of Australian states increasing indebtedness.

Second, Australian states revenue streams are also cyclical (Condition 2), specifically during crises. In Australia, because of the 3-year time lag that is built into Australia’s HFE, plus the vulnerability of stamp duty and property taxes on the local property market, and the reliance of payroll taxes on levels of employment including fluctuating resources royalties—makes the states and territories untied, and own-source revenue streams, cyclical. States untied revenue streams in Australia, however, are predominantly used to sustain high levels of infrastructure spending, which is a product of countercyclical spending in times of crisis or during natural disasters. And third, like Canada, the final driver of states increasing indebtedness is their ability to borrow without federal restrictions at low interest rates to cover revenue gaps when needed (Condition 3). According to international credit risk agencies, there are no real constraints to the size of subnational deficits in Australia, “despite what politicians can tolerate and what the bond market can digest” (S&P 2022). Moreover, the three largest states, NSW, Victoria, and Queensland, have borrowed considerably since 2018-19.

Condition 1 and 2 therefore, puts pressure on the states to borrow during times of crisis, including natural disasters such as flooding and bushfires. Most Australian States in the post-pandemic context have had substantially higher borrowing needs occurring because of revenue losses coupled by increased spending needs that has resulted in negative net operating balances (see Table 1). Australian state and territories generally rely on receipts from payroll taxes, transfer duties, gambling taxes, stamp duty, and property tax. Payroll taxes took a significant blow during the COVID19 lock downs. Moreover, the states deliver most high-cost public services such as health and education, which are funded out of tied and untied commonwealth grants that have not been reviewed since 2019-20. States and territories relied on the Commonwealth to fund 46.4% of their operating budget in 2020-21. Additionally, however during the COVID19 pandemic, exceptional powers were also granted to state ministers and premiers with little oversight.

State treasures for example were given power to spend money on a needs basis to meet the “exigencies of government” and Treasurer’s advances were increased to cover this emergency spending without the usual parliamentary oversight (S&P September 7th, 2020). According to S&P risk analysis, lifting advance limits plus health and stimulus expenditures coupled by revenue losses does not always imply a debt facility, but does often imply more borrowing to cover operating costs over capital expenditure. Such spending however would be pandemic created and not likely to indicate new longer-term trends in Australian fiscal federalism.
### Table 1: Net Operating Balance, State and Local General Government, 2020-22 (% of GDP).

<table>
<thead>
<tr>
<th>States</th>
<th>NSW</th>
<th>VIC</th>
<th>QLD</th>
<th>WA</th>
<th>SA</th>
<th>TAS</th>
<th>ACT</th>
<th>NT</th>
</tr>
</thead>
<tbody>
<tr>
<td>2020-21</td>
<td>-0.4</td>
<td>-0.8</td>
<td>-0.2</td>
<td>0.3</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2021-22</td>
<td>-0.4</td>
<td>-0.5</td>
<td>-0.2</td>
<td>0.1</td>
<td>-0.1</td>
<td>0.0</td>
<td>-0.1</td>
<td>0.0</td>
</tr>
</tbody>
</table>


Condition 2 however appears to be a larger determinant to increasing indebtedness, specifically in the Eastern States (NSW and Victoria) who had already committed to large infrastructure projects in the pre-pandemic period. Economic stimulus normally equals more borrowing, and the Commonwealth Government has been encouraging state leaders to spend more on higher infrastructure spending. This would signal higher medium to longer-term spending at the level of the states. Former Prime Minister Scott Morrison for example said the federal government’s direct economic support of around $251 billion is one of the “most significant COVID responses in the world” (Sky News, 2021). Mr Morrison said the states and territories have also made a valuable contribution to the economic response, committing an additional $122 billion. “But I think even they would say it’s fair to say the heavy lifting has been done by the Commonwealth over this past year,” he said.

According to my calculations in absolute terms the Prime Minister was correct, but he was not correct when comparing like with like. In 2018-19 the Commonwealth’s net debt represented 19.2 per cent of GDP. By 2021-22, this represented a 38-percentage change, equating to 22.5 per cent of GDP. In contrast with the states, in 2018-19 their net debt represented 1.8 per cent of GDP. By 2021-22, their levels of debt had increased by 510 per cent using the pre-pandemic year as a base, equating to a historical high of 8.3 per cent of GDP (ABS, GFS, 2021-22).

Commonwealth pressure on states and territory governments did not begin with the COVID19 pandemic. States/Territories began to expand infrastructure spending as a countercyclical measure following the 2008-2009 GFC recession. During this economic downturn however, the largest constraint to subnational borrowing was what the bond markets could digest. Therefore, the Rudd Government announced in 2009, that it would provide to the states and territories a time-limited guarantee over state borrowing to support jobs and protect vital nation-building plans that were dependent on state infrastructure investment. During the GFC however, the ALC as discussed previously placed de jure global limits on state borrowing. Moreover, in contrast with the GFC, international bond market conditions during the acute phase of the COVID19 pandemic were more favourable to subnational borrowing. Bond market conditions are therefore a permissive condition to subnational borrowing under a soft-budget constraint (Condition 3), with the latter being a necessary condition to increasing indebtedness at the level of the states/territories.

Net capital investments are a key driver of subnational public debt levels because the states were already gearing up for an infrastructure boom with several projects already approved by state parliaments, reflecting state-level commitments to large capital infrastructure spending that began in the post-2009 context. Moreover, during the pandemic, Premiers were under considerable pressure from federal policymakers to spend more on infrastructure investment as a fiscal response measure. In contrast with during the GFC however, instead of the Commonwealth guaranteeing state borrowing to ensure favourable contracts, the bond market was able to continue digesting state bond issuances.
This was also enabled because of the Royal Bank of Australia’s quantitative easing program that from 2020–2022, purchased A$56 billions of state governments securities on the secondary market, to keep subnational borrowing costs low and bond markets functioning (S&P, Ma2022). It would appear therefore that the biggest determinant of state borrowing is sustained infrastructure investment, that for reasons already discussed, Premiers had to keep financing but could only do so through borrowing because they are fiscally inflexible because of cyclical and limited revenue sources—in particular, during a crisis. As evident in figure five below, during crises both the net operating balances and net capital investments contributed to state-level borrowing, but outside of the crisis/disaster recovery phase, net capital spending appears to be a larger determinant to borrowing than to cover operating costs.

**Figure 5: Total State Contribution to GFS Net Lending/Borrowing**

![Chart showing total state contribution to GFS net lending/borrowing](Source: ABS, Customised Report, 2022.)

To summarize, condition 1 makes state budgets in Australia vulnerable to shocks because of their fiscal inflexibility, and conditions 2 and 3, encourages steady upwards spending, but condition 2 is supported by greater national support during times of crisis and natural disasters because of Australia’s institutional arrangements. Condition 3 allows the states to borrow because they can, most recently at historically low interest rates. Credit risk ratings were downgraded during the COVID19 pandemic, one notch in NSW and two notches in Victoria. They remain however two of the highest rated sub sovereign government debt issuers in the world. Government experts also relate this to the “halo effect” whereby Australian states creditworthiness continues to be among the highest on a global scale because of Australia’s diversified economy, its strong access to bond markets, and its excellent (federal) institutional settings (S&P, 2020). Even though Australia has no formal bailout procedures (a key enabling condition of the soft-budget syndrome), the VFI in Australia means the public’s expectation is that the federal government is responsible for economic performance, and, for providing extraordinary support during crises. For example, during the COVID19 pandemic, the newly formed National Cabinet quickly agreed to a 50/50 shared health funding deal to cover increased health services. And, during natural disasters, this extraordinary support is extended vis-à-vis the Disaster Recover Funding Arrangements, whereby the Commonwealth meets 50–75% of assistance costs to individuals and to maintain public services.
Condition 3, therefore, appears to be the one that makes Canada and Australia most alike in contrast to the United States. As Hanniman (2020) highlights, in contrast U.S. states cannot borrow to the same degree, because of widespread balanced-budget legislation. This is like other federations in the Americas such as Brazil and Mexico, where a rules-based hard budget approach to manage subnational debt accumulation is followed—but often at great social costs as was seen in Brazil during COVID19 crisis. The causal mechanism to condition three however, is evidently shown in this research to be fiscal necessity. This is the mechanism that varies most across federations and across crises as it is dependent on unique institutional arrangements and a country’s constitutionalism. Even though Australian states are fiscally inflexible, and this makes them vulnerable to shocks—they only collect 20 per cent of Australia's revenues. They have a built-in shirking-mechanism therefore, that blurs lines of government accountability and enables them to continue, in times of need, go knocking on the Treasurer's door.

1 Are Australian States Public Debt Fiscally Sustainable?

In the international fiscal federalism literature, one of the greatest concerns are questions around the sustainability of public debt accumulated at the subnational levels. This is because subnational public debt, represents a significant credit risk to macroeconomic stability if it is not monitored. Therefore, if for example, politically speaking, health and education is electorally rewarded in state-level elections, there is a built-in political incentive to spend more. The mechanisms however (legal, political, and fiscal) that incentivise and constrain subnational debt accumulation, as mentioned above, vary considerably across federal systems.

State-level public sector debt in Australia is currently fiscally sustainable. Even with increased global interest rates in 2022, debt interest payments remain historically low. Aggregate state public debt interest payments in 2021-22 were 0.4% of GDP, the same percentage of GDP as in 2011-2012, despite a 661-percentage change to state public sector debt from that same year. Beyond low debt interest payments, the ratio of state net public sector to GSP in Australia is also low. This ratio is frequently used as an indicator of the ability of SNGs to make future payments on their debt.

It remains however, territorially uneven. The Territorial Northern territory has the highest ratio of state net debt to GSP of 20.4%, followed by Victoria at 13.5%, and South Australia at 10.5% (ABS, 2020-21 Consultancy Data). These figures have increased from the previous year, representing approximately five percentage point increases from 2019-20. The Australian Capital Territory continues to have the lowest ratio of public sector debt to GSP of -3.8%, followed by Tasmania with a ratio of 1.1%. Ratio of state net debt to GSP however, has been steadily increasing in the post-2009 context, when the states began to take on a new role in promoting countercyclical spending to boost their economies (see Figure 6).
Australian states, despite unconstrained fiscal conditions and their favourable creditworthiness, don’t borrow that much in terms of the ratio of state net debt to gross state product (GSP). Moreover, because of Australia’s pronounced VFI and how the GST is distributed vis-à-vis the HFE system, they don’t have a comparable “need” to borrow to deliver baseline state services. For example, in 2021-22, Commonwealth Government financial assistance to states represented 46.4% of states’ expenditures (Commonwealth Government, 2022). Therefore, in contrast with more fiscally decentralized federations, subnational debt is unlikely to threaten critical service delivery. Nevertheless, states in Australia have increased their levels of public sector debt since the onset of the COVID19 crisis and they appear to have decided to prioritize financing their ongoing infrastructure projects before balancing their budget deficits. This decision has also critically paid off at the polls. Somewhat counterintuitively, centre-right governments in NSW, South Australia, and Tasmania, spent more liberally in health and economic support packages, based on GDP/GSP, than the centre-left governments of Victoria, WA, Queensland, and the two territories (S&P analysis, 2022). Two of those right-of-centre high spending pandemic state governments have since been replaced by centre-left State Labour Parties who have promised to increase public sector wages, alongside maintaining the state’s major-projects. Both promises will contribute to rising debt in both NSW and Victoria under the current governments.

V. CONCLUSIONS AND IMPLICATIONS

This paper has provided evidence that Australian net debt by government sector in 2021-22 was at an all-time high, and higher than that experienced during the previous GFC crisis, which did not have long-term effects on Australia’s public debt accumulation. The paper has importantly shown that the contribution of the states to all Australian public debt accumulation, is currently higher relative to any other point in the history.

5. Footnotes: (a) The L2 measure of debt is the measure most comparable to government reporting of net debt under the UPF. It comprises debt securities, loans, Special Drawing Rights and currency and deposits. No state holds SDRs, the zeros included here are for completeness with the definition.
of Australian federalism. The percentage increase of the states’ net public sector debt since 2011-12, has considerably outpaced the Commonwealth's. The key question at the outset of the paper was whether these increases represent a critical juncture in Australian Fiscal Federalism, or, if they were simply pandemic related?

Several qualitative answers can be suggested that have both political and policy implications. The paper has established that Australia indeed does have the necessary conditions to pressure increasing state indebtedness in the future. In particular, there are no de jure restrictions to the amount the states can borrow, apart from what the bond market can absorb and voters can tolerate. These conditions, however, have not been sufficient to produce high levels of subnational debt accumulation in Australia, relative to other more decentralized federations. Why?

Australian states do not have a comparable fiscal necessity to borrow given both the extent of the VFI and the HFE distribution system. They are however fiscally inflexible, during times of crisis because their limited revenue streams are vulnerable to economic shocks, and the HFE distribution system has a 3-year time lag. The HFE was updated in 2022, to assess changes to state circumstances from July 2018 to July 2021 (CGC, 2022). Therefore, the uneven impacts of the pandemic on the states in terms of those that had been hit hardest on both the revenue and expenditure side, will not be reflected in the actual GST distributions until 2022 and beyond. This partly explains why it is evident across the two crises, the GFC and the COVID19 crisis, that states’ operating, and fiscal balances are impacted upon negatively as expenses indeed outpace revenues, however, in more normal economic times, quick recovery is evident, except for NSW and Victoria. Net operating surpluses for 2024-25 are forecast for most of the states.

Moreover, the fiscal flexibility of the states has moderately increased since 2018 vis-à-vis the HFE update and increases to the size of the overall GST pool. The Commonwealth is offering a “no worse off” guarantee during the transition period up to 2026-27, that protects states from any falling GST revenues arising from the 2018 update that set a revenue floor of 0.7 and 0.75 thereafter. The Commonwealth has also perpetually topped-up the size of the actual GST pool to be distributed. Third, several states have recently funded large infrastructure projects through asset recycling, although this practice does not seem at the present time to be politically sustainable going forwards. Therefore, upward pressure on the states to borrow will remain elevated after the crisis, predominantly because the premiers in recent elections have vowed to continue playing a more significant role in the provision of infrastructure and capital investment expenditure. The HFE however does take a state’s net borrowing into account when calculating its assessments that determine the amount of GST to be distributed to that state. The HFE therefore, is according to this research’s findings a de facto hard budget constraint in Australia fiscal federalism. Any material increase to a state’s revenues or expenditures, has a negative relationship to the proportion of GST they will receive, relative to other states.

Politically, since the 1990s, political tolerance for high public spending at all levels of government in Australia has been low. In fact, in the 1990s, high spending at the state level became an electoral liability, with several state elections being lost to incumbent labour governments who were perceived as being fiscally irresponsible (Robinson 2001, p. 713). All jurisdictions’ reactions to what was publicly perceived as a debt crisis in the 1990s was to adopt rules requiring budget surpluses with a goal of reducing/eliminating public debts. NSW adopted a rule in 1995 that “the budget should be least balanced” with a medium-term objective of achieving zero net debt by 2020 (Robinson 2021: 715). Ironically, NSW’s net debt has done nothing since, but rise to a decade high ratio of state net debt to gross state product of 4.5% in 2020-21 (Based on ABS data, Customised Report 2022).
During recent state elections, politicians have tried to distinguish borrowing cash and privatising key state-owned asses to fund critical state projects, versus using debt to fund public services. This has led to less political aversion to debt related to large infrastructure projects. During the COVID19 pandemic, Premiers from both political parties were receiving political and fiscal support from the Commonwealth Government, the RBA, Business, and Economic commentators, all who were encouraging state governments to keep spending. Hence while states net operating balances have improved since 2021, capital investment on large public infrastructure projects continue to elevate state public sector debt and necessitate borrowing. This is not enough evidence however to suggest that crisis budgets will become electoral budgets.

Interstate budget variations, however, have never been so evident in Australia. As some states are wealthier than others in terms of revenues (in particular, those with mining royalties), their capital budgets are smaller relative to gross state product. Those with lower GSP such as Victoria relative to WA, are pressured to borrow to fund their capital budgets. They must borrow to compete in the reinvigorated infrastructure playbook. In Tasmania for example, major spending has been allocated to roads and bridges development, human services and housing development, and health and education infrastructure. Current budget on infrastructure spending in the states, however, has been overbudgeted due to capacity constraints, labour shortages, and supply shortages. Moreover, the Australian public continues to support cutting expenses to reduce deficits. In a recent survey taken before the October 2022 midterm budget, only 28% of those survey respondents polled supported maintaining current spending levels and living with government debt and deficits for now (SMH, October 11th, 2022).

Therefore, the political tensions over the HFE 2018 updates will continue to be salient, if the ‘no worse off guarantees’ are not perpetually maintained. The intention of the minimum revenue floors was to provide greater fiscal flexibility to resource-dependent states by reducing their volatility on fluctuating commodity prices, however as the HFE distribution remains a zero-sum game, if it is seen to necessitate rising public debt in the larger eastern state to cover capital investment in hospitals, schools, and infrastructure, the ‘fair go’ federal culture the underpins Australian fiscal federalism may become unhinged.

From a policy perspective, the fiscal need to pay for things that are seen as investments in future generations may lead to the increasing political willingness for the states to spend on capital infrastructure spending, including climate change and disaster preparedness such as bushfire response capabilities. This ought to lead to less public aversion for subnational debt accumulation.

It was clear during the COVID19 pandemic, that premiers with the highest perceived performance at managing the crisis in their territories, were electorally rewarded, regardless of the effect of those measures on national economic performance. This ought to create an electoral incentive to borrow in times of crisis, and the occurrence of such crises related to climate events (floods and bushfires), may no longer be just rare events that lead to short-term changes in Australian fiscal federalism.
REFERENCES


INTRODUCTION


- Stewart, M. (n.d.). Australia [unpublished manuscript], University of Melbourne.


FISCAL DECENTRALIZATION AFTER SYSTEMIC CRISES: AN ANALYSIS OF THE BRAZILIAN EXPERIENCE

by Silvana Gomes
University of Ottawa

To cite this article:

ABSTRACT

Systemic crises are often conducive to institutional changes that can affect, among others, the dynamics of fiscal decentralization in federal countries. In this case study on the recent Brazilian experience with two crises (the 2015-2016 economic crisis and the COVID-19 pandemic), I argue that systemic crises create an opportunity for endogenous centralizing forces to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization. To support this argument, I analyze the institutional contours of the Brazilian fiscal federalism and show how centralizing forces harness institutional ambiguities to instill transformations that affect fiscal decentralization and intergovernmental fiscal relations in the long run. This paper aims to contribute to research and policy-oriented discussions about the future of management of subnational finances with a focus on fiscal decentralization and intergovernmental fiscal relations.

Keywords: fiscal decentralization; fiscal federalism; intergovernmental fiscal relations; systemic crisis; tax reform.
I. INTRODUCTION

The aftermath of the 2008 crisis and the COVID-19 pandemic induced institutional changes that affected the dynamics of fiscal competition and decentralization in the Brazilian federation. While the 2008 financial crisis did not pose immediate shocks to the Brazilian economy, the country went through its worst economic recession between 2015 and 2016. This economic downturn prompted the creation of a Fiscal Recovery Regime that aimed to restructure the states’ finances with the federal government’s support. To join the program, states were required not to grant tax subsidies that could diminish their tax revenues, among other measures that limited their fiscal autonomy. During the COVID-19 pandemic, the federal government absorbed most economic shocks. However, a federal proposal to bring fuel prices down (whose spike was mainly attributed to the pandemic) through cuts in state taxes sparked new frictions between the federal government and the states. Moreover, the National Congress is wrapped around the promotion of a comprehensive national tax reform. Currently, three proposals to reform the Brazilian tax system seek to introduce significant changes in the fiscal architecture, either through a standard levy across all states or by replacing the tax on the circulation of goods and services (ICMS) – a state tax that is the primary source of revenue for most subnational governments – with a unified duty modeled on value-added taxes.

Against this background, a core question emerges: how do systemic crises affect fiscal de/centralization in federations? Through a case study of the Brazilian experience, in this paper I analyze the institutional dynamics of fiscal decentralization following periods of systemic fiscal crisis. The main argument is that systemic crises create an opportunity for endogenous centralizing forces to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization. I employ an institutionalist approach to explain how such centralizing forces persist and instill enduring effects onto the fiscal landscape through a process of policy displacement. This study aims to contribute to research and policy-oriented discussions about the future of management of subnational finances with a focus on fiscal decentralization and intergovernmental fiscal relations.

The paper is structured as follows. Section 2 provides a theoretical discussion about the interplay between fiscal decentralization and systemic crises, focusing on how the latter prompts institutional changes to the former. Section 3 presents an overview of the Brazilian fiscal architecture, focusing on its main sources of vertical and horizontal tensions. Section 4 delves into the 2015-2016 recession, showing how responses to its effects on subnational finances led to the creation of new instruments that allowed the federal government to curb fiscal decentralization and the fiscal autonomy of states that adhere to the Fiscal Recovery Regime. Section 5 explores how the federal government’s responses to the COVID-19 crisis was fueled by conflicts with the states and analyzes prospective reforms poised to re-take center stage as the space occupied by the pandemic in the policy agenda wanes. Finally, the concluding section summarizes the paper’s main arguments and points to new directions for future research on the relationship between fiscal decentralization and systemic fiscal crises.

II. FISCAL DECENTRALIZATION, SYSTEMIC CRISES, AND INSTITUTIONAL CHANGE: A THEORETICAL PERSPECTIVE

Do systemic crises induce changes in the institutional tenets of fiscal decentralization? The COVID-19 pandemic has renewed the interest in many facets of crisis and emergency management in federations (Downey & Myers, 2020; Hegele & Schnabel, 2021). To a lesser extent, it has inspired research on the implications of this critical event to the architecture and functioning of fiscal federalism, with most of the focus on
the United States (Clemens et al., 2021; López-Santana and Rocco, 2021; Rocco et al., 2020), even though some notable exceptions include Béland et al. (2020) and Hanniman (2020) works on Canada. Before the COVID-19 pandemic, some works addressed the consequences of economic crises to the dynamics of de/centralization in federations either from a theoretical (Dardanelli et al., 2019) or empirical perspective (Fenna, 2019). In the context of the fiscal crisis that struck many countries in the European Union, Muro (2015) showed how such critical context helped explain the trend towards re-centralization in Spain. In this piece, Muro (2015, p. 28) hypothesized that “[c]entral governments control sub-state levels of expenditure more intensively during periods of economic crisis”. While this hypothesis holds true for the Brazilian experience with the 2015-16 and COVID-19 crises, re-centralization was felt not only on the expenditures side. In both scenarios, the federal government put forward measures that directly affected the autonomy of sub-national governments over their revenues.

In a way, the limited scholarly attention to the consequences of crises on fiscal federalism and, more specifically, fiscal decentralization comes as a surprise, given that such circumstances are usually intertwined with economic shocks that trigger changes to the dynamics and balance of power in intergovernmental fiscal relations. In this paper, my focus lies on systemic fiscal crises. The working definition of systemic crises that I adopt posits that they are external events that affect stability by triggering shocks that affect all levels of government for a reasonable period. Therefore, isolated and transient critical events are excluded from its scope since they may not elicit significant institutional changes that yield effects in the long run, which is the focus of the present work.

Fiscal decentralization refers to assigning revenue and expenditure responsibilities from the central government to subnational and local tiers. It is a central issue in the broader realm of fiscal federalism, whose strong roots in public economics emphasize the positive economic effects of fiscal decentralization, despite some dissenting views (Prud’homme, 1995). Numerous works in the past few decades have drawn attention to the linkages between fiscal decentralization, economic growth, and enhanced public governance and policy outcomes (Cavalieri and Ferrante, 2016; Faguet, 2014; Martinez-Vazquez and McNab, 2003), generally assuming that decentralization leads to more efficient outcomes than centralization. Measuring fiscal decentralization in federations is not a straightforward process, though. Measurement difficulties arise because fiscal decentralization is a multifaceted phenomenon that cannot be directly observed and gauged. Over the years, academics and policymakers have developed a series of indicators that act as proxies of fiscal decentralization. (Ebel and Yilmaz, 2002), normally encompassing variables along four main dimensions: 1) decision-making powers, 2) revenues, 3) expenditures, and 4) the structure of public accounts, including the composition of debts, deficits, and the share of intergovernmental transfers in revenue and spending.

Aside from these economic approaches, political scientists have also studied fiscal decentralization, especially with regard to the political conditions that enable it to emerge and endure (Garman et al., 2001). For instance, the literature stresses the political appetite from subnational and local governments for both administrative and fiscal autonomy as of the 1980s in Latin America, when the countries in the region that had undergone authoritarian regimes started their re-democratization processes (Montero and Samuels, 2004; Willis et al., 1999). However, less attention has been paid to situations where decentralized regimes suffer drawbacks, especially in contexts of crisis.

The vast literature on institutional change provides some relevant insights to understanding the drivers and consequences of the relationships between crises and fiscal decentralization. The concept of critical juncture has been a cornerstone in explanations of institutional change, especially in the historical institutionalism stream (Capoccia
JOURNAL INFORMATION
INDEX
INTRODUCTION

and Keleman, 2007). Against a background of predominant stability and inertia, critical junctures constitute an opportunity for policy actors to push for institutional changes. In the context of crises, this means that they “can bring abrupt institutional change, as they present leaders with an opportunity to enact new plans and realize new ideas by embedding them in the institutions they establish” (Hogan, 2006, p. 657).

Nevertheless, not all institutional changes directly result from sharp transformations following major external events. Incremental policy changes that build upon rules, ideas, power relations, and other antecedent conditions endogenous to institutions can be more frequent and even more consequential than abrupt changes resulting from external shocks. Among the categories of gradual policy change proposed by Mahoney and Thelen (2010), policy displacement emphasizes the interplay between endogenous conditions for institutional change and limited veto possibilities. Furthermore, in institutional settings marked by ambiguous rules – such as the Brazilian experience – actors pushing for change might find fertile ground to enact the measures they envisage.

In the remainder of the paper, I will show how the institutional changes that affected the fiscal decentralization in Brazil in contexts of crisis are not the outcome of swift transformations but rather the apex of historical ambiguities, institutional legacies, power dynamics, and gradual changes that built up over time. As such, critical events act more as catalysts of change whose enabling conditions had already been underway than as their ultimate source. The following sections develop in length my argument that systemic crises create an opportunity for endogenous centralizing forces to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization. I further argue that the changes brought by systemic crises might favor centralization amidst the ambiguities permeating the relationship between centralization, decentralization, cooperation, and competition in the Brazilian federal system. I unpack these issues against the background of the recent Brazilian experience with two major crises: the 2015-2016 economic recession and the COVID-19 pandemic. To situate these crises within the Brazilian fiscal federalism landscape, the next section discusses its tenets and how the fiscal decentralization system is embedded in a complex institutional setting that nurtures tensions within and across levels of government.

III. BRAZILIAN FISCAL FEDERALISM: VERTICAL AND HORIZONTAL TENSIONS IN A COMPLEX FEDERATION


Brazil is a three-tier federation with a high degree of regional inequalities that manifest along economic, social, and demographic dimensions. The contrasting realities across Brazilian states have consequences for fiscal federalism and intergovernmental fiscal relations, such as nurturing subnational tax policy competition. The disparate levels of economic development and fiscal revenues lead to a high degree of variation in the capabilities of subnational governments to provide high-quality public goods and services, invest in infrastructure, and fund educational and professional development initiatives – elements that usually bear considerable weight in business decisions about where to base operations within a country (Agrawal et al. 2015; Zodrow, 2010). Thus, to attract businesses and private sector investments, states often pursue aggressive tax policy strategies that have historically created tensions in horizontal and vertical relations – a phenomenon commonly dubbed fiscal war.

The enactment of the 1988 Federal Constitution was a turning point in the institutional trajectory of fiscal federalism in Brazil. It established a new federal pact and set out a
complex division of powers and competencies across the federal, state, and local governments that led to an unprecedented level of fiscal decentralization (Souza, 2016). However, as this paper shows, the Brazilian federation is characterized by the co-existence of centralizing and decentralizing devices that have historically shaped intergovernmental fiscal relations in the country.

The decades preceding the 1988 Federal Constitution were marked by a 21-year civil-military regime that undermined the autonomy of subnational governments amidst a centralizing and authoritarian ethos that dominated political life from 1964 to 1985 (Desposato, 2001). During that period, elections for governors, the heads of the Executive Power at the state level, were suppressed. Overall, the distribution of power throughout the Brazilian republican history is often characterized as a pendulum that swings back and forth between centralization and decentralization (de Medeiros, 1994; Ward et al., 2010). Even though the alternation and instances of co-existence between these two forces are part and parcel of Brazilian institutions, between the 1930s and 1980s, periods of authoritarianism prevailed and undermined the political and fiscal autonomy of subnational governments, leaving a legacy of tensions in vertical intergovernmental relations.

Against this background, the 1988 Federal Constitution not only sought to consolidate democracy but also to institute a new federal pact predicated on decentralization and cooperation across levels of government. To achieve these goals, the Constitution created a series of mechanisms to secure the realization of elections at all levels of government, guarantee that subnational and local governments enjoy the autonomy they need to provide public goods and services and implement intergovernmental transfers to help fulfill the constitutional principle of reducing regional inequalities.

Through an extensive title dedicated to taxation and budget matters, the Federal Constitution set out the taxing powers of the federal, state, and municipal governments (Table 1). These provisions are regulated by several statutes containing specific rules, procedures, and exceptions. In general, the federal government has taxation powers over international trade, income, financial operations, and industrial goods. At the state level, the main source of tax revenue is the ICMS, the tax falling upon interstate and inter-municipal trade and transportation. State governments also have tax authority over the ownership of motor vehicles and the transmission of any goods and rights upon an individual’s death. Municipalities, in turn, mainly rely on property and services taxes (ISS) on top of certain real estate transactions.

1. When Brazil, a former Portuguese colony, conquered its independence in 1822, it became a constitutional monarchy. Later on, in 1889, it assumed its current republican form. The first republican Constitution, dated from 1891, recognized the autonomy of the states in relation to the federal government.


3. Brazil is notable for the complexity of its tax system, which lies upon a myriad of legal and sub-legal regulations across all levels of government. Such complexity negatively affects compliance with tax obligations and contributes to harmful practices like tax evasion by individuals and businesses. The World Bank’s data on time to prepare and pay taxes (measured in hours) indicates that Brazil ranks first among all countries: https://data.worldbank.org/indicator/ICTAX.DURS?most_recent_value_desc=true.
Although each level of government exercises its taxation powers within its competencies, not all revenues remain with the government that originally collected certain taxes. The Federal Constitution drew a distribution of tax revenues for some tax categories that takes place directly and indirectly. The direct distribution of tax revenues occurs when a political entity receives the concerned revenue directly from the government with the power to collect it. In turn, the indirect distribution is operationalized through participation and compensatory funds in which revenue is shared across beneficiaries following the criteria established by the governing legislation.

The distribution of tax revenues aims to ensure a reasonably predictable and stable level of transferred revenues for states and municipalities. Still, its underlying policy design has created some contradictions over time. First, it is important to note that not all revenues stemming from the taxation power exercised by the federal government are included in the sharing scheme. The Brazilian Federal Constitution provides for five categories of duties of which solely taxes are subject to tax revenue distribution.

Against a backdrop of decline in the collection of tax revenues at the federal level that is not matched by a decrease in the proportion of resources that the federal government must transfer to subnational and local governments, the federal government has adopted a new strategy to raise its revenues without sharing additional resources with other levels of government. Hence, instead of raising tax rates — implying that states and municipalities would receive a share of such increases — the federal government has prioritized raises in social contributions, which are not subject to the distribution of revenues under constitutional rules.

Historically, the federal government’s strategy to raise social contributions while granting benefits and exemptions involving federal taxes whose revenues are shared with subnational entities has led to conflicts with the states. As Rezende (2007, p.

---

4. The five categories are: taxes, fees, improvement contributions, general contributions, and mandatory loans.
78) argues, “conflicts come up whenever measures adopted by the federal government reduce revenues from the income and manufacturing taxes that form the basis of the present revenue-sharing system”. The model of intergovernmental transfers inscribed in the 1988 Federal Constitution is anchored in the so-called participation funds. The participation funds are fed with the resources stemming from the share to which states are entitled. For some of the poorer states (Acre, Amapá, Roraima, and Tocantins), the resources distributed through these funds constitute the main source of revenue. Along with the general participation funds, special funds provide federal resources for specific policy areas, such as basic education.

The fiscal equalization system currently in place in Brazil does equip states with an adequate level of resources because “[t]he national model adopts absolute (static) population and household income indicators and does not provide for periodic reviews or relative (proportional) and dynamic (growth) aspects of states’ socioeconomic context” (Mendes, 2022, p. 16). Therefore, supply-side considerations (i.e., fiscal capacity) and the contrasting socioeconomic indicators are not considered in the most important mechanism to tackle horizontal inequality between states in the country. Consequently, the current fiscal equalization model contributes to perpetuating inequalities across states.

Despite these remarkable developments towards decentralization, the new institutional arrangements set forth by the 1988 Federal Constitution suffer from implementation gaps and co-exist with enduring centralizing forces that raise vertical and horizontal tensions. Along with other countries in Latin America, the Brazilian political system is characterized by a strong federal Executive Power that grants extensive powers to the President, including in its relationship with the National Congress (Figueiredo and Limongi, 2000; Pereira et al., 2008; Reich, 2002). During the democratic transition that took place in many countries in the region as of the 1980s, the historical inclination to centralize power was preserved and overshadowed by the progress made in the consolidation of democracy and expansion of social rights in their constitutions—a common phenomenon in the wake of the New Latin American Constitutionalism (Gargarella, 2015). Thus, the federal government can garner support to advance measures that strengthen its power over policies affecting subnational entities, even bypassing the veto power that states could exert to prevent centralizing initiatives—a point to which I will come back later.

The original text of the 1988 Federal Constitution and its numerous subsequent amendments reflect the ambiguous relationship between centralization and decentralization that have historically characterized intergovernmental relations and the division of jurisdictional powers in Brazil. As Gonzáles (2007, p. 217) contends, the enactment of a constitution crystalizing a power arrangement between federal and subnational units does not mean that conflicts come to an end. Rather, “[t]he struggles over the distribution of power and resources continue over time and recurrently modify the relations between central and sub-national governments” (Idem).

In 1993, an amendment to the Federal Constitution eliminated the additional state rate of 5% that fell upon the federal income tax, apart from cutting off the municipal

---

5. It is interesting to note that these funds were created by an amendment to the Constitution in 1965—i.e., during the civil-military dictatorship—which illustrates the argument that Brazil has long experienced a co-existence between centralization and decentralization.


7. For an overview of the New Latin American Constitutionalism, see Curcó Cobos (2018).
tax on retail sales of liquid and gas fuels. As expected, these measures caused revenue losses for states and municipalities. Another source of tension between states and the federal government was raised in 2004 due to a change in the regime governing the compensation for losses arising from the exemption from the payment of ICMS on the exports of primary and semi-finished products or services established by the federal government in the mid-1990s. Such exemption had spurred controversy between the governors of exporting states and the federal government, but vertical conflicts were heightened when the compensation to states no longer fixed the amount of such payments. Thus, state governors saw themselves obliged to negotiate the amount to be transferred with the federal government every year, which undermined predictability.

Vertical conflicts have instilled enduring institutional changes in the dynamics of fiscal decentralization in Brazil. Long-ingrained centralizing devices that persist in Brazil’s contemporary political and economic institutions enable the federal government to yield unilateral top-down policies and decisions that might constrain the states’ fiscal autonomy. Intergovernmental fiscal relations in Brazil rest on a fragile balance between the unprecedented level of fiscal decentralization promoted by the 1988 Federal Constitutions and horizontal and vertical tensions that, from time to time, change the dynamics of fiscal decentralization in the country. This ambiguity allows centralization and decentralization to co-exist in periods of institutional stability and leaves room for centralizing forces to take over when external shocks create a favorable environment for institutional change.

These centralizing forces can be unpacked into structural and agency elements. On the structural side, the historical prominence of centralizing political practices was reinforced in periods of authoritarian rule (1937-1945 and 1964-1985), thus undermining the political and fiscal autonomy of subnational units. As the next section will show, the enactment of the 1988 Federal Constitution did not completely erase centralizing devices from the central government’s institutional repertoire. At first glance, the existence of federal safeguards (Schnabel, 2020), like a bicameral system that guarantees state participation in national decision-making, might suggest that such actors enjoy institutional mechanisms to act as veto players with powers to thwart unilateral actions over subnational matters. In practice, though, a combination of constitutional rules and poor party discipline weakens the veto power of subnational players. As Arrecthe (2013, p. 136) puts it, “there are few arenas where subnational units might be able to make use of vetoes. The centralization of policy competence, combined with the majority principle for changing federal legislation, means that no supermajority is needed to change the status quo of most subnational issues. The Brazilian federal state enables the center to initiate and approve general interest legislation”. These structural features create an enabling environment for centralizing forces to flourish on the agency side. The 1988 Federal Constitution grants extensive powers to the President that allows it to explore the fragile balance between autonomy and coordination in the Brazilian dual federalism system to bypass subnational governments and impose unilateral decisions. In recent years, such unilateral actions have created further tensions amidst an increasingly contested system of checks and balances where the Federal Supreme Court frequently assumes an arbitrator role to settle intergovernmental conflicts.

2. The effects of the 2015-2016 crisis

While most countries grappled with the economic shocks provoked by the 2007-2008 crisis, it did not put a major toll on the Brazilian economy. The commodities boom that began in the early 2000s and continued through approximately a decade greatly benefited Brazil, whose economy is largely based on the export of commodities like crude oil, minerals, soy, and sugar. Brazil saw a growth of 5.1% in its GDP in 2008,
followed by a slight retraction (-0.1%) in 2009 and a strong economic recovery in 2010 (+7.5%). Back in 2008, then President Luiz Inacio Lula da Silva famously stated that while the crisis was a tsunami elsewhere, it would be nothing more than a small wave in Brazil. Indeed, the favorable economic landscape for commodity exporters at the time helped Brazil navigate an otherwise turbulent period for most advanced industrial economies.

If the 2008 financial crisis did not affect the Brazilian economy immediately, the country went through its worst recession ever recorded between 2015 and 2016. The confluence between a sharp decline in economic growth, investments (both public and private), and consumption on the one hand and a rise in unemployment, interest rates, and public debt on the other created a challenging environment that had important social and political implications. The economic downturn that struck the country helped fuel massive popular upheavals in 2013 (Marqueti et al., 2020; Saad-Filho, 2013) and general discontent among economic agents (Pena, 2018). Moreover, the 2015-2016 crisis played a relevant role in the impeachment process of then-President Dilma Roussef, who was removed from office. The political and economic elites extensively construed the mismanagement of the crisis under Roussef’s leadership as an indication that she was no longer able to govern the country (Avritzer, 2017).

The causes of the 2015-2016 crisis involved both supply and demand shocks. However, many analyses (Barbosa, 2015; Oreiro, 2015) also draw attention to the role played by the New Economic Matrix (in Portuguese Nova Matriz Econômica) in the unfolding of the crisis. The New Economic Matrix (NEM) consisted of a set of economic measures pushed forward by the Roussef administration from 2011 onward that were characterized by a strong intervention of the federal government in several domains of the economy inspired by the developmental tradition that was highly influential in the country during the XXth century (Doering et al., 2017). The main goal of the NEM was to boost the industrial sector, which has undergone a trend toward deindustrialization since the 1980s (Flexor and Dias da Silva, 2021; Monteiro and Lima, 2017). To achieve this goal, the federal government adopted a broad range of measures that included new industrial and infrastructure plans, tax subsidies for businesses operating in 15 different sectors, a rise in tax rates for some foreign manufactured goods, and the concession of subsidized credit through public banks.

These measures, though, did not produce the results the federal government expected. Businesses that benefited from the tax rate reductions and exemptions the federal government granted used tax reliefs as an opportunity to recompose their profits instead of making investments to leverage production. Consequently, these measures did not translate into productivity gains or job creation (Garcia et al., 2018). This lack of investment was also explained by the limited demand levels, which the federal government had overestimated in the design of the NEM (Carvalho, 2018).

At the sub-national level, the 2015-2016 crisis affected the states’ finances in different ways. In the first quarter of 2016, states saw a more than 22% decline in their revenues and a concomitant increase in personnel expenses. Consequently, most states

10. It is worth noting that some economists challenge the weight commonly attributed to the New Economic Matrix to the 2015-2016 recession. An example of this position can be found in Borges (2017).
violated the expenditure-revenue ratio caps outlined in the Fiscal Responsibility Act. Moreover, as the federal government granted benefits involving taxes whose revenues are partially shared with states and municipalities, subnational entities saw a decline in intergovernmental transfer revenues, whose value is further deteriorated by rising inflationary pressures.

Figure 1. Evolution of the Federal Government’s Debt

Source: elaborated by the author based on the Brazilian Central Bank data

The deterioration of the states’ accounts and the pressure coming from political leaders at the state level led the federal government to act on the issue. In this sense, the federal government’s response came in the form of a Fiscal Recovery Regime that sought to restore fiscal balance at the state level through a comprehensive program to restructure the states’ finances. By adhering to the regime, states are allowed to enter into credit operations with the federal government (which is prohibited as a rule) and enjoy a temporary waiver of certain fiscal rules and suspension of debt payments. In exchange for those benefits, participating states must implement a series of institutional reforms required by the federal government, as I will discuss below.
Destined to states facing serious fiscal problems, the Fiscal Recovery Regime came into force in 2017 after a period of negotiations led by the state of Rio de Janeiro, which was going under severe imbalances in its accounts and became the first to adhere to the regime. Since the program aims to support states with challenging fiscal imbalances, eligibility criteria are very strict. States need to fulfill four cumulative criteria to join the Fiscal Recovery Regime:

1) net annual current revenue lower than the consolidated debt at the end of the fiscal year before the request to join the regime

2) current expenses higher than 95% of the net current revenue measured in the financial year before the adhesion request

3) current expenses with personnel representing at least 60% of the net current revenue measured in the fiscal year before the adhesion request, and

4) total value of contracted liabilities greater than cash and cash equivalents of available non-earmarked resources.

If the Brazilian Treasury Board Secretariat approves their request to join the regime, states must submit a detailed fiscal recovery plan outlining all measures they intend to take to ensure that fiscal balance will be restored by the end of the program, which can reach up to nine fiscal years. This plan must establish a clear and well-founded link between the fiscal imbalance faced by the state and the envisioned measures, implementation deadlines, and expected impacts. A Supervisory Council composed of representatives from the concerned state, the federal Ministry of Economy, and the Federal Court of Auditors oversee the implementation of the measures listed in the fiscal recovery plan. Such measures are institutionalized through the introduction of laws and other legal instruments allowing for the adoption of the following:
1. Selling (totally or partially) public companies’ shares owned by the state

2. Liquidating or terminating public companies to settle liabilities with the collected funds

3. Reducing tax or fiscal benefits that result in foregoing revenue by at least 20%

4. Adopting the social security rules applicable to federal public servants

5. Revising the legal regime governing the public service to reduce any benefits that are not granted to federal public servants

6. Establishing a complementary pension regime for public servants that is subject to the same limits as those for the general pension regime

7. Establishing rules and mechanisms limiting the annual growth of primary expenditures to the variation of the Broad National Consumer Price Index

8. Holding payment auctions to secure favorable conditions to settle liabilities, and

9. Adopting a centralized financial management system within the Executive Power.

Along with these obligations, the Fiscal Recovery Regime also implies a series of prohibitions that states must observe. Among the most restrictive measures, one can find the prohibition of raising salaries in the public sector, creating ongoing mandatory expenses, and granting tax benefits apart from limiting the hypotheses in which hiring personnel is allowed. The rationale behind these measures is to decrease expenditure levels while curtailing actions that could lead to losses in tax revenue. Taken together, the mandatory actions and prohibitions display the restrictive character of the Fiscal Recovery Regime.

This overview shows that the stringent requirements that the Fiscal Recovery Regime imposes on states compel them to 1) adopt the same institutional framework governing the public service at the federal level and 2) dispose of economic assets. Additionally, they deeply constrain the expenditures they may undertake and their capacity to make public investments and fund policy programs. For instance, Paiva et al. (2016) highlight that the regime can yield detrimental effects on social assistance policies. On top of restricting expenditures, the regime does not support states on the revenue side, which is crucial to maintaining their fiscal balance in the long run. As time goes by, it will be important to assess the impacts of the Fiscal Recovery Regime both on the promotion of sustained balance in the states’ finances and on policy expenditures.

The introduction of the Fiscal Recovery Regime changed the dynamics of fiscal decentralization in Brazil to the extent that it granted the federal government extraordinary powers to direct the finances of participating states. Even though adherence to the regime is voluntary, the top-down character of required measures and limited room for negotiation contradict the tenets of cooperative federalism enshrined in the Federal Constitution. Besides, the program conditioned federal support to the adoption of administrative, legal, and fiscal measures that curb the states’ capacity to autonomously decide on important aspects of their policies during a time frame that can reach almost a decade. This centralizing character helps explain the limited adhesion of states to the regime. So far, four states (Goiás, Minas Gerais, Rio de Janeiro, and Rio Grande do Sul) have joined the Fiscal Recovery Regime.
The long-term implications of the Fiscal Recovery Regime are unclear. The economic literature posits that fiscal policy and economic performance are interrelated (Prescott and Gjerde, 2022), but the Fiscal Recovery Regime does not address the potential effects of the fiscal constraints it imposes on states on their economic outlook in the long run. Moreover, up to this point, the implementation of the fiscal recovery plan does not seem to be sufficient to put participating states back on the fiscal balance track. In their analysis of the impacts resulting from the implementation of the fiscal recovery plan in the state of Rio de Janeiro, Torrezan and Paiva (2021) show that not only did the state’s level of indebtedness grow, but, except for a decline in personnel expenses, it failed to comply with the federal government’s demands until the end of 2019. Despite the immediate financial relief brought by the suspension of the payment of its debt with the federal government, Rio de Janeiro was unable to make substantive progress towards fiscal balance and solvency, which justified the recent renewal of the Fiscal Recovery Regime until 2031.

Figure 3. Evolution of Rio de Janeiro’s Debt

Source: elaborated by the author with data from the Brazilian Treasury Board

IV. BRAZILIAN FISCAL FEDERALISM IN THE AFTERMATH OF THE COVID-19 PANDEMIC

Governments worldwide took bold measures to slow down the propagation of the SARS-COV-2 virus and tackle the COVID-19 pandemic. Some of those measures, especially lockdowns and social distancing requirements, sparked a decline in economic activities that negatively affected the economy of many countries (Chen et al., 2020; Chiatchoua et al., 2020; Zinecker et al., 2021). In line with emerging evidence on the issue (Dougherty and de Biase, 2021), the Brazilian federal government absorbed most of the economic shock stemming from the COVID-19 pandemic, while state governments rapidly rebounded from a short period of revenue losses. Federal public debt has spiked amid increased expenditures and intergovernmental transfers to cope with the health crisis. In 2020, the federal government approved new
Introduction

Despite this growth in intergovernmental transfers, the pandemic triggered tensions between the federal and state governments. The spike in inflation led to a substantive increase in fuels price, which, in turn, harms political popularity. In response to the mounting pressure to bring inflation down, the federal government persuaded states to lower the ICMS rate falling upon fuels, energy, transportation, and telecommunications to reduce their final price to consumers. In this sense, the federal government imposed a cap of ranging between 17% and 18% on ICMS rates relating to certain essential goods. The federal government’s main target was reducing fuel prices, whose increase had created an upheaval in society as a whole and, more specifically, among truckers and other professional drivers. In the past, strikes motivated by high fuel prices among transportation professionals caused significant economic impacts, which is something the federal government seeks to avoid in light of the coming general elections to be held in October 2022.

The federal government’s policy to reduce the ICMS rates triggered an immediate reaction from state governors. The main concern of state leaders involved revenue losses and compensation mechanisms for such losses. For most Brazilian states, the collection of ICMS represents the primary source of revenue, so the federally mandated cap on ICMS rates could undermine the balance of subnational public accounts. States unsuccessfully tried to introduce a clause in the new legislation requiring the federal government to recompose health and education funds should these areas bear shortfalls resulting from the loss of tax revenues, which President Jair Bolsonaro vetoed. However, the states expect the reduction in the ICMS rates to spur a loss of approximately 17 billion Brazilian Reais (roughly USD 3.3 billion) from health and education alone.

Some states filed lawsuits before the Supreme Court to thwart the federal government’s strategy. Seven states (Acre, Alagoas, Maranhão, Minas Gerais, Piauí, Rio Grande do Norte, and São Paulo) resorted to the Supreme Court to secure compensation mechanisms for the loss of tax revenue in which they eventually incurred due to the federal government’s policy. Through the favorable decisions they obtained before the court, these states are now able to compensate ICMS revenue losses by discounts in the payment of their debts with the federal government.

The financial strains faced in the COVID-19 pandemic renewed the debate over the need to reform the country’s tax and fiscal system. In fact, calls for tax reform have been part of the public debate for at least three decades (Varsano, 2003; Werneck, 2000), but the controversial nature of the theme often hinders consensus-building around the scope of reform initiatives. Over the years, many bills have been proposed in the National Congress but failed to move along the legislative process. However, since 2019, three major proposals have been introduced by the House of Representatives, the Federal Senate, and the federal. Of these, the constitutional amendments proposed by the House of Representatives and the Federal Senate present the most consequential measures to subnational entities.

The two proposals presented by the chambers of the National Congress advance measures that, if adopted, would significantly change the tax system at the subnational and local levels. The main goal of the tax reform agenda is to simplify the Brazilian tax system. The core proposal within this simplification paradigm is replacing a bundle
of federal (IPI, PIS, and COFINS)\textsuperscript{12}, state (ICMS), and municipal taxes (ISS) for one single tax (IBS)\textsuperscript{13}. This proposal is modeled after international practices with value-added taxes (VATs). Its defenders argue that it will reduce tax costs, create a better business environment, and instill fairness into the tax system. The federal government maintains that the reform will reduce regional inequalities, benefiting 98% of the municipalities and being positive or neutral for 100% of the states\textsuperscript{14}.

**Figure 4. House of Representatives Proposal**

![Diagram of tax unification](source: elaborated by the author)

Recent amendments to the Senate’s proposal aim to create two VATs: one at the federal level (resulting from the unification of federal taxes and duties) and another one at the state and municipal levels (resulting from the unification of the states’ ICMS and the municipalities’ sales tax – ISS). This proposal also targets the fiscal war between states. On that account, it establishes a common tax rate for states and a general prohibition to grant benefits and exemptions relating to the common value-added tax at the subnational and local levels, with a few exceptions (for example, the food sector) that a specific law shall regulate.

---

\textsuperscript{12} IPI: Tax on Manufactured Goods; PIS: Program of Social Integration; COFINS: Contribution for the Funding of Social Security.

\textsuperscript{13} IBS: Goods and Services Tax.

On top of these provisions, other proposed measures have also sparked discontent with the tax reform models among states. According to current rules, the ICMS is charged in the state of origin of a service or good and not in its place of consumption. The reform proposals determine that the tax shall be levied and collected in the state where consumption occurs, as is usually the case with VATs. In the short and medium terms, this provision would create a cleavage between producer and consumer states because that could harm the finances of poorer subnational entities, which tend to have lower consumption levels. To avoid such imbalance, the House of Representatives and Senate proposals envision the creation of a regional development fund to offset potential revenue losses that predominantly producer states could bear due to the new tax regime. Additionally, during the transition period, states and municipalities would receive financial resources from the federal government equivalent to their current ICMS and ISS revenue earnings. Still, such measures face much resistance from states and municipalities, which see these changes as a threat to their finances and fiscal autonomy.

Given the enormous impacts of these initiatives on the structure of the national tax system, all reform proposals aim to implement changes gradually over a time frame that could reach up to 50 years in the case of the House of Representatives proposal. The history of tensions and unfulfilled commitments undermine trust in intergovernmental fiscal relations, though. Together with the uncertainty around future tax rates and revenues, governors tend to be wary of the impacts such measures could entail for their states. One interesting issue is that despite states’ representation in congress through the National Senate, they do not always constitute a relevant veto power to the federal government’s aspirations. In the Brazilian National Congress, party coalitions tend to be stronger than purely regional coalitions (Arretche and Rodden, 2004), which is reflected in the limited impact of state-level actors on national party cohesion (Desposato, 2004).

The ambiguities upon which the Brazilian fiscal federalism system is built enable the persistence of strong centralization devices even if the new constitutional order inaugurated in the late 1980s is explicitly premised on a cooperative and decentralized federal
pact. As the analysis of the 2015-2016 and COVID-19 crises showed, the external and systemic shocks that permeated these contexts were followed by federal responses that undermined the autonomy of states, especially—but not only—in the fiscal realm. On the surface, the federal government’s initiatives to quench the negative economic impacts of the pandemic might seem abrupt, but a more attentive analysis reveals that they are, in fact, part and parcel of the historical ambiguities and subtleties surrounding the relationship between cooperation and conflict, centralization and decentralization in the Brazilian federation.

V. CONCLUSION

Periods of systemic crises induce temporary strains on political and economic institutions and create windows of opportunity for institutional changes that may have lasting effects over time. This paper showed how two recent systemic crises affected the dynamics of fiscal decentralization in Brazil. Against the background of the 2015-2016 fiscal crises and the COVID-19 pandemic, I developed the argument that systemic crises create an opportunity for endogenous centralizing forces (at the structure and agency levels) to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization through policy displacement. These two crises entailed different financial implications for the states in the sense that the 2015-2016 crisis hit their economies hard, whereas the latter was mainly felt at the federal level. Despite these differences, the institutional responses to address them were similar: they granted more powers to the federal government and enabled it to dictate some aspects of the states’ finances. I contend that these changes towards centralization were made possible because the endogenous centralizing forces that have persisted within Brazilian political and economic institutions over a long time harnessed the opportunity for policy change created by significant external shocks such as the 2015-2016 and COVID-19 crises.

The analysis of the institutional changes that emerged in reaction to two recent systemic fiscal crises endorses and expands earlier claims in the literature that in contexts of fiscal constraints, powerful presidents in Latin America seek to introduce measures that give them more control over financial resources either at the federal or subnational level. This paper goes beyond the usual focus on the expenditures side and draws attention to the implications of centralization to subnational revenues. The recent attempt by the Brazilian federal government to interfere in the main source of tax revenue at the subnational level—the ICMS—to curb fuel prices is a clear illustration of this centralizing trend. Furthermore, as the COVID-19 pandemic is gradually debunked as the top policy priority for many governments, legislative activities around the proposals to reform the national tax and fiscal systems are poised to gain more space.

This article showed that central governments can also change the dynamics of fiscal decentralization through institutional innovations that affect the dynamics of fiscal decentralization and intergovernmental fiscal relations for an extended period. The Fiscal Recovery Regime created in 2017 constrained the autonomy of participating states to make policy decisions and manage their accounts on the revenue and expenditure sides for approximately a decade. Likewise, the regime conditions the concession of fiscal benefits to adopting certain federal frameworks and regulations. More recently, amidst the inflationary pressures that have escalated since the beginning of the COVID-19 pandemic, the federal government managed to reduce the states’ ICMS rates applying to energy and telecommunications. Tax reform proposal currently under discussion in the National Congress have the potential to introduce significant changes to the national federal system, overhauling the main sources of tax revenue for states and municipalities particularly.
This paper sought to shed light on the implications of systemic crises to fiscal decentralization in a federal system. However, some limitations and unaddressed issues deserve to receive attention in further research on the issue. First, while I have repeatedly referred to vertical tensions, the scope of this work did not allow me to explore in greater detail the relationships permeating federal and state actors. In this regard, situating such tensions within the Brazilian political system is a promising approach. Moreover, this paper was based on a single-case study of Brazil, a federation generally deemed to be centralized. Hence, it would be interesting to analyze how the relationship between systemic crises and fiscal decentralization plays out in more decentralized federations.
REFERENCES


- ______. (2007). Lei Complementar nº 159 de 19 de maio de 2017 [Lei Complementar No. 159 May 19, 2017].


JOURNAL INFORMATION

INDEX

INTRODUCTION


FROM SAFE SAVINGS TO BIG BANGS –
GERMAN FISCAL FEDERALISM DURING AND BETWEEN ECONOMIC CRISSES

by Christian Bender
Institute of Public Finance and Public Management at the University of Leipzig

by Fabio Botta
Institute of Public Finance and Public Management at the University of Leipzig

ABSTRACT

Since 2007, the Federal Republic of Germany has experienced various major and minor crises. Of these, the financial crisis from 2007 and the Covid crisis were particularly severe. Yet German federalism seems to have weathered the tests of these two economic crises well. Although the crises occurred at a time when the financial relations between the governmental entities were being fundamentally reorganized. In the case of the Covid crisis in particular, the exact long-term fiscal burdens on the various federal levels will not be known for years to come. While public budgets are counteracting the crisis, they are not fully recovering, so that the fiscal burdens are accumulating. This increasingly limits the state’s room for maneuver, and tendencies towards a polycrisis are becoming visible. This article shows what influence the respective crises had on the interaction between the federal, state and local governments and how the fiscal system adapted to the new economic environment.

Keywords: Fiscal-federalism; multi-level-government; public-finance; crisis management; polycrisis
I. INTRODUCTION

“We tell savers that their deposits are safe. The German government is committed to this as well.” (Angela Merkel, 2008).

“We want to come out of the crisis with a bang.” (Olaf Scholz, 2020)

Crises come and go. However, the associated uncertainty has the tendency of outlasting the actual crisis. It is therefore often politically advisable to convey a sense of security in uncertain times. Consequently, both quotes give an idea of how a holding line in uncertain times can be conceived through public statements by government leaders.¹

The economic crisis starting in 2007 and, more recently, the Covid pandemic of 2020 are striking examples. Even if masking obligations have been dropped, contact restrictions are being lifted and government support programs are being scaled back, there is still a deep sense of uncertainty about the challenges ahead. What is almost uncontested, however, is that both the great financial recession from 2007 and the economic crisis in the wake of the pandemic from 2020 onwards have challenged the way in which corresponding politics (along with policy) are made and how federal structures respond and function. While the financial and economic crisis from 2007 onwards initially affected individual sectors of the economy particularly hard and the resulting shock has spread consecutively to the economy as a whole, the Covid pandemic had a direct impact on the entire economy. What unites both crises, nevertheless, is that economic activity faded, corresponding tax revenues declined, unemployment rose, additional public spending hiked and economic outlooks worsened. Facing a sharp and abrupt economic recession, the German federal level as well as the states used different anti-cyclical measures in order to stabilize economic activity and to remain fiscal space. While the economic crisis from 2007 onwards with the economic downturn and the recovery phase lasting until 2020 have been extensively researched, the full impact of the economic downturn from 2020 onwards is still not fully overcome yet.

This paper examines the impact of both crises on the public finances of the federal authorities and the underlying measures taken in this regard. This also includes a quantitative analysis of publicly available data from all levels of government to provide a comprehensive picture of fiscal developments during and after the two crises. Special attention will be drawn to two federalism reforms that, as their content and timing are significant. This includes reform efforts during the major financial crisis and a redesign of the federal fiscal equalization system under the circumstance of an economically extraordinarily positive situation. Even though the financial crisis from 2007 is already 15 years in the past and the fiscal consequences of the Covid crisis are already fading, the controversy on the impact of both crises on the federal dynamics of the current federal structure is still ongoing.

II. FISCAL FEDERALISM IN GERMANY

The current structure of German fiscal federalism is characterized by its unitarism and cooperativism, which is reflected in the division of tasks, the distribution of taxes, and the active fiscal equalization between the levels of government under Article 70 of the Basic Law. A substantial part of public tasks, as stated in Art. 83 of the Basic Law

¹ At the time of the quote, Olaf Scholz was still Federal Minister of Finance under the Merkel government, but he also shaped the word “bang” or “double bang” during his later time as Federal Chancellor.
is initiated by the federal government (the ‘Bund’), but carried out by the states (the ‘Länder’) and municipalities. As a result of this functional or executive federalism, the distribution of expenditures and revenues is of central importance to ensure that all levels are endowed with the funds needed to fulfill their tasks (Lenk & Glinka, 2017a; Kempny, 2014). The German tax distribution can be characterized as a mixed system. Separate taxes are solely allocated to the respective level of government and account for around 26 % of total tax revenues (Bender et al., 2022). Yet the larger share of tax revenue (74 %) is generated by joint taxes, most notably the value-added tax and income tax. These are distributed to the various governmental levels according to different distribution keys (Bender et al., 2022). As federal laws regulate the specific distribution, the Bund holds the central position in the fiscal system.

In the federal system and in the two economic crises, municipalities play and have played a particularly important role: The municipal level accounts for 26 % of personnel expenditure, 55 % of capital expenditure, 39 % of operating expenditure and 38 % of operating grants to third parties (own calculations based on Destatis, 2019). The municipalities are not a third federal level in their own right, but they have a constitutional right to self-government (Brümmerhoff & Büttner, 2018 or Geißler, 2020). The municipalities are subject to the legislation of the Länder with regard to structure, tasks or financing, which also leads to considerable differences between the Länder (Brümmerhoff & Büttner, 2018). In principle, the federal government does not transfer any tasks to the municipal level and the Basic Law does not provide for direct cooperation between the Bund and the municipalities (Art. 83, 85 and 108 Basic Law or Seidel & Vesper, 1999).

In principle, a functioning federal state should be able to sustain itself over time (Brinkmann et al., 2017, p. 650). Even though theories of fiscal federalism generally start from the assumption of an existing, stable and self-sustaining system, this assumption cannot be taken as a given in principle (Oates, 2005, p. 366-367). The resilience of fiscal federal systems may well change over time, especially during or after economic crises, which is why the federal system is usually also ‘on trial’ during an economic crisis (see, e.g. Kincaid et al., 2010). These ‘trials’ will be discussed in the following section.

II. GERMAN FISCAL FEDERALISM IN THE WAKE OF THE POLYCRISIS

1. The Financial Crisis is Followed by the Sovereign Debt Crisis

For the Federal Republic of Germany - as well as for many other countries - the Great Recession from 2007 onwards was the most severe recession since the Great Depression of the 1930s. Germany was hit hard by the global financial market turbulences and the slump in international trade following the collapse of the investment bank Lehman Brothers in September 2008. The ECB - and other central banks around the world - cut their key interest rates dramatically and where there was no further room for interest rate cuts, they resorted to unconventional monetary policy measures. Germany - like many other countries - experienced three interrelated crises (Zimmermann, 2012, p. 101). In the first crisis on the financial markets, the focus was on guarantees and loans as fiscal measures, followed by a second crisis in the real economy, which was responded to with quite effective measures of classical budgetary stimulus policy. In particular, the negative effects of the financial crisis on the labor market could be strongly cushioned in a European comparison with the labor market policy instrument of short-time
allowance (Brenke et al., 2010, p. 6). Figure 1 shows that there were more than 1.4 mil. short-time workers at the peak in May 2009. Thus, despite a historic slump in economic output, the crisis in Germany was halfway overcome in 2010 according to most economic indicators (Borger, 2010, p.1). An example of this is the ifo Business Climate Index in Figure 1, which is an early indicator of economic developments and which had already returned to the relatively high level of May 2007 by October 2010.

**Figure 1: Short-Time Workers and ifo Business Climate Index for Germany**

![Figure 1: Short-Time Workers and ifo Business Climate Index for Germany](source)

However, the averting of the crisis was not for free, as the public budgets contributed considerably to the mitigation of the crisis (Eltges & Kuhlmann, 2011, p. 143). The financial crisis and the crisis in the real economy caused public deficits and debt to skyrocket, and these crises were followed by a third crisis, the euro or sovereign debt crisis (Neubäumer, 2011, p. 831). The public budgets of the federal level were plagued by tax shortfalls of an unprecedented magnitude. As can be seen in Figure 2, federal tax revenue slumped by almost 5% in 2009. As was to be expected, precisely those tax sources that were directly linked to the economy collapsed (Eltges & Kuhlmann, 2011, p. 143). Wage and income tax decreased by about €13 bn. from 2008 to 2009 (Eltges & Kuhlmann, 2011, p. 143). This happened, among other things, in the wake of short-time work. The direct taxes on profits such as corporate income tax and trade tax fell by almost the same amount from 2008 to 2009, each amounting to €8.6 bn. Only value added tax increased in the same period by €1 bn. by 2009 (Eltges & Kuhlmann, 2011, p. 143).

3. In the case of short-time work (‘Kurzarbeit’), the Federal Employment Agency provides wage compensation for lost working time (usually in the amount of unemployment benefit) in order to help companies retain their employees in economically weak times. Short-time work can be applied in the event of a temporary, substantial and unavoidable loss of capacity to work. (Gehrke & Weber, 2020).
Tax revenues at state and local level fell far more sharply than at federal level. In 2009, the Länder suffered a drop of -7%, while the municipalities were the most severely affected level with -11% (Figure 2). At the same time, the slumps in Länder and local government revenues were highly differentiated (Färber, 2013, p. 219). Because the slump in world trade was concentrated mainly on investment goods and durable consumer goods, those Länder whose economic structure was concentrated on the manufacturing sector suffered particularly from the slump in world trade (Zierahn, 2010, p. 275). While Baden-Württemberg and North Rhine-Westphalia were hit hardest by the crisis, the eastern Länder of Saxony, Saxony-Anhalt and Mecklenburg-Western Pomerania, for instance, lost significantly less than the national average (Eltges & Kuhlmann, 2011, p. 143; Schmidt-Seiwert, 2011, p. 117). At the municipal level, too, regions characterized by a particular export orientation were particularly affected (Eltges & Kuhlmann, 2011, p. 147). At the municipal level, in particular, profit-related taxes - especially corporate income tax and trade tax - slumped after they had risen strongly until 2008 (Deutsche Bundesbank, 2010, p. 76).

The crisis also caused a number of additional expenditures, mainly for economic stimulus programs and measures to bail out banks. The federal government increased its expenditures by 9.4% in 2009 and 2% in 2010 (Färber, 2013, p. 218). The Bund bore the main burden for the protection of illiquid financial institutions and banks as well as for the establishment of economic stimulus programs (Färber, 2012, p. 8). This was managed not only through the federal budget but also through newly established special funds (Färber, 2013, p. 217). In 2008 and 2009, the economic stimulus packages I and II, with budgetary measures amounting to around €30 and €50 bn., were adopted by the federal government to support the economy (Zimmermann, 2012, p. 102). Partly criticized for being decided too late (Roos, 2009, p. 400), the packages included funds for government investment, tax and duty cuts, declining balance depreciation, labor market policy measures, improved regulations on the use of short-time work and a scrappage premium for cars (van Deuverden, 2022, p. 176). Other measures included for example, the quite significant statement on safe savings deposits in Germany mentioned in the introduction, the financial market stabilization fund of €480 bn., which mainly supported the German banking sector and avoided contagion effects on other institutions and the real economy. The Financial Market Stabilization Fund existed as a special fund from 2008 to 2015 and consisted of €400 bn. in guarantees for banks.
and other capital collection agencies and €80 bn. in capital measures (German Finance Agency, 2023). To rescue the Hypo Real Estate Group alone, a bad bank was set up to which the bank's risk positions were transferred and which had raised loans of €192 bn. on the capital market at the end of 2010 (Färber, 2013, p. 218). At the level of the Länder, the picture was also very mixed, as some Länder had to pay for the losses of their state banks – especially in Bavaria, Schleswig-Holstein, Hamburg, North Rhine-Westphalia and Baden-Württemberg (Kallert, 2017, p. 20). In the case of a number of (state) banks, public funds were also used in an attempt to stabilize them and slow down the further decline in prices on the financial markets and the increase in the cost of loans (Kallert, 2017., p. 20f.). At the same time, not all crisis measures were directly budget-relevant, e.g. through the use of guarantees (Färber, 2013, p. 218f.). In addition, €115 bn. was made available as guarantees and credit assistance in an Economic Fund Germany (Schambach, 2010, p. 53). Whereby the economic fund, due to a low utilization, is a good example of how originally planned large financial amounts can ultimately turn out to be small and then even put little strain on the budget and, in particular, can also function psychologically (Zimmermann, 2013, p. 16). The measures were also aimed at a positive signal effect: for example, the insolvency of the car manufacturer Opel would have had a fatal signal effect, which is why the rescue seemed justified for the special situation of these years (Zimmermann, 2012, p. 102). The Investment and Redemption Fund (ITF) granted financial assistance to the Länder and municipalities to stabilize the economy for investments begun between January 27, 2009 and December 31, 2010. At the end of 2011, the ITF had taken out loans totaling €21.2 bn. to finance these investments (Färber, 2013, p. 217f.). Furthermore, the Federal Employment Agency was paid a subsidy of €16 bn. in 2010 to compensate for the loss of income due to the economic crisis (German Bundestag, 2010). Social security funds, in particular the Federal Employment Agency, made an important contribution to stabilizing the economy; Social security spending rose by 5.9 % in 2009 and by 1.3 % in 2010 (Färber, 2013, p. 218).

With the revenue shortfalls and substantial additional spending, public debt increased significantly. As Figure 3 shows, public debt (as a percentage of GDP, pink line) increased by a maximum of 18 percentage points from 2007 to 2010 (from 64.9 % to 82.8 %), with the share of public debt held by the Länder and the share held by municipalities remaining relatively constant at 30 % and 8 %, respectively. At the federal level, debt increased by €988 bn. to €1,398 bn. (+41.6 %) from 2007 to the end of 2014. The Länder debt increased by 30.6 % in absolute terms over the same period. At the same time, however, significant differences can be seen in the debt ratios as a percentage of GDP between the federal and state (as well as local) levels: the federal level increased from 39.5 % to 52.1 % from 2007 to 2010, while at the same time the state level saw an increase from 20.2 % to 24.6 % and the local level from 5.1 % to 6 %.
Simultaneously, the budget balances of the various levels of government decreased considerably. As can be seen in Figure 4, the federal government again recorded the most extensive slump, followed by the Länder and local governments. Nevertheless, particularly relevant for the German context, local governments closed with record high deficits, especially in 2009 and 2010 (Boettcher & Freier, 2022, p. 647). A municipal budget crisis escalated in the context of the international financial crisis and the budget balance reached negative record levels of €-7.5 and €-6.9 bn. in 2009 and 2010 (Figure 4). This also led to a record increase in short-term municipal debt, for example in the form of cash advances (2012: €47 bn.) (Person & Geißler, 2020, p. 200). Although the German economy recovered relatively quickly after the economic and financial crisis, it took several years for budget balances to recover (Figure 4). Against the backdrop of rising municipal cash advances and the euro crisis, public budgets could not be relieved conclusively for a long time (Eltges & Kuhlmann, 2011, p. 144). Even though the impact of the financial crisis on public budgets varied until 2020, however, federal budgets improved significantly from 2011 and were in positive territory from 2015 to 2019 (Figure 4).
After all, the federal, state and municipal authorities have greatly mitigated the consequences for the population at the price of a sharp increase in debt (Eltges & Kuhlmann, 2011, p. 144). Even though the successes on the labor market were quite remarkable, the consolidation phase that was then initiated did not leave people and various federal levels unscathed (Eltges & Kuhlmann, 2011, p. 144). In the course of the Federalism Reform II, a debt brake was introduced in June 2009 (Art. 109 Basic Law), which stipulated, among other things, that the federal government may only have a structural debt of 0.35% of the gross domestic product (Art. 115 Basic Law). The Länder were also no longer allowed to run structural deficits over the economic cycle from 2020 onwards. Politicians set themselves narrow debt limits with the so-called debt brake (Eltges & Kuhlmann, 2011, p. 144). The new regulation applied to the federal government and the Länder from 2011 onwards, although a transitional regulation stipulated that deviations would still be possible for the federal government until and including 2015 and for the Länder until and including 2019. Although this meant that the deadlines were several years in the future, some state governments, for example, immediately began to introduce their own debt limits and thus influenced their spending capacities (Hecker et al., 2016, p. 14). Even though the debt limit refers to the federal level and the Länder, the municipal level, as a constitutional part of the Länder level, felt immediate effects, as in the following years there was potentially a transfer of tasks from the federal and Länder governments to the municipalities, which led to higher additional financial expenditures for the municipal level (Lenk et al., 2012, p. 16). Although the debt limit refers to the federal level and the Länder, the municipal level, as a constitutional part of the Länder level, felt immediate effects, as in the following years there was potentially a transfer of tasks from the federal and Länder governments to the municipalities, which led to higher additional financial expenditures for the municipal level (Lenk et al., 2012, p. 16). It thus closed the “valve” of indebtedness for the public budgets and put all federal levels under considerable fiscal adjustment pressure (Eltges & Kuhlmann, 2011, p. 144). As a result, the budget balances of the Bund, Länder and municipalities improved significantly (Figure 4), which was also influenced by a significant improvement in the revenue situation (Eltges & Kuhlmann, 2011, p. 144). Moreover, a distinctive feature of the crisis was that horizontal fiscal relations temporarily became more balanced when transfer payments from donor countries to recipient countries declined for the first time in recent history (Kincaid et al., 2010, p. 11).

The federal Republic experienced an upswing from 2010 onwards and the longest period of growth in the unified Germany, with 2019 being the tenth consecutive year of GDP growth (BMWK, 2019, p. 9; Destatis, 2020). It remained among the world’s top exporters in the aftermath of the financial crisis, achieving its highest-ever trade surpluses in 2015-2017, while experiencing robust domestic growth and being a historically low interest rate environment (BMWK, 2019, p. 9; Destatis, 2023, p. 3). The federal government itself achieved a balanced budget as of 2014, which was last achieved in 1969 (BMF, 2015, p. 4). Alongside the dynamic development of the economy and public finances

---

4. The second stage of the federalism reform focused in particular on modernizing the financial relations between the Federation and the Länder in order to adapt them to the changed framework conditions for growth and employment policy. Between March 2007 and March 2009, the Federalism Commission II, set up by the Bundestag and the Bundesrat, drew up a package of measures, the result of which centered on the introduction of the new joint debt rule. The introduction of the debt brake was motivated not least by the fact that European requirements regarding the general government deficit were to be met by implementing the debt-limiting regulation. In this context, it is particularly relevant that the debt targets relate to the country as a whole. With a maximum structural net new debt of 0.5%, the aim was to create a balance between the governmental entities. While the federal government was relatively quick to claim a share of 0.35% for itself, the Länder first discussed whether they needed the remaining leeway of 0.15% and second couldn’t agree on an allocation mechanism. This resulted in a common position on the structural prohibition of new debt. The remaining 0.15% was consequently not used. The debt brake is thus significantly more restrictive than the European requirements with regard to structural net borrowing. (German Bundestag & German Bundesrat, 2010, p. 91-106).

5. The implemented fiscal rule was also intended to help resolve a conflict that entered the new Article 109 of the Basic Law in the course of the Federalism Reform II. While paragraph 1 refers to the autonomy of the budgets of the Bund and the Länder, paragraph 2 describes that the Bund and the Länder jointly bear obligations arising from legal acts of the European Community. In order to find a balance between individual autonomy and joint obligations, the debt brake has been implemented as a regulatory coordinator (Art. 109 Basic Law).
negotiations began on the redesign of the federal fiscal equalization system, which was to permanently change the financial relations between the Bund and the Länder.

2. The Reform of German Fiscal Federalism Between the Chairs

10 years after the start of the crisis in 2007 and 8 years after Federalism Reform II, in 2017, the financial relations between the Bund and the Länder were reformed again, as the regulations on federal fiscal equalization had to be reorganized. The reform was necessary insofar as central legal bases for the vertical and horizontal distribution of available public funds expired at the beginning of 2020 (Lenk & Glinka, 2017a, p. 103). This included the legal basis of the central postulate of the Basic Law, which states that the different financial strengths of the Länder must be adequately balanced. The subject was therefore no less than the question of how financial resources had to be distributed in the future so that state and local authorities are in a position to adequately fulfil the tasks incumbent upon them. The outcome of the political negotiations meant comprehensive changes to the status quo, which was valid until 2019, with significant consequences for the federal government, the Länder, and indirectly also for the municipalities. The reform covers two different aspects of federal governance: One part of the reform covers the existing distribution of responsibilities between the federal levels, the other part covers the existing distribution of public revenues in the Länder (Lenk & Glinka 2017b, p. 422-426). However, there is no direct connection between the results of the two parts of the reform. The changes in the distribution of tasks and revenues were - in contrast to the fundamental demands of the economic theory of federalism - not coordinated with each other, but rather discussed and ultimately decided upon as different packages of demands side by side (Lenk & Glinka, 2017c, p. 506-507).

It was not until October 14, 2016 that the heads of the federal and Länder governments reached a final agreement. The Länder had largely prevailed in the reorganization of federal-Länder financial relations. In return, the Länder agreed to the transfer of responsibilities demanded by the federal government in April 2016. In its entirety, the compromise involved a comprehensive legislative initiative. The required approval of both chambers of parliament was still pending for the multiple amendments to the Basic Law and the drafting and rewriting of numerous individual laws. In the parliamentary groups in particular, there seemed to be a certain amount of resistance to the design of the reform (Lenk & Glinka, 2017c, p. 506-507).6

The value added tax share of the Länder was increased by about €4.02 bn. at the expense of the federal share (Art. 2 ‘Act on the Reorganisation of the Federal Fiscal Equalisation System from 2020 onwards and on the Amendment of Budgetary Provisions’). The increase was partly by means of an annual fixed amount and partly in a dynamic form by a relative increase in the Länder’s share of total value added tax revenue (Lenk & Glinka, 2017c, p. 507). The distribution of the value added tax to the single Land is based on the number of inhabitants. Financially weak Länder receive a surcharge, financially strong Länder a discount (Lenk & Glinka, 2017c, p. 507). This is done by a comparison of an equalization measure with a financial strength measurement. Gaps in financial strength will be uniformly compensated by 63 % (§10 ‘Act on the Financial Equalization between the Federal Government and the Länder’). The direct fiscal equalization among the Länder and the preceding advance value added tax equalization of the former system were thus completely abolished. Furthermore, unconditional grants of the

6. In particular, there was criticism of a reduction in solidarity among the Länder and the increasing dependence of financially weak Länder on the federal government that the compromise would entail. The draft bills were referred to the Budget Committee, which, among other things, set up several expert hearings. Most of the invited experts were critical of the reorganization of federal-Länder financial relations.
federal level to the Länder have been increased, and two new vertical instruments were introduced (German Bundestag, 2022a, p. 8). The agreed regulations on federal fiscal equalization are generally valid for an unlimited period. According to Art. 143f of the Basic Law, a further reorganization is possible after 2030 at the earliest, provided that it is requested by the Federal Government, the Bundestag or at least three Länder (Art. 143f Basic Law). Until a further reorganization has been decided, the recently agreed regulations continue to exist with a maximum duration of 5 years, starting from the time of the request for negotiations on a reorganization. In the very year in which the reformed tax rules were to take effect, the new system was tested by an unprecedented health care crisis and a subsequent economic crisis.

3. A Unique Combination of Health and Economic Crisis

The economic crisis from 2020 onwards - as in other countries - had quickly displaced the economic crisis from 2007 onward from its position as the most severe economic crisis since 1930 (BMWK, 2020, p. 11; OECD, 2021, p. 7). The Covid pandemic led to a historically unique combination of a health crisis and an economic collapse worldwide, with supply and demand shocks (including large stock market slumps), with the economy highly dependent on pandemic events and containment measures closely interacting with economic and business cycle policy instruments to mitigate the economic consequences (OECD, 2020, p. 4; OECD, 2021, p. 7; Vöpel, 2021, p. 319). As in the crisis from 2008 onwards, the ECB was also characterized by quick action in the form of further monetary policy easing during the Covid crisis. At the time, there was still a risk that low inflation would become entrenched in view of the severity of the crisis and after years of very weak price development (Nagel, 2022).

While Bund and Länder budgets were in a favourable starting position at the beginning of 2020, with the outbreak of the pandemic in Germany in the spring of 2020, both levels of government faced the challenge of dealing with the exogenous shock and, in particular, the economic consequences of recurrent closures. On the one hand, fiscal policy measures were aimed at closing the financing gap created by falling tax revenues and rising expenditure burdens - this was necessary because the countercyclical offset of automatic stabilizers proved insufficient for this purpose. On the other hand, a number of measures were adopted to relieve the financial situation of private households and companies with the help of transfer payments. Although Germany also experienced its most severe and rapid stock market collapses ever, the fact that a renewed ‘top-down financial crisis’ was largely avoided in 2020 with substantial national intervention is potentially also due, among other things, to ‘lessons learned’ from the past decade (Buch, 2021).

The Bund took a three-pronged approach to combat the pandemic effects. First, extensive direct action was taken to protect public health. Second, the Bund took measures to safeguard the industrial economy and employment. Third, it provided aid to the Länder and municipal governments. While the initial focus (April to September 2020) was set on short-term measures to secure the liquidity of private households and businesses that were rather vague regarding their direction of impact, but fiscally effective, the support measures changed in the further course to more tailored solutions for private households and businesses (Aronney et al., 2021, p. 126). These solutions required more processing and therefore exhibit a time lag, but were more accurate. The Bund generously resolved the typically conflicting goals of accuracy versus swiftness by providing rapid emergency aid (Aronney et al., 2021, p. 126). To support private households and businesses, the Bund primarily resorted to transfer payments, subsidies and loans. These included the short-time allowance, the extension of unemployment benefit, the child bonus and the numerous bridging aids for companies. Moreover, lending had been supported via the creation of the Economic Stabilization Fund and the special programs
of the ‘Kreditanstalt für Wiederaufbau’ (KfW). The most important individual federal measures in the two supplementary budgets for 2020 are the Corona emergency aid (max. €18 bn.), the bridging aid (max. €25 bn.), the additional spending regarding livelihood protection (around €5.5 bn.), the coverage of additional burdens on the Federal Employment Agency (over-year loan of €9.3 bn.), which also includes the extension of short-time working allowance, and the payments to the healthcare fund (€11.5 bn.). The supplementary budget for 2021 approved further one-off business assistance of €25.5 bn. In addition, the KfW special program provides a significant part of the liquidity support for companies: Since the launch of the special program on March 23, 2020, it had enabled a total of €49 bn. in additional corporate financing (Arbeitskreis Steuerschätzungen, 2020; BMF, 2021; KfW, 2021).

In addition to the economic measures, the window of opportunity had been used to implement structural measures that were not directly related to the pandemic (Thater, 2021, p. 34). In addition, the Bund supported the Länder and municipalities. This particularly included the permanent increase in the federal share of municipal expenditures for housing and heating, which now amounts to 74 % (approx. €3.4 bn. in additional annual expenditures for the Bund). In addition, a lump-sum compensation for the municipalities’ shortfall in trade tax revenues granted for 2020 was borne equally by the federal and Länder governments and totaled €11.8 bn. Moreover, the Bund had increased its contribution to the expenses of the ‘new’ Länder in East Germany under the Entitlement and Vested Rights Transfer Act by 10 % to amount to a total of 50 % (€300 mil. p.a.), starting in 2021. On the revenue side, the Bund also used crisis instruments. These included, among others, the temporary reduction in value-added tax, adjustments to advance tax payments and deferrals of tax payments coordinated by the Bund, as well as the extension of the tax loss carryback.7 The latter results in a delayed return of corporate taxes to pre-crisis levels (Bender et al., 2021, p. 198).

As depicted in Figure 1, the ifo business index decreased sharply from 2019 to 2020 by -34.9 %. This was a more severe downturn than during the great financial crisis. Consequently, the amount of short-time workers increased significantly in the same period from around 50,000 to 5.7 mil. However, this sharp increase was only temporary as the decline already started in the consecutive year. This time period was also shaped by the economic consequences of the Russian invasion of Ukraine, which unfolded during the recovery from the Covid-related impact on the job market. However, while the number of short time workers decreased since 2020 onwards, the business climate index worsened again.

The developments on the job market and the overall economy also led to a decline of taxes on all governmental levels. Overall tax revenues declined by -10.3 % for the Bund, roughly -3.1 % for the Länder and about -6.4 % for the municipalities. The harsh decline in taxes was mainly due to tax decreases of the corporate tax and value added tax. As shown above, the tax decline was not distributed evenly between the governmental levels. The main burden was distributed to the Bund which not only had to deal with a decline in its own tax revenues due to a decline in the shared taxes but also decided to introduce changes in tax legislation in order to support businesses and private households.8 However, one year later, taxes already increased rapidly due to the effects of anticyclical fiscal policy as well as less Covid-related measures, such as lockdowns. The tax decline of the municipalities, however, was offset by federal and state measures. In

7. By the end of June 2022, four Covid tax aid bills had been passed by the federal legislature.
8. During the crisis, a discussion arose whether the recovery of taxes would be more V-shaped or U-shaped, i.e. more rapidly or rather in the medium term. Since the assumption of the general tax recovery path differed, also the proposed measures to cope the crisis differed significantly.
particular, this included historically unique trade tax compensation which was borne equally by the Bund and the Länder. As shown in Figure 5, the compensation scheme broadly offset the trade tax losses of the municipal level. A symmetrical picture would mean that those municipalities that suffered a relatively sharp drop in trade tax compensation also received a high compensation payment. Conversely, municipalities that suffered a comparatively weak slump in trade tax would also have to have received a low compensation payment. In Figure 5, a symmetrical behavior can be observed for a total of just 25.9% of the municipalities. There were high outliers in the extreme case where the trade tax slump was relatively small and, at the same time, the compensation payment was high. This was the case in 20.8% of all cases. Conversely, in 16% of the cases, the trade tax slump was severe, but the compensation was relatively weak.

Figure 5: Municipal trade tax compensation during the Covid pandemic

![Map showing municipal trade tax compensation during the Covid pandemic](image)

Source: Bundestag (2021) and Destatis (2022); Own presentation, own calculations.

However, the compensation payments were offset if the Länder had made a prior compensation payment. The downward deviations can thus be partially explained by that. The deviations from symmetric behavior are generally caused by the fact that the trade tax revenue shortfalls to be compensated were forecasted values at that point in time. These were taken from the regionalized tax estimate. All in all, for the municipal level, the trade tax compensation scheme led to an overcompensation which not only balanced trade tax losses but also, in sum, led to considerable additional financial revenues.

The measures of the federal and state level led to sharp increases in the debt levels, as shown in Figure 3. This was mainly due to the fact that substantial borrowing was inevitable, caused by expenditure increases and decreases in revenues. The Bund, therefore, made use of the option to activate the exception clause in the federal debt rule on account of the pandemic. As a result, the Bund’s debt increased by around €214 bn. in 2020 (+18% compared with 2019), increasing to a total of around €1.4 trillion as of December 31, 2020. Further borrowing of around €215.4 bn. was done in 2021. As a
consequence, the debt-to-GDP ratio for the Bund increased from 59.7 % (2019) to 68.7 % (2020) and currently amounts in 2021 69.3 % (Deutsche Bundesbank 2022). In 2022, the debt-to-GDP ratio declined to 66 % due to two major reasons. First, borrowing on the capital market in 2021 exceeded cash requirements due to the uncertain budget situation which will reduce new borrowing and secondly, the expected high nominal GDP growth in 2022 (+6.6 %) will in itself reduce the ratio significantly (German Bundesbank, 2022b, p. 11).

These large amounts reflect, not least, the task facing the Bund in dealing with the crisis. In this respect, the federal budget, with its general government control function, had the task of implementing a macroeconomic stabilization policy and support measures. However, the Bund has not only used Covid-related borrowing to cope with the pandemic. For example, around €60 bn. of unused credit appropriations have been channeled into the Climate and Transformation Fund for the green transformation (Thater & Flachs, 2022, p. 37).

All these developments led to a sharp decrease in the budget balance of the federal government. As Figure 4 indicates, the municipal level however, in total, experienced only a slight decrease in the budget balance. This was possible due to the extensive aid provided by the Bund and the Länder as discussed above. Concerning the federal level, not only crisis measures led to a worsening budget balance. The extensive use of borrowing was extended in 2022 with the implementation of a military special fund (€100 bn.) in the wake of the Russian invasion of Ukraine. That was only possible because the exemption clause of the debt brake was still activated and an additional article in the basic law was introduced, stating that deficits of the military special fund are not included in the calculation of the debt brake (Art. 87a Basic Law). Besides the military special fund, the federal government introduced an economic stabilization fund in order to cope the economic impact of the pandemic. It had a volume of roughly €600 bn. which was reduced to €250 bn. in 2022 in guarantees and loans (German Finance Agency, 2022). Originally ending in July 2022, it was used afterwards to tackle the effects of the energy crisis and was equipped with credit authorizations of €200 bn. (German Finance Agency, 2022). However, since gas and electricity prices normalized relatively quickly on a broad scale, a considerable amount of credit authorizations (€35 bn.) is left unused. Furthermore, around €44 bn. has been allocated to a reserve in 2023 (Bundeshaushaltsplan, 2023, p. 105).

The Länder hold less decision-making authority compared to the Bund. Although their role is central to the organization of public health protection, the effectiveness of their fiscal measures can be considered to be limited. As a result of their dependence on the revenue from shared taxes, the Länder are exposed to corresponding effects without

---

9. A constitutional complaint by the CDU/CSU parliamentary group against the transfer of unused credit authorizations is still pending at the Federal Constitutional Court.
10. For example, the State Court of Hesse recently ruled for the state that a causal connection must exist between the triggering event and the increased borrowing. In this respect, the special fund implemented in Hesse to deal with the pandemic was not covered by the constitution. (Buscher, 2022, p. 42).
11. In addition, the Bund increased its contribution to the cost of housing by up to 75 %, which provided structural relief for the municipalities. State measures had a complementary effect here. However, these measures varied from state to state and included stabilization of the municipal fiscal equalization system, compensation for shortfalls in income tax, subsidies for social spending, the coverage of defaulted daycare contributions, and deficits in local public transport and municipal hospitals (Meyer 2022, p. 60-61).
12. In this regard, the Bund currently plans to use these unused credit authorizations for other measures, which are not directly linked to the energy crisis. This will be subject to an extensive legal debate.
having sufficient room to maneuver. Amid the pandemic emergency, the Länder made extensive use of the option of suspending the Länder debt brakes – although these debt brakes had formally been in place since 2020 to prevent the Länder from taking on new structural debt. In addition to borrowing, which all Länder resorted to, some Länder chose to release reserves, transfer financing surpluses or suspend repayment obligations (CoR, 2021, p. 42; Vallée et al., 2021, p. 12). While pandemic-related net borrowing in 2020 averaged €1,344 per inhabitant in the Länder, net borrowing by the Bund averaged €2,621 per inhabitant (Hesse et al., 2021, p. 14). In addition to the cyclical policy measures, structural policy measures such as spending to advance digitization were taken (Hesse et al., 2020, p. 110-111). This shows that, on the one hand, pandemic-related additional spending has been recognized and priced in and, on the other, structural policy measures have been taken. Like the Bund, the Länder have thus taken advantage of the window of opportunity to finance projects that are not directly related to the pandemic but have a sustainable economic effect. In 2020, the Länder realized a total €56.7 bn. in net borrowing and increased their debt level to around €636 bn. (+9.7 % compared with 2019), although the Länder as a group had originally mobilized borrowing authorizations far more than €100 bn. (Woisin, 2021, p.20).

In addition to the cyclical policy measures, structural policy measures such as spending to advance digitization were taken (Hesse et al., 2020, p. 110-111). This shows that, on the one hand, pandemic-related additional spending has been recognized and priced in and, on the other, structural policy measures have been taken. Like the Bund, the Länder have thus taken advantage of the window of opportunity to finance projects that are not directly related to the pandemic but have a sustainable economic effect. In 2020, the Länder realized a total €56.7 bn. in net borrowing and increased their debt level to around €636 bn. (+9.7 % compared with 2019), although the Länder as a group had originally mobilized borrowing authorizations far more than €100 bn. (Woisin, 2021, p.20).

In the case of the Länder, too, the tendency is continuing to use additional debt options for other purposes as a result of the pandemic-related exemption from the state debt brakes. The Saarland and North Rhine-Westphalia have already set up special funds for transformation tasks and crisis management with a volume of €3 bn. and €5 bn. respectively. Meanwhile, the state of Berlin is planning to implement a special fund for climate protection, resilience and transformation with a volume of up to €10 bn. (Beirat des Stabilitätsrates, 2023, p.23).

After the individual crises have been described in more detail in terms of their impact and scope, the following section compares the two events.

**IV. DIFFERENT CRISES DEMAND DIFFERENT MANAGEMENT**

The period before, during and after the crises can be classified in terms of fiscal policy, with a comparison of the fiscal stance and economic development. This can be done through the annual change in the cyclically adjusted balance and the annual change in the output gap (difference between actual output and potential output). The resulting fiscal path of Germany, plotted in Figure 6, can be divided into four modes: (1) First, a decrease in the output gap (deterioration of the economic environment) hand in hand with an increasing budget balance (restrictive fiscal policy) leads to a procyclical restrictive course. In this scenario, fiscal policy does not stabilize the economic downturn with additional spending. (2) If the output gap increases and the budget balance stays restrictive, an anti-cyclical restrictive behavior is implemented which curtails an overheating of the economy. (3) If the budget balance deteriorates and the output gap turns negative, the fiscal stance stays anti-cyclical, but in an expansive manner. Fiscal policy increases its expenditures in order to tackle an economic downswing. (4) Lastly, if the economic situation improves (output gap improves) and the budget balance stays...

---

13. In comparison: net borrowing was zero in 2019 and federal net lending/borrowing of around €70 per PE was generated (repayments).

14. It should be mentioned that the capital markets also attribute a strong burden-sharing and transparent role to the fiscal equalization system for the subnational levels, which weakens the link between tax revenues and the individual economic performance of the regional authorities and keeps the creditworthiness of the subnational levels in line with the rating of the Bund. (Fitch Ratings, 2021; Zimmermann & Barisone, 2021, p. 1)
in negative territory, a procyclical expansive course appears. This would indicate, that the economy is overheating but fiscal policy is not stopping its expenditure growth.

The German fiscal stance in Figure 6 changes from 2002 to 2024 considerably. Especially in the first crisis from 2008 to 2009, the fiscal stance turned anti-cyclical, indicating that fiscal policy limited the downswing of the economy. This continued in 2010. Since the change in the cyclical adjusted balance improved just slightly but the economic environment recovered fast, a procyclical expansive fiscal stance occurred. Starting from an anti-cyclical restrictive fiscal stance in 2019 the fiscal stance turned into an anti-cyclical expansive stance in 2020 due to crisis measures. For 2021 to 2024, the fiscal stance is considered to stay anti-cyclical since the economy is currently recovering from the Covid-impact as well as the economic implications for Germany following the Russian invasion of Ukraine.

Figure 6: Fiscal Stance, 2002-2024

Source: AMECO 2023; Own Illustration.

Both crises differ fundamentally in their causes. After the financial crisis starting in 2007, the effect on the real economy was delayed. This was followed by lengthy structural adjustment processes. In contrast, the Covid pandemic had a direct and severe impact on supply and demand. In both crises, the government (especially the German federal government) substantially increased its spending to stimulate demand and mitigate the negative effects of the crisis on the population and the economy. At the same time, spending by social security systems increased massively, for example, as a result of short-time work benefits. The short-time work instrument was particularly significant in both crises, but the crises in the labor market had different impacts. While the increase in registered unemployment after 2007 was relatively moderate and concentrated in the manufacturing sector, the Covid crisis hit the labor market much harder and more
comprehensively. However, the Covid crisis followed a long-lasting boom (also in the labor market), which is why the unemployment rate was still below the level of the financial crisis in absolute terms. During the financial crisis, there were two stimulus packages; measures included for example a scrappage premium for cars and the introduction of declining-balance depreciation. In the Covid crisis, bridging aid for companies in particular, but also costs for vaccinations and tests, caused government spending to rise. The Covid crisis was also used extensively to build up new special funds that can be used after the crisis. This can also be interpreted as ‘tricking’ the debt brake, which was created to prevent excessive deficits. This ‘trick’ is mainly used at federal level, but it is also used to some extent at the Länder level. (Arnold, 2022; Gehrke & Weber, 2020)

Table 1: Comparing the Two Crises

<table>
<thead>
<tr>
<th></th>
<th>The Great Recession</th>
<th>Covid crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Origin and development</strong></td>
<td>Subprime mortgage crisis in the USA, spread to global financial crisis, followed by sovereign debt crisis in Europe</td>
<td>Covid pandemic triggers health crisis leading to global economic collapse, with economy highly dependent on pandemic events and containment efforts</td>
</tr>
<tr>
<td><strong>Basic monetary policy conditions</strong></td>
<td>Interest rate cuts, followed by unconventional monetary policy measures</td>
<td>After years of low interest rates, even further monetary policy easing; unconventional monetary policy prevails</td>
</tr>
<tr>
<td><strong>Magnitude</strong></td>
<td>Second most severe recession since the Great Depression in the 1930s</td>
<td>Quickly displaced the economic crisis from 2007 from its position as the most severe economic crisis</td>
</tr>
<tr>
<td><strong>Impact</strong></td>
<td>Contraction in lending in the wake of the financial crisis, followed by a slump in consumer spending and private investment, deduction of public and private debt delays recovery in subsequent years</td>
<td>Unique simultaneity of global supply and demand shock (including largest stock market crash), crisis hit the labor market disproportionately harder</td>
</tr>
<tr>
<td><strong>Public countermeasures</strong></td>
<td>Focus on stabilizing the financial system and consumer and investment demand (through economic stimulus packages), only demand stabilization necessary</td>
<td>After previous experience from the financial crisis, there was no fundamental debate on whether the state should take countermeasures, extensive and rapid measures followed, even more extensive use of short-time workers. Measures weren’t highly accurate, but where implemented in a timely manner (accuracy vs. volume: discussion was decided in favor of volume).</td>
</tr>
<tr>
<td><strong>Recovery phase</strong></td>
<td>Slow recovery, but then long growth phase</td>
<td>Strong and rapid rebound, with medium-long-term effects being overshadowed by a new crisis (war in Ukraine)</td>
</tr>
<tr>
<td><strong>Federal dynamics</strong></td>
<td>Bund absorbed most of the shock</td>
<td>Bund absorbed most of the shock, with subnational levels seeming to come out of this crisis even better</td>
</tr>
</tbody>
</table>

Source: Own Illustration.
V. CONCLUDING ON THE FEDERAL DYNAMICS

Since 2007, the Federal Republic of Germany has gone through various major and minor crises, and it seems that the crisis mode has changed significantly: one storm follows another. Although public budgets are counteracting the crisis, they are not fully recovering, so that fiscal crisis burdens are accumulating. This increasingly limits the state's room for maneuver. Tendencies toward a polycrisis are becoming visible. This is also being fueled by the long-term transformation tasks, such as in the areas of climate protection, energy transition and digitization, which make fiscal policy action necessary.

For the most part, German federalism seems to have weathered the tests of the two economic crises well. The Bund in particular absorbed most of the shock to public finances through relief and support measures (without a clear reduction in the competences of the subnational levels) in both crises. Even if federal support, at least directly for the time being, is not subject to any clear centralizing tendency, but fiscal policy with the ‘bang’ may have influenced the symbolic leadership position of the federal government federal debates also in the future. Whether the fiscal measures under discussion were in some sense ‘oversized’ is a matter of debate, but what is quite clear is that the fiscal responses (especially in the Covid pandemic) were quick, and thus the spontaneous crisis management (by the Bund and the Länder) created discretionary fiscal space where there was no systemic resilience. Crisis hedging has worked either way, insofar as the level that can bear the heaviest fiscal burdens (the federal government) has also essentially shouldered them. Crises of that magnitude undoubtedly required an unconventional and proactive response. Even though economic crises can in principle have considerable consequences for a state and also for its federal structures (e.g. through centralization), the balance of power and responsibility between the different levels of the German government remained largely unchanged. Although the new fiscal equalization system between the federal levels was applied for the first time in 2020 (due to the Federalism Reform II), the system of tax collection and allocation under the fiscal equalization system was retained. The way the system has dealt with the two special situations is also a key indicator for the long-term resilience of the fiscal system. However, for the Covid crisis in particular, the precise long-term fiscal burdens on the various federal levels will not be known for years to come. This is reinforced by the fact that the effects of the Corona pandemic are overshadowed by the Russian invasion of Ukraine and the consequences for the German economy. Old and new challenges mix since the energy crisis, record inflation and supply shortages are putting the German federal state on a new trial – the polycrisis continues.
REFERENCES


INTRODUCTION


JOURNAL INFORMATION

INDEX

INTRODUCTION


• Lenk, T., Rottmann, O., & Kunzle, M. (2012). Auswirkungen der Schuldenbremse auf die kommunale Ebene. Studie im Auftrag der Commerzbank AG.


JOURNAL INFORMATION

INDEX

INTRODUCTION


ABSTRACT

The world economies in the recent past were affected by two major crises. First, the 2008 global financial crisis and the second being the COVID-19 pandemic. The common effect of these crises was an increase in public spending and high fiscal deficits of all governments in a multi order federal structure. Likewise, Indian federation was no exception. However, the first crisis in India was largely addressed through monetary policy instruments. Though, fiscal deficit of both the centre and state governments had risen from 2.5 to six percent of GDP and 1.5 to 2.4 percent of GDP from the fiscal year 2007-08 to 2008-09, respectively. The main factors of this rise were both internal and external. Though the internal factors outweigh the external ones in the rise of fiscal deficits of both the centre and states. The second crisis emanated from the medical emergency due to Covid-19 Pandemic. The situation of pandemic was largely disruptive in terms of human lives and economic activity. As a result, the GDP in 2020-21 registered a nominal growth of (-) 7.3 per cent as compared to high positive growth in the previous years. In fact, all sectors declined except agriculture which continued to grow at three percent. The negative economic growth had limited the fiscal space of the governments—both the centre and states. But, later on, the situation fairly improved to the extent that India has again become the fifth largest economy in the world in the year 2022-23.

Keywords: Covid-19, fiscal deficit, fiscal federalism, global financial crises, India, subnational finances.
I. INTRODUCTION

The Indian constitution is based on federal principles, however, Article one of the constitution affirms that “India, that is Bharat, shall be a Union of States”. In fact, the constitution has all the features of a federal polity, viz. a) statutorily mandated two orders of elected government (increased to three in 1993) with clear assignment of responsibilities to federal and state governments as contained in the union list (97 items), state list (66 items) and concurrent list (47 items) of the seventh schedule in the constitution b) union and states are competent to enact laws, and c) institutions to support a federal polity including techniques for intergovernmental fiscal transfers (IGFT) to correct vertical and horizontal imbalances. The territories of India consist of 28 states and eight union territories including three with legislature.

India is the largest democracy in the world inhabited by about 1.36 billion people over an area of 3287 thousand square kilometers according to an estimate for 2021 based on Census 2011. Out of total population, more than 0.9 billion were eligible to exercise their adult franchise in 2019 general election for the lower house of parliament.

The Indian economy is characterized as a middle income emerging market economy. At the time of India’s independence the mainstay of the economy was agriculture which contributed more than fifty per cent to the GDP. The economy consistently registered low growth due to extensive centralized state intervention and protectionist economic regulation. Due to alarming economic crises emanated from high fiscal deficit, mounting external trade imbalances and double digit inflation, broad economic liberalized policies were adopted in 1991. As a result, India moved from low rate of economic growth to one of the fastest growing economies in the world. Consequently, the share of agriculture declined significantly due to prominence that service sector acquired with about 55 per cent share in Indian economy.

The 2008 financial crisis has affected Indian economy in many different ways. This includes three channels, namely, financial markets, trade flows and exchange rate. The GDP growth rate immediately declined by 2.5 percent from 2007 to 2008 and approximately $12 billion worth of investors withdrew from the stock market. The exchange rate which was hovering around 42 INR per USD before the crises, gained the pace and got increased to 53 INR per USD in 2012. The impact was further noticed in current account deficit which was -0.27 percent of GDP (taken as the five year average from 2003-2007) and got increased to -3.21 percent of GDP (taken as the five year average from 2008-2012). The crisis was largely addressed through monetary policy instruments. Though, fiscal deficit of both- the centre and state governments had risen from 2.5 to six percent of GDP and 1.5 to 2.4 percent of GDP from the fiscal year 2007-08 to 2008-09, respectively. The main factors of this rise were both internal and external. The internal factors included farm loan waivers, sharp rise in the salaries of government employees through the sixth pay commission, and the expansion of livelihood security programme of the centre from 200 districts to all 700+ districts. The sharp escalation of

---

2. Though the term ‘union’ is used in the constitution, ‘Centre’ is interchangeably used in this paper.
3. At sub-national level, composition of state GDP and pattern of economic growth differs significantly across states.
5. Reserve Bank of India
international crude oil prices and global financial crises were external factors. It may be noted that India’s dependence of crude oil is more than three fourth of its internal demand. Hence, one may argue that internal factors contributed substantially to the deficits of the centre and states and global financial crises was managed through the central bank.

During the period 2014-19, the average GDP\(^7\) (gross domestic product) growth rate in the country was 6.8 per cent against the world’s annual average of 3.5 per cent. The per capita GDP in India recorded in 2021 was at US $ 1936.94 which is equivalent to 15 per cent of the world’s average. When the figure is adjusted by purchasing power parity (PPP) the per capita GDP in India is estimated at US $ 6592.04 which is equivalent to 37 percent of the world’s average.\(^8\) The article further analysis the pandemic and financial crisis

The second crisis emanated from the medical emergency due to Covid-19 Pandemic. The situation of pandemic was largely disruptive in terms of human lives and economic activity. As a result, the GDP in 2020-21 registered a nominal growth of (-) 7.3 per cent as compared to high positive growth in the previous years.\(^9\) This contraction in GDP was largely attributed to a very significant contraction in trade, hotels, transport and communication. In fact, all sectors declined except agriculture which continued to grow at three percent. The negative economic growth had limited the fiscal space of the government and made them to revise its fiscal deficit target to 9.3 per cent of GDP in the covid year.\(^10\) But the situation has fairly improved to the extent that India has again become the fifth largest economy in the world after it was pushed back to sixth position in 2020 due to the impact of pandemic. The US $3.4 trillion Indian economy\(^11\) is on its growth path and it is estimated that India’s real GDP might go up by 6.9 percent in the fiscal year 2022-23, with the growth being driven by strong domestic demand, government-backed investment in infrastructure, and a buoyant private consumption, especially among individuals with higher incomes.

This paper is an attempt to understand India’s fiscal situation during the time of both 2008 global financial crisis and Covid-19 pandemic and its impact on the Indian federal structure. This paper is divided into five sections. Beside the introductory part, the section two provides an insight over how the fiscal powers are divided in Indian governance and types of fiscal transfers. The third section deals with the federal finance and the macroeconomic management of the crisis. The fourth section analyses the fiscal equity and efficiency through deficits and debt of the centre and state and the intergovernmental fiscal transfers. The final section concludes and discusses broader implications of the findings.

---

7. GDP is the sum of the gross value added at basic prices, plus all taxes on product, minus all subsidies.
8. [https://tradingeconomics.com/india](https://tradingeconomics.com/india)
10. Fiscal deficit in the year 2020-21 was set at 3.5 of GDP in the beginning.
11. The GDP of India consist of about 20 per cent primary sector (comprising agriculture, fishing, forestry, and mining & quarrying), about 25 per cent secondary sector (comprising manufacturing, electricity, gas, water supply & other utility services, and construction), and about 55 per cent tertiary sector (services).
II. DIVISION OF FISCAL POWERS IN INDIAN GOVERNANCE

1. The Governance

The constitution has an arrangement for a separate jurisdiction between the parliament and the legislative assemblies of states and union territories to make laws in their respective areas as stipulated in the central and state lists of the constitution. Like parliamentary elections, there is a provision for election, in every fifth year, of assemblies in states and three union territories, i.e. Delhi, Jammu & Kashmir, and Puducherry in India to elect members of legislative assemblies (MLAs). Election Commission of India conducts both the elections. MLAs of the political party having a majority choose their leader who stakes his claim before the governor of the state to form the government. On the basis of this exercise, the governor appoints the chief minister and other ministers, as per the former's advice. The governor is appointed by the President of India for five years or earlier. In other five territories, the president appoints administrator at the advice of the central government. At sub-national level, the state government, headed by the chief minister, has all the powers to a) legislate matters in the state list of the constitution; and b) administer the state through state civil servants.

Sharp inter-state variations can be seen across all 28 states and eight UTs. Population of Uttar Pradesh, the biggest state is about 340 times than that of Sikkim, the smallest state. The per capita income of Goa, the richest state is about ten times than that of Bihar, the poorest state. Their pattern of economic developments is also different. A few states register double digit economic growth whereas a few others cannot achieve even five per cent. This affects the quality of governance across states. As a result, institutions deciding allocation among states have to take all these factors into consideration.

At the third tier, elections are also held in every fifth year to elect representatives of panchayats (rural local governments) and municipalities (urban local governments). Panchayat is constituted, through election, in every state at three rungs, i.e. the district, the intermediate and the village. Intermediate panchayat may not be established in a state having a population not surpassing two million. Similarly for urban areas, municipalities are constituted at three levels, i.e. municipal corporation for a large urban area, municipal council for small urban area and nagar panchayat for an area having transition from rural to urban. Though these institutions became legal entities through the 74th constitutional amendment act which is a central act but these institutions are defined in the conformity act (state municipal act) based on population, area and activity.

As the local government is a state subject, the state legislature may make their own rules to conduct elections, in every fifth year, through the state election commission. After the election, the group of elected representatives provides leadership to officials in his/her respective local area for delivery of services and preparation of plans for local economic development and social justice as stipulated in the respective state act. There are separate laws in each state for panchayats and municipalities. Similarly, separate schedules, eleventh and twelfth, were inserted, among others, in the constitution in 1993 through the seventy-third and seventy-fourth constitutional amendments.

12. This section is drawn upon Alok (2011)
13. See article 243B of the constitution
14. See article 243Q of the constitution.
for panchayat and municipalities respectively. These eleventh and twelfth schedules enumerate twenty-nine and eighteen subjects respectively. These subjects are only indicative and not exhaustive. Most subjects in these two lists are state concurrent which lead to overlapping. At any case, it is ultimately the authority of state legislature to make laws on these subjects and devolve functions to local governments.

Hence, election is held at three levels, i.e. parliament, state assembly and local governments. In all the cases, there is an in-built feature of accountability of elected representatives. Every fifth year incumbent candidate or party seek re-election for their people who in turn, approve or disapprove them. Accountability of the governments is also fixed through parliamentary proceedings, media, right to information, autonomous audit, ombudsman, vigilance commissions etc.

2. Division of Fiscal Powers

The fiscal powers shared between union and the constituent units, i.e., states in India are mostly stated in the constitution or are specified by the law, like most federations of the world. As mentioned earlier, the powers and jurisdiction of the respective levels of government are set forth in the seventh schedule of the Indian constitution which contains the union list, the state list and the concurrent list (covering areas of joint authority). The residual powers belong to the centre\(^\text{15}\). Therefore, the centre can enter tax fields not classified in the constitution. For example, the central government, under such power, imposed gift tax in the past which was abolished in 1998. Similarly, service tax was also imposed in the beginning of this century under such power. In 2017, the tax has been subsumed under nationwide goods and services tax (GST).

It can be argued that the tax assignment in the Indian constitution is consistent with the theoretical literature on the subject. The special case identified in relation to the power of the states to tax natural resources, like minerals was rectified subsequently by giving dominant power to the Union to levy or regulate the tax on minerals.\(^\text{16}\)

However, the Indian constitutional scheme on tax assignment appears to be acceptable on paper, its real working has identified few limitations including the issue of vertical imbalance, despite the fact that considerable number of taxes have been allotted to the states but the buoyant taxes, viz., corporate income tax and personal income tax and custom duties are with the union (see table 1). Till 2017, even the central excise duty was also assigned to the centre which has been subsumed under GST. As a result, the union government collects around two-thirds of the combined total revenue. The states along with the local governments\(^\text{17}\) collect the rest. Since sub-national governments are assigned two-thirds of expenditure responsibilities (see table 2). This requires enormous amount of fiscal transfers from union to state governments (see table 3). In any case, vertical imbalance of some degree is viewed as desirable in a federation to guarantee intergovernmental fiscal transfers or redistribution of income to ascertain equity. Such provisions have been designed deliberately by the constitution makers.

\(^{15}\) This provision is contradictory to the principle of subsidiarity under which first choice is given to local government.

\(^{16}\) Mines and Minerals (Development and Regulation) Act, 1957

\(^{17}\) Local governments except municipal corporations collect negligible revenue. For details, see Alok, 2009 and 2019.
Table 1: Tax assignment to various orders of Government*

<table>
<thead>
<tr>
<th></th>
<th>Determination of</th>
<th>Collection and administration</th>
<th>Share in combined revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal income tax (non-agricultural)</td>
<td>Union</td>
<td>Union</td>
<td>Union</td>
</tr>
<tr>
<td>Corporation income tax</td>
<td>Union</td>
<td>Union</td>
<td>Union</td>
</tr>
<tr>
<td>Union excise duties</td>
<td>Union</td>
<td>Union</td>
<td>Union</td>
</tr>
<tr>
<td>Customs</td>
<td>Union</td>
<td>Union</td>
<td>Union</td>
</tr>
<tr>
<td>Taxes on services</td>
<td>Union</td>
<td>Union</td>
<td>Union</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>State or Provincial</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax and land and agricultural incomes</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td>Stamp duties and registration fees</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td>Sales tax</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td>State excise duties</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td>Taxes on transport</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td>Electricity duty</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entertainment tax</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td>Others</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td>Fees, fines, and charges</td>
<td>State</td>
<td>State</td>
<td>State</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Local</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property tax</td>
<td>Provincial</td>
<td>Local</td>
<td>Provincial</td>
</tr>
<tr>
<td>User fees on water supply</td>
<td>Local</td>
<td>Local</td>
<td>Local</td>
</tr>
</tbody>
</table>

Source: Alok (2023).

Note: Latest actual data are available only for the fiscal year 2015-16. The same is used. Assignment of taxes have undergone changes since the introduction of nationwide Goods and Services Tax (GST) in 2017.

N- Data not available
Table 2: Shares of different levels of government in total expenditures

<table>
<thead>
<tr>
<th>Item of expenditure</th>
<th>Centre</th>
<th>States</th>
<th>Total</th>
<th>Percent of total expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Interest payment</td>
<td>67.0</td>
<td>33.0</td>
<td>100</td>
<td>16.1</td>
</tr>
<tr>
<td>B. Defence</td>
<td>100.0</td>
<td>0.00</td>
<td>100</td>
<td>5.5</td>
</tr>
<tr>
<td>C. Administrative service</td>
<td>34.2</td>
<td>65.8</td>
<td>100</td>
<td>4.8</td>
</tr>
<tr>
<td>D. Social and community services</td>
<td>19.5</td>
<td>80.5</td>
<td>100</td>
<td>20.1</td>
</tr>
<tr>
<td>i. Education</td>
<td>16.9</td>
<td>83.1</td>
<td>100</td>
<td>10.9</td>
</tr>
<tr>
<td>ii. Medical and health</td>
<td>10.4</td>
<td>89.6</td>
<td>100</td>
<td>3.9</td>
</tr>
<tr>
<td>iii. Family welfare</td>
<td>55.8</td>
<td>44.2</td>
<td>100</td>
<td>0.9</td>
</tr>
<tr>
<td>iv. Others</td>
<td>26.4</td>
<td>73.6</td>
<td>100</td>
<td>4.4</td>
</tr>
<tr>
<td>E. Economic services</td>
<td>34.5</td>
<td>65.5</td>
<td>100</td>
<td>24.8</td>
</tr>
<tr>
<td>i. Agri. and allied services</td>
<td>32.9</td>
<td>67.1</td>
<td>100</td>
<td>8.7</td>
</tr>
<tr>
<td>ii. Industry and minerals</td>
<td>66.8</td>
<td>33.2</td>
<td>100</td>
<td>1.8</td>
</tr>
<tr>
<td>iii. Power, irri. flood control</td>
<td>4.1</td>
<td>96.0</td>
<td>100</td>
<td>6.5</td>
</tr>
<tr>
<td>iv. Tpt. and communication</td>
<td>52.1</td>
<td>47.9</td>
<td>100</td>
<td>5.5</td>
</tr>
<tr>
<td>v. General economic services</td>
<td>74.2</td>
<td>25.8</td>
<td>100</td>
<td>1.8</td>
</tr>
<tr>
<td>vi. Public works</td>
<td>13.3</td>
<td>86.7</td>
<td>100</td>
<td>0.5</td>
</tr>
<tr>
<td>F. Others</td>
<td>52.5</td>
<td>47.5</td>
<td>100</td>
<td>26.4</td>
</tr>
<tr>
<td>G. Loans and advances</td>
<td>5.9</td>
<td>94.1</td>
<td>100</td>
<td>2.2</td>
</tr>
<tr>
<td>Total</td>
<td>44.5</td>
<td>55.5</td>
<td>100</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Alok (2023).

Note: Latest actual data are available only for the fiscal year 2015-16. The same is used.
Table 3: Vertical fiscal gaps

<table>
<thead>
<tr>
<th></th>
<th>Total revenue collected</th>
<th>Total revenue available, after net transfers(^@) to other level of government</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>27320.93</td>
<td>15846.14</td>
<td>18149.58</td>
</tr>
<tr>
<td>State/provincial</td>
<td>18631.94</td>
<td>30106.73</td>
<td>22853.53</td>
</tr>
<tr>
<td>Local</td>
<td>NA</td>
<td>NA</td>
<td></td>
</tr>
<tr>
<td>All orders</td>
<td>45952.87</td>
<td>45952.87</td>
<td>41003.11</td>
</tr>
</tbody>
</table>

Source: Alok (2023).

Note: Latest actual data are available only for the fiscal year 2015-16. The same is used.

\(^@\) Transfer to States is calculated @42% from Total Revenue of National Government as recommended by the 14th Finance Commission for the period 2015-20.

NA- Reliable data for local governments are not available

3. Sharing of Central Taxes

In spite of the fact that powers have been assigned to both the union and the states, however, the union cannot appropriate the proceeds of all the taxes collected by them. According to the design of the constitution, revenue from central taxes should be shared with the states to fulfill their necessities.

Since 2000, all union taxes have been brought into a divisible pool and a certain percentage is shared with the states\(^18\). Historically, only personal income tax and the union excise duties were shared with the states\(^19\). In addition, the central government used to collect the tax on behalf of the states, under the tax rental arrangements, and then allocated the proceeds among the states on the basis of formula suggested by the successive finance commissions. These were (a) additional excise duties in lieu of sales tax on textiles, tobacco and sugar\(^20\) and (b) grant in lieu of tax on railway passenger fares.

The constitution provides for sharing of all central taxes except a) stamp duty levied by the centre but collected and retained by the states; b) integrated goods and services tax (IGST) in course of interstate trade and commerce; and c) surcharge on taxes and duties and any cess levied for specific purposes by the centre. Only net proceeds of tax revenue are shared, after deducting cost of collections.

In 2017, a nationwide goods and services tax (GST) was introduced.\(^21\) The GST replaced a host of indirect taxes being levied by the central and state governments. It subsumed central excise duty, services tax, additional excise duties, central sales tax, additional

\(^18\) Following the constitution (eightieth amendment) act, 2000
\(^19\) Sharing of the income tax was mandatory under Article 270 while that of the union excise duties was discretionary under Article 272 of the constitution. These Articles have been amended.
\(^20\) These commodities were considered to be of national importance and the states did not levy sales tax on these items as per the agreement, in 1956, between the union and the states
\(^21\) Through constitution (one hundred and one) amendment act.
customs duty commonly known as countervailing duty, and special additional duty of customs at the central level; and state value added tax/sales tax, entertainment tax (other than the tax levied by the local governments), octroi or entry tax, purchase tax, luxury tax, and taxes on lottery, betting and gambling at the state level.

The basic attribute of GST implemented in India is that it is based on the principle of destination-based consumption taxation contrary to the earlier principle of origin-based taxation. It is a dual GST with the union and the states simultaneously levying tax on a common base. Centre levies and collects the central GST (CGST) and states levy and collect state GST (SGST). Rates of both GSTs are equal. In addition, an integrated goods & services tax (IGST) is imposed by the central government on inter-state supplies of goods and services and on imports. The GST accounts for 35 per cent of the gross tax revenue of the centre and around 44 per cent of own tax revenue of the states, as per the analysis of the 15th FC.

4. Types of Fiscal Transfers in India

Inter-governmental fiscal transfers (IGFT) from the central government to the states in India go as far back as 1919, and have encountered many changes since the Independence of India in 1947. Like most of the nations, globally, there are two purposes of India’s fiscal transfer system which includes, first, correcting vertical fiscal imbalances between the union and the states; and second, correcting horizontal imbalances in fiscal capacity among the states. These two aims are not always independent of each other and have both been integrated into the actual operation of the system. The IGFT from the centre to states/UTs can be broadly categorized as finance commission (FC) transfers and other transfer or non-FC transfers. The FC transfers comprise a) devolution to states/UTs from the union tax divisible pool; b) fiscal transfers to local governments – both panchayats and municipalities; c) revenue deficit grants to states incurring revenue deficit even after the central tax devolution; d) grants for disaster management and e) other specific grants. These are made primarily under Article 280 of the constitution, but some of the transfers are mandated under Articles 270 and 275.

Non-FC transfers can be ascribed to article 282 of the constitution which empowers the “Union or a State to make any grants for any public purpose”. These transfers include central sector schemes\textsuperscript{22}, centrally sponsored schemes\textsuperscript{23} (CSS) and compensation to select states/UTs for GST revenue loss (till 2022). Article 282, inter alia, mandated the institution of planning commission to make ‘plan transfers’ comprising formula-based unconditional transfers and specific purpose transfers some of which were matching grants. The planning commission was abolished in 2015-16 and distinction of ‘plan’ and ‘non-plan’ in budgets was also discontinued.

\textsuperscript{22} Central sector schemes are hundred per cent funded and executed by the central government on subject in the union list of the constitution.

\textsuperscript{23} Centrally sponsored schemes (CSS) are designed and funded by the central ministries to attain national goals largely on subjects in the state list of the constitution. State government implements each scheme with a matching contribution up to maximum fifty per cent.
Table 4: Transfers from the Union to States as Proportion of Gross Revenue Receipts (in per cent)

<table>
<thead>
<tr>
<th>Commission</th>
<th>Finance Commission (FC) Transfers</th>
<th>Other Transfer (Non-FC)</th>
<th>Total Transfers* (4+5)</th>
<th>Ratio of FC to Non-FC Transfers</th>
<th>Total Transfers as %age of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share in Central Taxes</td>
<td>Grants</td>
<td>Total FC Transfers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>FC-XII (2005-10)</td>
<td>22.03</td>
<td>4.35</td>
<td>26.38</td>
<td>21.01</td>
<td>47.39</td>
</tr>
<tr>
<td>FC-XIII (2010-15)</td>
<td>23.80</td>
<td>3.96</td>
<td>27.75</td>
<td>20.47</td>
<td>48.22</td>
</tr>
<tr>
<td>2010-11</td>
<td>21.68</td>
<td>3.12</td>
<td>24.79</td>
<td>23.87</td>
<td>48.66</td>
</tr>
<tr>
<td>2011-12</td>
<td>25.27</td>
<td>4.35</td>
<td>29.62</td>
<td>23.73</td>
<td>53.35</td>
</tr>
<tr>
<td>2012-13</td>
<td>24.84</td>
<td>3.86</td>
<td>28.70</td>
<td>19.96</td>
<td>48.66</td>
</tr>
<tr>
<td>2013-14</td>
<td>23.79</td>
<td>4.03</td>
<td>27.82</td>
<td>17.93</td>
<td>45.75</td>
</tr>
<tr>
<td>2014-15</td>
<td>23.41</td>
<td>4.28</td>
<td>27.70</td>
<td>18.57</td>
<td>46.27</td>
</tr>
<tr>
<td>FC-XIV (2015-19)</td>
<td>31.37</td>
<td>4.51</td>
<td>35.88</td>
<td>14.74</td>
<td>50.62</td>
</tr>
<tr>
<td>2015-16</td>
<td>29.66</td>
<td>4.96</td>
<td>34.61</td>
<td>13.24</td>
<td>47.86</td>
</tr>
<tr>
<td>2016-17</td>
<td>30.57</td>
<td>4.80</td>
<td>35.38</td>
<td>13.04</td>
<td>48.41</td>
</tr>
<tr>
<td>2017-18</td>
<td>31.87</td>
<td>4.37</td>
<td>36.24</td>
<td>16.77</td>
<td>53.01</td>
</tr>
<tr>
<td>2018-19</td>
<td>32.88</td>
<td>4.05</td>
<td>36.92</td>
<td>15.45</td>
<td>52.38</td>
</tr>
<tr>
<td>2019-20 (RE)</td>
<td>26.15</td>
<td>4.93</td>
<td>31.08</td>
<td>18.61</td>
<td>49.69</td>
</tr>
<tr>
<td>FC-XV (2020-21 BE)</td>
<td>27.93</td>
<td>5.34</td>
<td>33.27</td>
<td>18.22</td>
<td>51.48</td>
</tr>
</tbody>
</table>

Source: Government of India (2020) Main Report (pg. 90)

Note: RE means revised estimate; BE means budget estimates

*from 12th FC onwards, transfers include direct transfers to State implementing agencies

FC Transfers include the share in central taxes, general purpose grants and specific purpose grants; and Non-FC transfers include matching grants for vertical programs of union government and other grants.

Consequently, as can be seen in table 4, non-FC transfers have been reduced from 18.57 per cent of gross revenue receipts in 2014-15 to 13.24 per cent in 2015-16 after the recommendation of the 14th FC which increased the share of the states in union divisible pool from 32 per cent to 42 per cent. In addition, one can note, a shift in enlarging the total transfers as a share to GDP from 5.76 per cent during the 13th FC period to 6.30 during the 14th FC award period.

5. Union Finance Commission (UFC)

The constitution stipulates the appointment of an independent finance commission by the president of India every five years to make recommendations on the devolution of central taxes and grants to be given to the states[24]. The commission has a chairman who is appointed based on his experience and eminence in public affairs. His status

[24. See Article 280 of the constitution]
The commission is at par with the minister in the union cabinet. There are four other members whose qualifications for appointment are based on their experience and special knowledge in economics, public administration, law and government accounting. The terms of reference (ToRs) of the commission, as per constitutional provisions, are:

(i) the distribution between the Union and States of the net proceeds of Union taxes and the allocation between the States of the respective shares of such proceeds;

(ii) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India.

(iii) the measures needed to augment the Consolidated Funds of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commissions of the State; and

(iv) any other matter referred to the Commission by the President in the interest of sound finance."

Under the last item, a number of tasks had been relegated to the commission in the past like setting the fiscal rules and goals for the union and states, measures to be taken for sustainable development and the security of ecology and environment, rescheduling and writing-off of states’ borrowings, assessment of public expenditure management framework, review disaster management systems, strategic way to deal with public enterprise reform and giving incentives to the states to undertake tax reforms, doing away with the losses of power sector, proposing measurable performance-based incentives for states at appropriate level of government, encouraging ease of doing business, supporting digital economy etc.

The commission is the agency that suggests the method for allocating the transfers based on revenue sharing. It is not a standing body and is dissolved after it has made the recommendations and submitted the report to the president of India. Till 2021, fifteen UFCs have submitted their reports. The last was the 15th FC which submitted two sets of reports, the first in December 2019 and the second in November 2020 covering the award period 2020-21 and 2020-26 respectively.

6. Finances of the Local Governments

In general, the functional responsibilities are closely related to the financial powers given to local government. In reality, there is a significant mismatch between the two, resulting in severe budgetary stress at the local and consequent reliance on inter-governmental fiscal transfers. Even in the progressive states, fiscal transfers, viz. revenue sharing and grants are main source of finances for the panchayats and municipalities. The state finance commission (SFC), which is an autonomous institution to review the financial position of the panchayats and the municipalities respectively, defines these fiscal transfers and make recommendations to the governor of the state on the principles that should govern:

25. See Articles 243 I and 243 Y of the constitution
i. “The distribution between the state and the panchayats and municipalities of the net proceeds of the taxes, duties, tolls and fees leviable by the state, and their allocation between the panchayats and municipalities at all levels for such proceeds;

ii. The determination of the taxes, duties, tolls and fees which may be assigned to, or appropriated by, the panchayats and municipalities;

iii. The grants-in-aid to panchayats and municipalities from the consolidated fund of the state;

iv. The measures needed to improve the financial position of the panchayats and municipalities;

v. Any other matter in the interest of sound finance of the panchayats and municipalities”.

With few exceptions, the states have verbatim reproduced the constitutional provisions and placed them as the terms of reference for the SFC. However, significant variations are noticed in the approach, methodology and recommendations of the SFCs across states and time. Even though, the following common major heads can be found from these diverse recommendations of about eighty SFC reports attempted at different period of time (Alok, 2021). These are: a) global sharing; b) assignment of revenue; c) horizontal distributions; d) grants-in-aid; e) devolution of functions and functionaries; and f) other measures. The heads emanate from the constitutional provisions and common pattern found in SFC reports:

In general, the capacity to generate its own revenue is very limited for the local governments. The sources which contribute most to the small kitty of own revenue of local governments are mainly, advertisement tax, professional tax, property tax, taxes on vehicles and animals, theatre tax, developmental charges, fees and fines, rental income from properties, user charges on services, etc. The reliance on fiscal transfers is eroding their autonomy to use resources as per their own priorities.

It is, therefore, the central government’s responsibility to transfer sufficient funds to the local government through a) UFC mechanism and b) centrally sponsored schemes (CSSs). UFC mechanism is discussed in previous section. CSSs bring about significant conditional grants to local governments. Developmental ministries of central government design and administer these schemes and assign various responsibilities to the local governments for grass root implementation. The budget provisions to such programs have registered a significant growth and the institutional mechanisms tend to provide key role to the panchayats and municipalities in their planning and implementation.

III. FEDERAL FINANCE AND MACROECONOMIC MANAGEMENT OF THE CRISIS

The central government, in Indian federation, has a predominant role in macroeconomic management as dependency of a state on centre is high by design. The resource mechanism is small with the states whereas center has large number of resources. On
the other hand, states are responsible for all the basic primary services to the citizens. Hence, the coordination between central and state governments in fiscal arrangements decides the fate of the state and its people. But, the liberalized policies initiated in 1991 provided opportunities to states to control domestic and foreign investment (Singh and Srinivasan, 2005; Singh 2007). This has enhanced the autonomy and increased the space of states in designing their own economic policies to compete among themselves and attract corporate investments.

Table 5: Expenditure Pattern of Centre and States

<table>
<thead>
<tr>
<th>Year</th>
<th>State Total Expenditure</th>
<th>Centre Total Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003-04</td>
<td>18.42</td>
<td>16.58</td>
</tr>
<tr>
<td>2004-05</td>
<td>17.37</td>
<td>15.37</td>
</tr>
<tr>
<td>2005-06</td>
<td>15.46</td>
<td>13.69</td>
</tr>
<tr>
<td>2006-07</td>
<td>15.45</td>
<td>13.58</td>
</tr>
<tr>
<td>2007-08</td>
<td>15.36</td>
<td>14.29</td>
</tr>
<tr>
<td>2008-09</td>
<td>16.00</td>
<td>15.70</td>
</tr>
<tr>
<td>2009-10</td>
<td>15.95</td>
<td>15.82</td>
</tr>
<tr>
<td>2010-11</td>
<td>15.18</td>
<td>15.38</td>
</tr>
<tr>
<td>2011-12</td>
<td>15.47</td>
<td>14.93</td>
</tr>
<tr>
<td>2012-13</td>
<td>15.43</td>
<td>14.18</td>
</tr>
<tr>
<td>2013-14</td>
<td>15.19</td>
<td>13.88</td>
</tr>
<tr>
<td>2014-15</td>
<td>16.25</td>
<td>13.34</td>
</tr>
<tr>
<td>2015-16</td>
<td>17.14</td>
<td>13.00</td>
</tr>
<tr>
<td>2016-17</td>
<td>17.60</td>
<td>12.83</td>
</tr>
<tr>
<td>2017-18</td>
<td>17.11</td>
<td>12.53</td>
</tr>
<tr>
<td>2018-19</td>
<td>17.66</td>
<td>12.25</td>
</tr>
<tr>
<td>2019-20</td>
<td>17.41</td>
<td>13.38</td>
</tr>
<tr>
<td>2020-21</td>
<td>20.23</td>
<td>17.73</td>
</tr>
<tr>
<td>2021-22</td>
<td>19.54</td>
<td>15.93</td>
</tr>
</tbody>
</table>

Source: Author’s computation from Reserve Bank of India.
Notes: 1. Data for 2020-21 relate to Revised Estimates while 2021-22 are Budget Estimates.
The changing federal fiscal architecture has enhanced the states’ public expenditure. It is the fact that “total state expenditures as a percent GDP are greater than that of the Union” (GoI, 2020, p 11) (see figure 1). Such increasing expenditure decentralization is arguably beneficial for macroeconomic performance (Rodden and Wibbels, 2001; Shah, 1999). However, the capacity of state governments in spending on infrastructure is constrained due to their inability to take independent decisions to borrow. States have to take central government’s permission for internal borrowing if they are indebted to the latter27. As a matter of fact, all states remain in debt to the centre that tends to reschedule the lending. Unlike the centre, the sub-national government can borrow only from internal sources after a prior consent of the parliament. These sources include public sector banks, other state owned financial institutions and national small savings fund comprising largely household savings deposited in post offices28.

In India, the central government has a larger share of expenditure responsibilities, particularly in areas like defense, external affairs, and major infrastructure projects. However, state governments bear the primary responsibility for delivering essential services like education, healthcare, and law enforcement.

The burden of increase in expenditure was borne by both centre and states during 2008 financial crisis and the covid-19 pandemic. But the total tax revenue as percentage of GDP declined (see table 6) during the same time period majorly for centre. It is observed that post 2008 crisis and covid-19 pandemic, the total central tax revenue declined because of fall in both direct and indirect tax revenues. But the same trend was not observed for state’s total tax revenue. In fact, the revenue as percentage of GDP did not decline for the states at the time of crisis mainly because the composition of state’s tax revenue comprises of indirect taxes.

27. See article 293 of the constitution.
28. The small savings collected through post offices contribute substantially to total household savings.
Table 6: Direct, Indirect and Total Tax Revenues of Central and State Government (as % of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Centre (gross)</th>
<th></th>
<th>States</th>
<th></th>
<th>Centre &amp; States combined</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Direct</td>
<td>Indirect</td>
<td>Total</td>
<td>Direct</td>
<td>Indirect</td>
<td>Total</td>
</tr>
<tr>
<td>2003-04</td>
<td>3.76</td>
<td>5.29</td>
<td>9.05</td>
<td>0.72</td>
<td>4.84</td>
<td>5.56</td>
</tr>
<tr>
<td>2004-05</td>
<td>4.17</td>
<td>5.35</td>
<td>9.52</td>
<td>0.75</td>
<td>4.95</td>
<td>5.71</td>
</tr>
<tr>
<td>2005-06</td>
<td>4.55</td>
<td>5.49</td>
<td>10.04</td>
<td>0.83</td>
<td>5.00</td>
<td>5.84</td>
</tr>
<tr>
<td>2006-07</td>
<td>5.41</td>
<td>5.67</td>
<td>11.08</td>
<td>0.91</td>
<td>5.02</td>
<td>5.93</td>
</tr>
<tr>
<td>2007-08</td>
<td>6.37</td>
<td>5.70</td>
<td>12.07</td>
<td>0.89</td>
<td>4.95</td>
<td>5.84</td>
</tr>
<tr>
<td>2008-09</td>
<td>6.05</td>
<td>4.89</td>
<td>10.94</td>
<td>0.80</td>
<td>5.05</td>
<td>5.85</td>
</tr>
<tr>
<td>2009-10</td>
<td>5.93</td>
<td>3.83</td>
<td>9.76</td>
<td>0.74</td>
<td>4.96</td>
<td>5.71</td>
</tr>
<tr>
<td>2010-11</td>
<td>5.84</td>
<td>4.50</td>
<td>10.34</td>
<td>0.82</td>
<td>5.22</td>
<td>6.04</td>
</tr>
<tr>
<td>2011-12</td>
<td>5.65</td>
<td>4.48</td>
<td>10.13</td>
<td>0.88</td>
<td>5.50</td>
<td>6.38</td>
</tr>
<tr>
<td>2012-13</td>
<td>5.62</td>
<td>4.77</td>
<td>10.39</td>
<td>0.93</td>
<td>5.65</td>
<td>6.58</td>
</tr>
<tr>
<td>2013-14</td>
<td>5.68</td>
<td>4.41</td>
<td>10.10</td>
<td>0.79</td>
<td>5.56</td>
<td>6.34</td>
</tr>
<tr>
<td>2014-15</td>
<td>5.58</td>
<td>4.38</td>
<td>9.96</td>
<td>0.86</td>
<td>5.49</td>
<td>6.25</td>
</tr>
<tr>
<td>2015-16</td>
<td>5.39</td>
<td>5.14</td>
<td>10.53</td>
<td>0.64</td>
<td>5.11</td>
<td>6.15</td>
</tr>
<tr>
<td>2016-17</td>
<td>5.52</td>
<td>5.63</td>
<td>11.15</td>
<td>0.71</td>
<td>5.47</td>
<td>5.89</td>
</tr>
<tr>
<td>2017-18</td>
<td>5.86</td>
<td>5.34</td>
<td>11.21</td>
<td>0.70</td>
<td>5.52</td>
<td>6.22</td>
</tr>
<tr>
<td>2018-19</td>
<td>6.01</td>
<td>4.98</td>
<td>11.00</td>
<td>0.58</td>
<td>5.77</td>
<td>6.35</td>
</tr>
<tr>
<td>2019-20</td>
<td>5.23</td>
<td>4.77</td>
<td>10.00</td>
<td>0.83</td>
<td>5.27</td>
<td>6.10</td>
</tr>
<tr>
<td>2020-21</td>
<td>4.57</td>
<td>5.00</td>
<td>9.57</td>
<td>0.84</td>
<td>5.63</td>
<td>6.47</td>
</tr>
<tr>
<td>2021-22</td>
<td>4.68</td>
<td>4.66</td>
<td>9.34</td>
<td>0.86</td>
<td>5.98</td>
<td>6.84</td>
</tr>
</tbody>
</table>

Source: Author’s computation from Reserve Bank of India.

Notes: 1. Data for 2020-21 are Revised Estimates and data for 2021-22 are Budget Estimates.
2. States direct taxes, indirect taxes and total taxes exclude States’ share in Central taxes as reported in Central Government Budget documents.
In view of the 2008 financial crisis and Covid-19 pandemic, the financial crunch faced by the state governments motivated the central government to enhance the market borrowing limit of states from three per cent to four per cent of state GDP for the year 2021-22. This temporary measure for a year was decided with a rider that a portion of the additional limit was meant for capital expenditure. In the year 2021-22, the states were also allowed to borrow 75 per cent of the limit in the initial nine months of the fiscal. In the year 2020-21 they were allowed to borrow only up to 50 per cent of the annual limit. However, the states, can also secure short term debt of up to 90 days, at low interest rate from the Reserve Bank of India (RBI)\(^{29}\) which manages the public debt of the central and the state governments and acts as a banker to them. An independent statutory body namely public debt management authority is being contemplated to ease RBI out from this role\(^{30}\).

\(^{29}\) RBI is the central bank set up on April 1, 1935 and its affairs are governed by a central board of directors appointed by the Government of India in keeping with the RBI Act, 1934. It decides the monetary policy and controls monetary instruments such as bank rate, interest rate, exchange rate, statutory liquidity ratio, cash reserve ratio etc to achieve the goals.

Table 7: Revenue Receipts of State Governments  
(as % of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue Receipts</th>
<th>Tax Receipts</th>
<th>Share in Central Taxes</th>
<th>Non-tax Receipts</th>
<th>of which</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c*)</td>
<td>(d)</td>
<td>(e )</td>
<td>(f)</td>
</tr>
<tr>
<td>2003-04</td>
<td>11.07</td>
<td>7.92</td>
<td>2.40</td>
<td>3.15</td>
<td>0.28</td>
</tr>
<tr>
<td>2004-05</td>
<td>11.41</td>
<td>8.18</td>
<td>2.47</td>
<td>3.23</td>
<td>0.27</td>
</tr>
<tr>
<td>2005-06</td>
<td>11.87</td>
<td>8.43</td>
<td>2.59</td>
<td>3.43</td>
<td>0.26</td>
</tr>
<tr>
<td>2006-07</td>
<td>12.47</td>
<td>8.76</td>
<td>2.83</td>
<td>3.71</td>
<td>0.28</td>
</tr>
<tr>
<td>2007-08</td>
<td>12.73</td>
<td>8.94</td>
<td>3.09</td>
<td>3.79</td>
<td>0.26</td>
</tr>
<tr>
<td>2008-09</td>
<td>12.60</td>
<td>8.76</td>
<td>2.92</td>
<td>3.84</td>
<td>0.30</td>
</tr>
<tr>
<td>2009-10</td>
<td>12.07</td>
<td>8.29</td>
<td>2.59</td>
<td>3.77</td>
<td>0.24</td>
</tr>
<tr>
<td>2010-11</td>
<td>12.25</td>
<td>8.91</td>
<td>2.87</td>
<td>3.34</td>
<td>0.20</td>
</tr>
<tr>
<td>2011-12</td>
<td>12.57</td>
<td>9.31</td>
<td>2.93</td>
<td>3.27</td>
<td>0.21</td>
</tr>
<tr>
<td>2012-13</td>
<td>12.59</td>
<td>9.51</td>
<td>2.93</td>
<td>3.08</td>
<td>0.24</td>
</tr>
<tr>
<td>2013-14</td>
<td>12.19</td>
<td>9.18</td>
<td>2.83</td>
<td>3.01</td>
<td>0.24</td>
</tr>
<tr>
<td>2014-15</td>
<td>12.77</td>
<td>8.96</td>
<td>2.71</td>
<td>3.81</td>
<td>0.19</td>
</tr>
<tr>
<td>2015-16</td>
<td>13.31</td>
<td>9.83</td>
<td>3.68</td>
<td>3.48</td>
<td>0.13</td>
</tr>
<tr>
<td>2016-17</td>
<td>13.30</td>
<td>9.88</td>
<td>3.95</td>
<td>3.42</td>
<td>0.16</td>
</tr>
<tr>
<td>2017-18</td>
<td>13.58</td>
<td>10.16</td>
<td>3.54</td>
<td>3.43</td>
<td>0.16</td>
</tr>
<tr>
<td>2018-19</td>
<td>13.86</td>
<td>10.38</td>
<td>3.95</td>
<td>3.48</td>
<td>0.17</td>
</tr>
<tr>
<td>2019-20</td>
<td>13.30</td>
<td>9.34</td>
<td>3.24</td>
<td>3.96</td>
<td>0.13</td>
</tr>
<tr>
<td>2020-21</td>
<td>14.10</td>
<td>9.25</td>
<td>2.98</td>
<td>4.85</td>
<td>0.15</td>
</tr>
<tr>
<td>2021-22</td>
<td>14.60</td>
<td>9.65</td>
<td>2.92</td>
<td>4.94</td>
<td>0.11</td>
</tr>
</tbody>
</table>

Source: Author's computation from Reserve Bank of India  
Note : * includes share in central taxes
At the state level, fiscal health depends both on revenues from state taxes as well as constitutional and other transfers from the central government. There is a fiscal transfer mechanism in India. The Indian Constitution provides for mandatory transfer of revenue as percentage share from central taxes on the basis of the recommendation of a union finance commission in every fifth year. Each UFC uses different criteria to transfer funds. In addition, there are optional transfers through various union ministries and agencies. Fund transfers from the central government form a large part of revenue of the state governments.

The trend of receipts of state government over the years may be seen in table 7. The total revenue receipts of the state government declined marginally after the 2008 global financial crisis and this decline continued subsequently. The revenue receipts of the states as percentage of GDP gained pace and reached at 13.31 per cent only after 2015-16. However, the own tax receipts within the total revenue came back on track within two years of the crisis. That shows the fiscal resilience of States. As the states own revenue declined during the financial crises the share in central taxes also declined. Moreover, an effort was made by the central government to increase the grants to the states but this was also not maintained for long instead the grants from centre (as percentage of GDP) started declining from 2010-11 and continued till 2013-14.

During the Covid-19 crisis, the state's total revenue receipts as percentage of GDP increased due to fall in GDP and not because of increase in revenue receipts of states. But, the centre supported states through grants route as the money transferred through share in central taxes could not be increased due to fall in central revenue. Therefore, centre intervened through grants to the states in both the crisis. As tax receipts declined for both the centre and states during the crisis, the situation became difficult for the centre to increase the fiscal transfers to states from the central taxes.

In response to the 2008 financial crisis, the Indian government took several steps to increase public expenditure on infrastructure and social welfare programs. The government prioritized infrastructure development by expediting the implementation of key projects. It may be noted that the rural economy had been affected badly due to the global financial crisis. Hence, the government enhanced spending on rural development programs, i.e. MGNREGA, social welfare schemes like National Rural Health Mission (NRHM), Sarva Shiksha Abhiyan (SSA), and Integrated Child Development Services (ICDS). The government enhanced budgetary allocations for sectors like transportation, energy, irrigation, and urban development. This allowed the increase in public spending on infrastructure projects, leading to job creation, economic growth, and improved public services from the fiscal year 2007-08 to 2008-09.

In order to tackle the COVID-19 pandemic, the Government of India implemented several measures to increase public expenditure on infrastructure and social welfare programs. The government allocated significant funds for the development of healthcare infrastructure, including the establishment of COVID-19 dedicated hospitals, upgrading existing medical facilities, and enhancing testing and vaccination capabilities. The AtmaNirbhar Bharat Abhiyan (Self-Reliant India Mission) was launched to revive the economy and boost public expenditure. The PM Garib Kalyan Yojana was introduced to provide immediate relief to vulnerable sections of the society affected by the pandemic.
IV. CONCERNS OF FISCAL EQUITY, EFFICIENCY AND INTERGOVERNMENTAL FISCAL TRANSFERS

1. Fiscal Equity and Efficiency Concerns

The effect of two shocks on the centre and state deficits is shown in figures below. As it is evident that GDP declined during both the crisis but the fiscal deficit, revenue deficit and primary deficit of the centre and states increased. During the 2008 crisis, the central government provided financial assistance and support to states to manage the fiscal challenges. This support included debt restructuring, grants, and enhanced devolution of funds. The extent of support from the central government helped states in maintaining their fiscal deficits. But, during the Covid-19 pandemic, the central government provided financial assistance and support to states mostly through various schemes during the pandemic. Since the assistance given was mostly indirect and states were allowed to borrow through provisions made in Fiscal Responsibility and Budget Management Act. Earlier the borrowing limit was set at 3 per cent of the Gross State Domestic Product (GSDP), but it was raised to 5 per cent to provide states with additional funds to tackle the COVID-19 crisis.

Table 8: Major Deficit Indicators of Central and State Government

<table>
<thead>
<tr>
<th>Year</th>
<th>Fiscal Deficit</th>
<th>Revenue Deficit</th>
<th>Primary Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Centre</td>
<td>State</td>
<td>Centre</td>
</tr>
<tr>
<td>2003-04</td>
<td>4.34</td>
<td>4.25</td>
<td>3.46</td>
</tr>
<tr>
<td>2004-05</td>
<td>3.88</td>
<td>3.32</td>
<td>2.42</td>
</tr>
<tr>
<td>2005-06</td>
<td>3.96</td>
<td>2.44</td>
<td>2.50</td>
</tr>
<tr>
<td>2006-07</td>
<td>3.32</td>
<td>1.80</td>
<td>1.87</td>
</tr>
<tr>
<td>2007-08</td>
<td>2.54</td>
<td>1.51</td>
<td>1.05</td>
</tr>
<tr>
<td>2008-09</td>
<td>5.99</td>
<td>2.39</td>
<td>4.50</td>
</tr>
<tr>
<td>2009-10</td>
<td>6.46</td>
<td>2.91</td>
<td>5.23</td>
</tr>
<tr>
<td>2010-11</td>
<td>4.80</td>
<td>2.07</td>
<td>3.24</td>
</tr>
<tr>
<td>2011-12</td>
<td>5.91</td>
<td>1.93</td>
<td>4.51</td>
</tr>
<tr>
<td>2012-13</td>
<td>4.93</td>
<td>1.97</td>
<td>3.66</td>
</tr>
<tr>
<td>2013-14</td>
<td>4.48</td>
<td>2.21</td>
<td>3.18</td>
</tr>
<tr>
<td>2014-15</td>
<td>4.10</td>
<td>2.62</td>
<td>2.93</td>
</tr>
<tr>
<td>2015-16</td>
<td>3.87</td>
<td>3.05</td>
<td>2.49</td>
</tr>
<tr>
<td>2016-17</td>
<td>3.48</td>
<td>3.47</td>
<td>2.06</td>
</tr>
<tr>
<td>2017-18</td>
<td>3.46</td>
<td>2.40</td>
<td>2.60</td>
</tr>
<tr>
<td>2018-19</td>
<td>3.44</td>
<td>2.45</td>
<td>2.40</td>
</tr>
<tr>
<td>2019-20</td>
<td>4.65</td>
<td>2.58</td>
<td>3.32</td>
</tr>
<tr>
<td>2020-21</td>
<td>9.18</td>
<td>4.72</td>
<td>7.32</td>
</tr>
<tr>
<td>2021-22</td>
<td>6.72</td>
<td>3.67</td>
<td>4.60</td>
</tr>
</tbody>
</table>

Source: Author’s computation from Reserve Bank of India Source: Author’s computation from Reserve Bank of India Notes: 1. Data for 2021-22 are Revised Estimates and data for 2022-23 are Budget Estimates. 2. Negative (-) sign indicates surplus.
The impact of the crisis is visible on both the central and the state finances. The fiscal burden on centre increased to 9.18 percent of GDP (2020-21) from 4.65 percent of GDP (2019-20). The fiscal deficit of states increased to as high as 4.72 percent of GDP (2020-21) from 2.58 percent of GDP for all the states combined.

**Figure 3: Centre deficit vis-a-vis GDP**

![Figure 3: Centre deficit vis-a-vis GDP](Source: Author)

**Figure 4: State deficit vis-a-vis GDP**

![Figure 4: State deficit vis-a-vis GDP](Source: Author)
Table 9: Debt Indicators of Central & State Government

<table>
<thead>
<tr>
<th>Year (end-March)</th>
<th>Total liabilities of the Centre</th>
<th>Total liabilities of the States</th>
<th>Combined total liabilities of Centre &amp; States</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003-07</td>
<td>63.13</td>
<td>29.94</td>
<td>78.11</td>
</tr>
<tr>
<td>2008-12</td>
<td>54.61</td>
<td>24.02</td>
<td>68.48</td>
</tr>
<tr>
<td>2013-17</td>
<td>50.83</td>
<td>23.39</td>
<td>68.10</td>
</tr>
<tr>
<td>2018-19</td>
<td>49.62</td>
<td>25.33</td>
<td>70.53</td>
</tr>
<tr>
<td>2019-20</td>
<td>52.68</td>
<td>26.65</td>
<td>75.33</td>
</tr>
<tr>
<td>2020-21</td>
<td>63.32</td>
<td>31.05</td>
<td>89.41</td>
</tr>
<tr>
<td>2021-22</td>
<td>62.62</td>
<td>31.17</td>
<td>89.26</td>
</tr>
</tbody>
</table>

Source: Author’s computation from Reserve Bank of India

The combined total liability was 75.33 percent of GDP in the pre-pandemic year (2019-20) of centre and states in which the debt of the states was 26.65 percent of GDP and of the centre was 52.68 percent of GDP. Though combined public debts have been constantly increasing since 2010-11, but, the extraordinary situation due to pandemic turned this constant increase to a giant leap emanated from shrinking GDP and increasing foregone revenue, public spending and liquidity support. However, this increase is at pace with the current global trend. The situation of combined total liabilities before the 2008 financial crisis was 78.11 percent of GDP (2003-07) which improved to 68.48 percent of GDP post-crisis (2008-12).

Figure 5: Debt Indicators of Centre & State Government

Source: Author

31. Only central government can borrow from external sources.
**Table 10: Major Macroeconomic Indicators from 2003-2022**

<table>
<thead>
<tr>
<th>Year (end-March)</th>
<th>Nominal GDP</th>
<th>Consumer price inflation</th>
<th>Share of public debt in GDP</th>
<th>Share of current account in GDP</th>
<th>Share of Budget revenue</th>
<th>Share of Budget expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003-07</td>
<td>14.48</td>
<td>4.80</td>
<td>79.35</td>
<td>-0.27</td>
<td>11.28</td>
<td>14.94</td>
</tr>
<tr>
<td>2008-12</td>
<td>15.24</td>
<td>9.92</td>
<td>69.29</td>
<td>-3.21</td>
<td>9.70</td>
<td>15.38</td>
</tr>
<tr>
<td>2009-13</td>
<td>11.44</td>
<td>5.98</td>
<td>68.15</td>
<td>-1.37</td>
<td>9.24</td>
<td>13.12</td>
</tr>
<tr>
<td>2010-13</td>
<td>10.59</td>
<td>3.96</td>
<td>70.78</td>
<td>-2.39</td>
<td>8.81</td>
<td>12.25</td>
</tr>
<tr>
<td>2011-14</td>
<td>6.22</td>
<td>3.71</td>
<td>73.72</td>
<td>-1.02</td>
<td>9.62</td>
<td>13.44</td>
</tr>
<tr>
<td>2012-14</td>
<td>-1.36</td>
<td>6.63</td>
<td>84.23</td>
<td>1.25</td>
<td>8.54</td>
<td>17.73</td>
</tr>
<tr>
<td>2013-14</td>
<td>19.51</td>
<td>5.14</td>
<td>85.16</td>
<td>-1.14</td>
<td>9.21</td>
<td>15.93</td>
</tr>
</tbody>
</table>

Source: Author's computation from Reserve Bank of India, Ministry of Statistics and Programme Implementation, Government of India

The effect of 2008 financial crisis had a huge impact on the inflation rate, i.e., inflation for the post-crisis period increased to 10 percent from 4.8 percent (2003-07) which effected the current account deficit of the country for the same period. However, the case was totally different during pandemic. Due to high government expenditure, the share of public debt in GDP increased to 84.2 percent in 2020-21 from 74 percent in 2019-20. Although the current account deficit became positive (1.25 percent of GDP) after 15 years. This evidently showcases that the nature of crises has different effect on the macroeconomic variables of the country.

The imbalance in expenditure responsibilities can strain the finances of state governments. Therefore, the arrangement of central transfers to the states and local governments has been an effective way to manage the finances in general and during the uncertain times. Although there are certain caveats in the transfers made which has been discussed in the following section.

**2. Concerns of Intergovernmental Fiscal Transfers**

The allocation of resources between the centre and the states and among the states begins with a discussion on vertical fiscal imbalance and horizontal imbalances. The vertical imbalance between the centre and the states was created through the constitutional assignment of expenditure responsibilities and revenue powers. The central government has more resources and state governments carry more responsibilities. In order to correct this vertical imbalance formula based IGFT from centre to states was envisaged.

In this context, the UFC has been recommending a share from the net proceeds of all central taxes (after deducting cost of collection, cess and surcharges). It started with the recommendation of the 10th FC (award period 1995-2000) which estimated 28 per cent states’ share in the divisible pool. Successive UFCs made incremental increase to this share till 32 per cent that the 13th FC recommended for its award period 2010-15. The
year 2015, was the turning point for Indian federal finance when the age old Planning Commission was abolished. The UFC acquired the status of the only institution for IGFT between the centre and the States. Consequently, the 14th FC (2015-20) recommended a quantum jump to this share from 32 per cent to 42 per cent. As explained earlier, a portion of this share was to cover up the discontinuation of various grants that the Planning Commission used to provide. The 15th FC (2020-26) made it 41 per cent after adjusting the central government share that rose due to the additional responsibility for newly carved out union territories of Jammu & Kashmir and Ladakh.

From the states’ aggregate share, the UFC distribute the resources among the states to correct horizontal imbalances. This horizontal devolution by successive UFCs has been based on objective parameters reflecting equity and efficiency considerations. In fact, it has been the endeavor of all UFCs to keep a fine blend of equity and efficiency in their formula for horizontal distribution among states that are heterogeneous in their fiscal capacities. However, no two UFCs adopted identical formula. All of them are of different varieties carrying the flavor of the then UFC. The series of these formulas are divided into two phases and summarized in the box given below:

### Phases in Horizontal Devolution

#### Phase 1: From First to Seventh Finance Commission
- Till 7th FC, income tax and union excise duties were shared using different parameters.
- Income tax was broadly shared using population and tax contribution parameters.
- The 3rd FC considered equity parameters like relative backwardness, backward caste/tribal population, financial weakness etc. for distribution of union excise duty for the first time.
- In the case of distribution of union excise duty, the 7th FC considerably reduced direct weightage of population and increased weightage of equity parameters, like inverse of per capita income, percentage of poor, etc.

#### Phase 2: From Eighth to Fifteenth Finance Commission
- 8th FC to 10th FC recommended similar parameters, including equity considerations, for distribution of both income tax and union excise duties.
- After the eightieth amendment to the constitution in 2000, a single sharing formula from the divisible pool of taxes was recommended. Parameters used by earlier finance commissions continued in the formulae.
- Weight for equity parameters increased significantly, with a proportionate decrease in direct weight for population.
- The 10th FC introduced fiscal performance criteria for the first time with 10 per cent weight to tax efforts of states. Later, criteria like fiscal discipline and fiscal capacity were used by finance commissions.

Source: Government of India (2020).

Successive UFCs have been constructing formula comprising parameters and their relative weights. These parameters harmonize the attributes of equity, need and cost disability and performance for horizontal devolution of resources. ‘Income distance’ with high weights (about 50 per cent) has been used for equity consideration. The criterion is acceptable to all states for redistribution of income among states. It makes the formula more progressive and provides higher IGFT to states with lower per capita income. The UFC uses per capita gross state domestic product (GSDP) as a proxy for state’s tax capacity. Generally, low per capita income represents poor state (mostly more populous state) in need of resources to provide comparable public services. As can be seen from table 5, it was only the 13th FC which used ‘fiscal capacity’ instead.

---

32. The 15th FC assigned 45 per cent weight to this criterion.


Table 11: Criteria and weights assigned for horizontal Distribution (For States)

<table>
<thead>
<tr>
<th>Criteria</th>
<th>11th FC</th>
<th>12th FC</th>
<th>13th FC</th>
<th>14th FC</th>
<th>15th FC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>10</td>
<td>25</td>
<td>25</td>
<td>17.5</td>
<td>15.0</td>
</tr>
<tr>
<td>Income</td>
<td>62.5</td>
<td>50</td>
<td>-</td>
<td>50</td>
<td>45.0</td>
</tr>
<tr>
<td>Area</td>
<td>7.5</td>
<td>10</td>
<td>10</td>
<td>15</td>
<td>15.0</td>
</tr>
<tr>
<td>Index of Infrastructure</td>
<td>7.5</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Tax Efforts</td>
<td>5</td>
<td>7.5</td>
<td>-</td>
<td>-</td>
<td>2.5</td>
</tr>
<tr>
<td>Fiscal Discipline</td>
<td>7.5</td>
<td>7.5</td>
<td>17.5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Fiscal Capacity</td>
<td>-</td>
<td>-</td>
<td>47.5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Demo Change</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>10</td>
<td>12.5</td>
</tr>
<tr>
<td>Forest Cover</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>7.5</td>
<td>10.0</td>
</tr>
</tbody>
</table>

Source: Reports of various Union Finance Commissions, India
Note: FC means Finance Commission

Table 12: Criteria and weights assigned for horizontal Distribution (For Local)

<table>
<thead>
<tr>
<th>Criteria</th>
<th>11th FC</th>
<th>12th FC</th>
<th>13th FC</th>
<th>14th FC</th>
<th>15th FC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>40</td>
<td>40</td>
<td>50</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>Area</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Distance</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Decent/Devolution Index</td>
<td>20</td>
<td>-</td>
<td>15</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Revenue Efforts</td>
<td>10</td>
<td>20</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Deprivation Index</td>
<td>-</td>
<td>10</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Grant Utilization</td>
<td>-</td>
<td>-</td>
<td>5</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Reports of various Union Finance Commissions, India
Note: FC means Finance Commission

‘Population’ and ‘area’ of a state represent the ‘need’ factor. All UFCs used population as a criterion which is simple and transparent. The 15th FC has assigned 15 per cent weight to this indicator. ‘Area’ of the state is another indicator which reflects need for simple reason – the larger the area, the higher is the resource requirement for public services. The 14th FC and the 15th FC assigned 15 per cent weight to this indicator. ‘Forest cover’
for the first time was used by the 14th FC in the formula. The 15th FC retained it and assigned even higher weight due to the merits of this indicator. It serves two purposes. First, the state needs to be compensated for this ‘cost disability’, and second, it is considered beneficial for environment purpose in the interest of the nation or even the world.

In order to incentivize fiscally prudent states, criteria such as ‘tax efforts’ and ‘fiscal discipline’ were used. These criteria reflect performance and efficiency and intend rewarding states for efficient tax collection. This is important as tax evasion and avoidance are high in states. Likewise, ‘fiscal discipline’ encourages states to adhere to the targets set by the ‘fiscal responsibility and budget management act’, under which revenue deficit, fiscal deficit, public debt, etc. need to be contained. In addition, the 15th FC used ‘demographic performance’ as a criterion which reflects performance of states in their efforts to move towards the replacement rate of population growth. Such states also get better outcomes in health, the 15th FC believes.

The IGFT arrangements between the states and their local governments stipulate every state to constitute, at regular interval of five years, a state finance commission (SFC), and assign it the task of IGFT to panchayats and municipalities from state's kitty. However, state government is not as serious about SFC as the central government is about the UFC. This conclusion can be drawn based on the following general treatments to SFC. First, SFC is not constituted at a regular interval of five years in some states; second, loyal retired civil servants and side lined politicians are made members of SFC; third, SFC reports sometimes are not placed in the legislative assembly, and fourth, if the report is accepted, the money is not released. These practices weaken the institution of SFC (Alok, 2021).

A review of the SFCs’ reports suggests that IGFT design by SFCs takes into considerations the following fiscal attributes: equity; fiscal needs and cost disability; fiscal efforts and efficiency. Various indicators reflecting these attributes have been used. These include total population, ratio of backward and tribal population, population below poverty line, population density, population per hospital bed, area, backwardness of the area, remoteness index, distance from state capital, length of road, literacy rate, sex ratio, index of infrastructure, income distance, own income efforts, tax efforts, etc. (Alok, 2021).

Local governments receive a large amount of resources from UFC. As mentioned in table 12, six UFCs, so far, have recommended fiscal transfers to the local governments and attempted to: a) equalize basic civic services, b) provide incentives for strengthening accounts and audit and c) set rules to strengthen SFCs. The recommendations have been subject to considerable criticism mainly on the following grounds:

- The grants provided are too small to make any difference to the functioning of about quarter million local governments.
- The formula used for the allocation among the states were needlessly complicated and proved to be ineffective in promoting the cause of decentralized governments.
- Contours of decentralization across states have never been very clear and each UFC adopted ad hoc approach that too of different variety breaking the continuity. For instance, the fiscal transfers to local government that the 13th FC recommended was not in the form of lump sum ad hoc grant but a share in the central tax divisible pool so that the local government could share the revenue buoyancy of central taxes. This practice, based on its inherent merits, could have been followed by the successive UFCs, but the 14th FC discontinued it without assigning convincing reasons.
• UFCs attempted, though half-heartedly, to enhance capacity of local governments by making conditional grants. These conditions had been formed based on practices prevalent in a small southern state. It remained difficult for almost all states to fulfil those conditions and claim conditional grants. The next UFC complicated the issue further by recommending different set of conditions to claim performance grants.

Table 13: Union Finance Commission Grants to Local Governments

<table>
<thead>
<tr>
<th>Finance Commission</th>
<th>Panchayats</th>
<th>Municipalities</th>
</tr>
</thead>
<tbody>
<tr>
<td>10th [1995-00]</td>
<td>43.81</td>
<td>10.00</td>
</tr>
<tr>
<td>11th [2000-05]</td>
<td>80.00</td>
<td>20.00</td>
</tr>
<tr>
<td>12th [2005-10]</td>
<td>200.00</td>
<td>50.00</td>
</tr>
<tr>
<td>13th [2010-15]</td>
<td>630.51</td>
<td>231.11</td>
</tr>
<tr>
<td>14th [2015-20]</td>
<td>2002.92</td>
<td>871.44</td>
</tr>
<tr>
<td>(for village Panchayats only)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15th [2020-21]</td>
<td>607.50</td>
<td>292.50</td>
</tr>
<tr>
<td>First report</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15th [2021-26]</td>
<td>2368.05</td>
<td>1210.55</td>
</tr>
<tr>
<td>Final report</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Reports of various Union Finance Commissions, India
Note: bn = billion; INR = Indian Rupee

V. CONCLUSION

The 2008 global financial crisis led to a decline in tax revenues of the Government of India and states due to reduced economic activity and consequent fiscal stimulus that lead to a widening fiscal deficit. Increased public spending on infrastructure and social welfare programs were parts of fiscal stimulus. These measures aimed to revive economic growth and mitigate the negative impact on public finances.

On the other hand, the COVID-19 pandemic had a severe impact on India’s economy and public finances. To contain the spread of the virus, the government implemented strict lockdowns, resulting in a significant decline in economic activities and output loss. This led to reduced tax revenues, increased public expenditure, and a consequent surge in fiscal deficit of the centre and states. The government introduced a fiscal policy involving relief packages to support affected sectors and income support to vulnerable populations. This enhanced the economic recovery of the country. These measures included direct cash transfers, enhanced healthcare spending, and loan moratoriums. However, the increased public spending and lower revenue generation caused a strain on public finances, resulting in a widening fiscal deficit and increased public borrowings.

The robustness of Indian federalism was put under test during the 2008 financial crisis and covid-19 pandemic. The center acted as bulwark during the crisis as it was observed
that state liabilities were not much impacted in comparison to liabilities of the centre (see table 9). The effect of 2008 financial crisis had a huge impact on the inflation rate, i.e., the inflation for the post-crisis period increased to 10 percent from 4.8 percent (2003-07) which effected the current account deficit of the country for the same period. However, the case was totally different during pandemic. Due to high government expenditure, the share of public debt in GDP increased to 84.2 percent in 2020-21 from 74 percent in 2019-20. Although the current account deficit became positive (1.25 percent of GDP) after 15 years.

Overall, both the 2008 financial crisis and the Covid-19 pandemic had adverse effects on India’s public finances. The government implemented expansionary fiscal policies to support economic recovery and mitigate the impact of these crises. However, these measures also led to increased fiscal deficits and higher borrowing levels due to fall in revenues and increase in expenditure (see table 5 and 6). Interestingly, it is observed that after the 2008 crisis the average central and state debt for the period 2008-12 declined from 63.1 and 30 percent of GDP to 54.6 and 24 percent of GDP, respectively. On the other hand Covid-19 pandemic had an immediate adverse impact on both centre and state, as the debt increased to 63.3 and 31 percent of GDP from 52.7 and 26.7 percent of GDP, respectively.

The long-term consequences of these crises on India’s public finances may require sustained efforts to restore fiscal stability and achieve a sustainable growth trajectory. This evidently showcases that the nature of crises has different effect on the macroeconomic variables of the country. In order to strengthen the intergovernmental fiscal relations among centre, states and local governments issues related to equity, transparency, accountability, ownership need to be addressed. They are considered as growth inhibitors and create political tensions among different levels of governments.

It is essential to recognize that in order to handle an uncertain situation, a continuous evaluation of the evolving global and domestic fiscal landscape is required. Flexibility, adaptability, and proactive policy measures with equitable distribution will be crucial in addressing any economic crises of any kind.
REFERENCES:


JOURNAL INFORMATION

INDEX

INTRODUCTION

FISCAL FEDERALISM IN ITALY TWENTY YEARS AFTER THE CONSTITUTIONAL REFORM: AN APPRAISAL

by Andrea Filippetti
Istituto di Studi sui Sistemi Regionali Federali e sulle Autonomie, Consiglio Nazionale delle Ricerche

by Costanza Giannantoni
Sapienza University of Rome

by Sandro Rondinella
University of Naples Federico II

by Fabrizio Tuzi
Istituto di Studi sui Sistemi Regionali Federali e sulle Autonomie, Consiglio Nazionale delle Ricerche

To cite this article:
Filippetti, Andrea; Giannantoni, Costanza; Rondinella, Sandro; Tuzi, Fabrizio (2023): Fiscal federalism in Italy twenty years after the constitutional reform: an appraisal, Cuadernos Manuel Giménez Abad, Special Issue 9. DOI: 10.47919/FMGA.CM23.0116

ABSTRACT

One of the pillars of the reform of Title V of the Italian Constitution has been the implementation of fiscal federalism via the devolution of taxation from the centre to the regions and local governments. By conducting a statistical analysis of revenues and financial resources transfer by central government to support regional spending (central government transfer), we demonstrate that despite twenty years having elapsed since the reform the regions are yet to acquire real financial autonomy. The ratio for central government transfers to the regions is analysed here, assessing revenues between 2008-2020 in conjunction with an evaluation of the trend in these same aggregates during the pandemic period. The re-centralization process during the pandemic emergency increased the reliance of the regional system on transfer of finance from central government. Thus, inadequate regional fiscal autonomy is reflected in the ongoing dependence on central government funds. The dependence of regional budgets on central government transfers did not reduce over the period examined, but rather tended to increase from 2008 onwards, especially in the case of the southern Regions. Over this period this led to decreased regional financial autonomy. The data correlates with a process of re-centralization of legislative spaces and financial autonomy to address, the financial crisis of 2009 and the sovereign debt crisis in Europe in 2011, causing the pendulum of regionalism to swing towards the State.

Keywords: fiscal federalism; regional fiscal autonomy; central governments transfers; central governments – regions disputes; financial crisis.
I. INTRODUCTION

The 2001 revision of Title V of the Italian Constitution was intended to reshape the relationship between central and subnational government, in accordance with the principles of so-called fiscal federalism. Article No. 119 was amended to introduce a basis for shifting the power of taxation from the centre to regional and local governments into the Constitution. The reform set out steps for the gradual implementation of the process of fiscal federalism through a series of ordinary legislative measures to enhance subnational governments’ autonomy in revenue and expenditure, to enable the localities to finance and implement their own policies. It was intended to reduce the region's reliance on resources transferred from the centre, facilitating co-participation in raising both central government’s tax revenues and their own taxes and revenues. However, today it is apparent that the expected fiscal autonomy of the regions and local governments has manifested incompletely and unevenly. The reform aimed to encourage subnational governments to obtain the revenues required for financing local public services from their own territories, so they would pursue appropriate economic and fiscal policies. The so-called legislation of crisis, introduced to tackle the financial crisis of 2009, initiated a period of re-centralization, with the implementation of measures to return some of the regulatory tools of regional (and local government) autonomy to the realm of central government budget and public finance coordination. Furthermore, the strengthening of financial constraints by the European Union, especially for Member countries with high public debt, further contributed to this re-centralization process. The result has been curtailment of the fiscal federalism reform, such that, today fiscal federalism remains largely unimplemented (Filippetti & Tuzi, 2020).

Within this framework, an analysis of central government transfer of financial resources to the regions to support regional spending, and revenues raised locally (dating from the 2008 financial crisis to the present), could offer useful insights into the implementation of fiscal federalism in Italy, clarifying the real extent of any financial autonomy acquired by the regions. Additionally, specifically focusing on these same aggregates during the pandemic period would verify how regional dependence on central funding has evolved. For the purpose of this study, data regarding central government transfers and own revenues were extracted from the SIOPE (Information System on Public Entities Operations), which is the primary source of information for monitoring public accounts. The dataset obtained was sufficiently detailed to facilitate the reconstruction of time series data for each region regarding the total amount of central transfers and own revenues.

The remainder of this article is structured as follows: the second section briefly reviews the milestones that led to the current development of the Italian regional system. Section 3 provides some background to explain national public finance according to key indicators such as debt and spending by different levels of government. Section 4 discusses the constitutional provisions required to realize fiscal federalism, the principles guiding this process, the regulatory instruments implemented to achieve it and their state of implementation. Section 5 highlights the role and actions of the Constitutional Court within this pathway. In section 6 the ratio of central government transfers (current transfers) to the regions and their own revenues, collected during the period 2008-, is analysed to highlight the dependence of regional budgets on central funds. The dependence of the regional system on the central government funds, even to fulfil basic requirements such as health care, is examined in the section 7. The paper then offers some conclusions regarding the last twenty years of (attempted) regional financial autonomy, in terms of implementation of the decentralization process and the dependence of the regions on central government funds.

1.https://www.siope.it/Siope/
II. HISTORY AND THE DEVELOPMENT OF REGIONALISM IN ITALY

Italy is a relatively ‘young’ country with a frail national identity. It has historically been characterized by strong regional and local identities, unified through a top-down political processes that took place in the second half of the nineteenth century, ending in 1861 with the unification of the Italian Kingdom. Its character has been informed by “cultural differences between regions, the developmental gap between north and south, the lack of a national language until the late nineteenth century, and the weakness of central authority relative to social institutions such as families and the Catholic Church” (Casaglia et al., 2020, p. 14).

Regionalism became relevant again after political and social turmoil led to the formation of the Italian Kingdom during the drafting of the Italian constitution, immediately following the Second World War. The founding fathers of the Italian constitution, which was released in 1948, introduced the regional level of government departing from the centralized model of the unitary state, offering a compromise between unitary and federalist forces. The allocation of political and administrative powers at the regional level, was also included in the Constitution to impede the possible reemergence of fascism. The formal establishment of the Italian Regions took place as recently as 1970, and the regional governments were initially characterized by inadequate political influence and insufficient financial autonomy.

Italian regionalism has coexisted with a developmental gap between north and south, which remains unresolved. Since the unification this gap has never been addressed through significant political and economic efforts, with the result that Italy is subject to more significant income disparities across its regions than any other European country (Asso, 2021). The dispersion index of regional per capita GDP versus the national average (Eurostat - Regional economics accounts) provides indications of the regional gap within a given nation. The value of the index is zero if regional per capita GDP values are the same across all regions, while values other than zero indicate the presence of different levels of development within the country. For Italy, the dispersion values are quite high (the index shows values of about 25 percent) and highlight a decline in convergence between different regions over the period 2008-2017, due to the economic crisis at that time (Mangiameli et al., 2020).

The issue of regional economic disparities and the agendas of some political movements have become progressively interlaced, leading to the emergence of secessionist groups in the north of Italy at the beginning of the 1990s. Lega Nord (Northern League) is the most significant example of this. During the 1990s the Lega Nord encapsulated northern entrepreneurs’ dissatisfaction regarding high taxes and central state bureaucracy, as well as the national political class, proposing secession of the Northern regions from the Southern regions, which it accused of being lazy and hanging on the coat-tails of the productive north.

The starting point for political discussions regarding secession included requests for a stronger regional autonomy, which eventually led to a reform of the Constitution in 2001. The new constitutional provisions reshaped the relationship between central government, and regional and local governments. It granted the regional governments a stronger political legitimacy, legislative powers over several aspects, and financial autonomy (Keating & Wilson, 2010). The direct election of regional governors has played a key role in growing their importance, and today, these governors are outstanding political figures in the national political landscape: “directly elected territorial leaders have become assertive political actors vis-à-vis the central government, introducing a further centrifugal dynamic in the system that counters the centripetal tendency of national parties” (Palermo & Wilson, 2013, p. 2). The constitutional reform of 2001
also allowed for complete autonomy of the regions over several policies. Furthermore, several other policies that were concurrent, were to be managed together with central government, while justice, education, defense, and several others remain in the hands of the central government. The shared competences, according to the Italian Constitution, provide for the vertical allocation of powers between central government and regions; the former establishing primary principles, while the regions themselves were responsible for the programming, organization and delivery of services. The result of this reform (and consequent legislation) was the transformation of the structure of the state from unitary to ‘regionalized unitary’, similar to Spain.

The ‘regionalization’ process has been affected by several conflicts regarding the allocation of powers between central government and the regions, resulting in intensive work by the Constitutional Court to fundamentally rearrange regional competences. Meanwhile, decisions by the Court led to the fulfilment of the principle of mutual and loyal co-operation between central government and the regions, so central government began to consult with the regions about an increased number of matters, including not only regional concerns, but also items of general politics and economic policy (Palermo & Wilson, 2013).

In more recent years, some regions (e.g., Lombardy, Veneto, and Emilia Romagna, and some others) have started the process of acquiring further competences and financial autonomy from central government, based on the provision of Article 116 third paragraph of the Constitution\(^2\). This process has been interrupted by the pandemic, but requests have started again, providing evidence of the growing political ambitions of the Italian regions.

In Italy, decentralization receives broad institutional and political support, as the decentralization program fully reflects the political climate. Thanks to prior reshaping of the division of labour between central government and the subnational levels of government, devolution not only aims to transform the role of the central government, but also appears to be a fundamental component of the whole process of modernization of the public administration (Longo & Mobilio, 2016; Lippi, 2011; Mele, 2010).

From this perspective this paper aims to explore the effectiveness of the implementation of fiscal federalism in Italy through the devolution of taxation from the centre to the regions and Local Authorities, analysing the trend in the ratio of central government transfer to the regions and their own revenues during the period 2008-2020, as well as the trend in the same aggregates during the pandemic period.

### III. CONSTITUTION PROVISIONS RELATING TO FISCAL FEDERALISM

The revisiting of relations between central and subnational government, according to the principles of the so-called fiscal federalism, was one of the main goals of the 2001 reform of Title V of the Italian Constitution. article No. 119 of the Constitution reshaped

---

2. Article 116 of the Constitution states: Friuli Venezia Giulia, Sardinia, Sicily, Trentino-Alto Adige/Südtirol and Valle d’Aosta/Vallée d’Aoste have special forms and conditions of autonomy, according to their respective special statutes adopted by constitutional law.

The Trentino-Alto Adige/Südtirol region consists of the autonomous provinces of Trento and Bolzano.

Further special forms and conditions of autonomy, concerning the matters referred to in the third paragraph of Article 117 and the matters indicated by the second paragraph of the same Article in subparagraphs (l), limited to the organization of justice of the peace, (n) and (s), may be attributed to other Regions, by State law, on the initiative of the Region concerned, after consultation with the local authorities, in compliance with the principles referred to in Article 119. The law shall be approved by the Chambers by an absolute majority of its members, on the basis of agreement between the State and the Region concerned.
the boundaries of the financial autonomy of the subnational government. However, it was necessary to wait for Law No. 42 (May 5, 2009), the so-called Delegation to the Government on fiscal federalism, in implementation of Article 119 of the Constitution, to initiate the process of shifting the power of taxation from the centre to the regions and Local Authorities on a scale that aligned with the attributed competencies.

The principle that has guided the bestowing of greater financial autonomy on the regions and Local Authorities proceeds from the belief that autonomy in the policies of the regions assumes autonomy in terms of revenue and expenditure. That is, regions should no longer be expected to finance and implement policies based on resources transferred from the centre, but rather raise funds from co-participation in the revenue of central government taxes, or from regional taxes and revenues. This reform relies on a set of theories that fall under the so-called 'tax assignment problem'. According to this theory, in decentralized systems an overlap of spending responsibilities, on the one hand, and taxing responsibilities, on the other, must be sought. Thus, in this case, greater responsibility of the regions in terms of policies and functions must be matched by a greater emphasis on fiscal responsibility (Liberati, 2011; McLure, 1994; Bird, 1999; Oates, 2005).

This approach both reinforces the political accountability of regional rulers to citizens, voters and taxpayers, according to the criterion of political representation, and enables politicians to modulate expenditures according to the demand of the region’s citizens. This makes it possible to respond efficiently to fulfil local preferences according to the criterion of allocative efficiency. These are two basic elements of fiscal federalism, in that they make it possible to improve the relationship between politics and citizens (constituency) and generate the production of public goods and services in a manner that is responsive to local preferences, as opposed to cases of centralized production, which tend to homogenize public goods and services.

One of the milestones in the implementation of fiscal federalism is overcoming the requirement to finance subnational government through central transfers of funds - except in cases where these have an institutional justification, as in the case where the central

---

3. Article 119 of the Constitution states: Municipalities, Provinces, Metropolitan Cities and Regions have financial autonomy in revenue and expenditure, subject to the balance of their budgets, and contribute to ensuring compliance with the economic and financial constraints arising from the European Union system. Municipalities, provinces, metropolitan cities and regions have autonomous resources. They establish and apply their own taxes and revenues, in harmony with the Constitution [53 c.2] and in accordance with the principles of coordination of public finance and the tax system. They dispose of co-participations in the revenue of state taxes referable to their territory.

The law of the State shall establish an equalization fund, with no allocation constraints, for territories with lower fiscal capacity per inhabitant.
To promote economic development, cohesion and social solidarity, to remove economic and social imbalances, to promote the effective exercise of personal rights, or to provide for purposes other than the normal exercise of their functions, the State shall allocate additional resources and make special interventions in favor of certain municipalities, provinces, metropolitan cities and regions.
The Republic recognizes the peculiarities of the Islands and promotes the necessary measures to remove the disadvantages arising from insularity.

Municipalities, Provinces, Metropolitan Cities and Regions have their own assets, allocated according to general principles determined by State law. They may resort to borrowing only to finance investment expenditures, with the concomitant establishment of amortization schedules and provided that for the totality of the entities of each Region the budget balance is respected. Any state guarantee on loans contracted by them is excluded.

4. There are two strands of fiscal federalism theory: the so-called first-generation theory and the so-called second-generation theory. The former includes the classic contributions of public finance and finance science approaches, among others see Musgrave (1961); the latter includes those theories that use an economic policy approach, such as Oates (2005). For a general discussion, see Brosio & Piperno (2009).

5. For a look at the federalism model, see Zanardi (2006). For a discussion of the degree of homogeneity and differentiation of local public services in unitary and federal systems see Breton (2012).
government allocates ‘additional resources’ or carries out ‘special interventions’. The aim here is the recovery from the territory of a large amount of revenues for financing the policies performed by subnational governments, enabling each institutional level in the exercise of spending power, as well as ensuring the ‘solidaristic character of the system’. In general, fiscal policies based mainly on ‘unconditional’ central transfers may disincentivize subnational governments from pursuing appropriate economic and fiscal policies which then reduces their resilience to meet economic crises.

In Italy, the process of implementing fiscal federalism has also provided for the determination of the so-called ‘essential levels of performance (LEP)’ for health care, social assistance, education and local public transport in reference to capital expenditures. These basic functions of Local Authorities should have been fully financed to meet standard cost and standard requirements criterion. The slow process towards determining standard requirements has been another factor hindering the effective implementation of fiscal federalism in Italy.

The implementation of Law No. 42 introduced a complex process involving further legislative decrees. The most relevant was Legislative Decree No. 68/2011, which aimed to ensure revenue autonomy by providing for the gradual replacement of central government transfers with regional taxes and co-participation in national taxes (Nania, 2009; Buglione, 2010). The law assumes VAT revenue funds all essential levels of health, welfare, education and local public transport. Where tax revenues are insufficient, the shares of an equalization fund should contribute. This fund would then be fed through a VAT revenue and its value determined to guarantee the full financing of expenditures in each region to meet essential levels calculated at the standard cost level. IRAP (regional tax on productive activities) should have been another relevant tax revenue supporting regional financial autonomy. The surtax on national personal income tax (IRPEF), should have provided the other major source of revenue for the regions. The 68/2011 Legislative Decree stipulated that the IRPEF surtax be recalculated to guarantee covering the total amount of central transfers that would then have to be eliminated. To this minimal level of IRPEF surtax the regions could then add surcharges. Finally, a very residual role would be played by regional taxes that would not concern items already subject to taxation by central government.

Up to date fiscal autonomy, as outlined by Law No. 42 of 2009 and Legislative Decree No. 68 of 2011, which defined a system of financing regional spending based on the above-mentioned sources – i.e. VAT revenue sharing, IRAP revenue, IRPEF surtax, shares of the equalization fund and own revenue - has not been implemented. Nor has the overall process of fiscal federalism, which was only partially and differentially achieved for municipalities, provinces and metropolitan cities and regions.

Today, it can be observed that VAT revenue sharing is the main tax revenue supporting regional budgets, providing 60 percent of the total tax revenue of the regions. This tax is intended to cover expenses incurred by maintaining the health care system. IRAP weighs 24 percent of total regional tax revenues, and even this tax is used substantially

6. On the genesis and (partial) implementation of fiscal federalism in Italy, see among others Filippetti & Tuzi (2020); Mangiameli (2011); Ferrara & Salerno (2010); Carabba & Claroni (2012); Antonini (2014).
7. On the evolution of regional and local government finance in recent years, see the various editions of A.A.V.V. La finanza territoriale, different years, Rubettino.
8. It should be pointed out that Law 42 gave rise, in addition to Legislative Decree No. 68 of 2011, to other decrees implementing it, such as, among others, the decree on state-owned federalism (Legislative Decree May 28, 2010, no. 85), the legislative decree on the transitional order of Roma Capitale (Legislative Decree No. 156 of September 17, 2010), the legislative decree on municipal fiscal federalism (Legislative Decree No. 23 of March 14, 2011), and the legislative decree on the harmonization of budgets (Legislative Decree No. 118 of June 23, 2011).
to finance health care (83 percent of total revenue). Starting in 2014, several measures have gradually compressed the tax base in the labour component, creating a significant impact on overall revenue. In fact, together with the effects of the economic crisis, the measures to sterilize the cost of labour generated a revenue loss of 30 percent between 2008 and 2018 (Ferretti et al., 2021). The regional surtax on IRPEF (national income tax) accounts for 11 percent of total tax revenues in the regions. However, the regional use of this tax to replace central government transfers could amplify the problems that already plague the national IRPEF, and are mainly attributable to evasion and territorial disparities (Lagravinese et al., 2018).

The OECD taxonomy (Fiscal decentralization database) is useful to better understand the level of autonomy of subnational governments in Italy. This classification is based on five macro-categories that represent in a decreasing manner the level of autonomy of territorial governments. The typology of tax revenues of subnational Italian governments is characterized by a system basically polarized into categories B and D and, in particular: i. Discretion on rates within upper/lower bounds (52% as share of subcentral tax revenues), ii. Tax sharing arrangements where revenue is a split set with subnational governments consent (32% as share of subcentral tax revenues). Only 14% of subnational governments have discretion over rates and reliefs.

However, between 2008 and 2011, because of the economic crisis, there was a freeze on the processes that should have led to fiscal federalism. Attempts to establish the process of financial autonomy were partially hindered by central government legislation enacted during that period to cope with the delayed economic crisis and reduce public spending and net borrowing. The regions, as well as local governments, were asked by the central government to make a considerable financial effort to contribute to the country’s financial balance, as pursued by the Stability Pact (Mangiameli, 2013). The result of such interventions has been to reduce both the autonomy of the regions ‘own’ taxes and the taxable amount of revenues.

IV. THE ROLE OF THE CONSTITUTIONAL COURT

Constitutional jurisprudence has played an incisive role in determining the path of implementation of fiscal federalism, especially since 2008, due to national policies aimed at consolidation of the public finances (Filippetti & Tuzi, 2020). The Court’s decisions on the financial autonomy of the regions and Local Authorities were decisively affected by Constitutional Law No. 1 of 2012 and Reinforced Law No. 234 of 2012, which were enacted to make the constitutional dictate operational, extending the principle of balanced budgets between revenues and expenditures and the principle of debt sustainability to territorial autonomies, in compliance with the provisions of the European Union (Rivosecchi, 2016; Salerno, 2012).

The quantitative analysis of the Constitutional Court’s decisions in the central government-region disputes provides for useful information concerning the path of implementation of fiscal federalism. The Constitutional Court’s decisions are analysed by employing a novel dataset developed by the authors, collecting decisions from the Court regarding disputes between the central governments and the regions during the

---

9. A) Autonomy over tax rates and reliefs; B) Autonomy over tax rates; C) Autonomy over tax reliefs; D) Tax sharing arrangements; E) Central government sets tax rates and reliefs; F) None of the above. The category A codes characterize taxes over which subnational governments have the highest level of tax autonomy, setting both tax rates and tax reliefs. Categories B and C cover situations where subnational governments could set either rates or reliefs, but not both. Category D covers tax sharing arrangements. Categories E and F cover situations in which subnational governments have no tax autonomy, or to which the other codes do not apply.
period 2001-2022. The single records present in the dataset are the single rulings within each decision. For each record the following information was gathered: the plaintiff, the defendant, the subject, and the outcome of the dispute. Each ruling examined different items relating to the disputes and could involve different regions. Consequently, the ruling is disaggregated into different observation units relating to each item of the dispute, and subsequently these units are further disaggregated considering the regions involved in the dispute. For this reason, based on total decisions (“sentenze”) analysed (about 2,340), the number of rulings become about 5,500.

The next graph (fig. 1) illustrates how the Court's decisions regarding matters of public finance (Const. articles 117 c. 2, 117 c. 3 - coordination of public finance and the tax system, 119 - about budget balance) are among the most abundant.

Figure 1. Number of central government-region disputes by subject matter (number of rulings)

Source: Issirfa - CNR dataset. Own elaboration.

10. For each dispute between the central governments and the regions the Court issues a decision (“sentenza”) that could include more rulings (“capo di dispositivo”) because the plaintiff may raise different items, each requiring a distinct ruling.
The temporal dynamics of the conflicts in terms of the plaintiff (fig. 2) concerning the issues of finance show a greater activity among the regions towards preserving or seeking greater spaces of autonomy.

**Figure 2. Trend of central government-region public finance disputes (number of rulings)**

![Graph showing trend of central government-region public finance disputes](image)

Source: Issirfa - CNR dataset. Own elaboration.

The temporal dynamics of conflict outcomes concerning financial matters (Fig. 3), results in a significant prevalence of decisions that are favourable to central government, as well as a slight extending of the gap over the time. The increasing potential of the regions to win the petition in the years following the Title V reform is noteworthy, as is the process of closing gap during the COVID crisis. Another relevant aspect is the presence of a significant difference in the number of disputes before 2011 and after 2012. In the former case, the number of rulings averages about 100 per year; whereas, from 2012 onward, the number of rulings increased considerably, remaining above 200 per year in the years 2012-2014, and then declining. This suggests that in correspondence with the re-centralization process, that started with the so-called legislation of the crisis from 2011, financial aspects become particularly relevant in central government-region disputes. This was consistent with the fact that the legislation of the crisis acts in an important way to influence aspects concerning the allocation of finance coordination to central government, also in compliance with new financial constraints imposed by the European Union.  

11. On September 2010, the so-called Six Pack was approved; on 2012, the Treaty on Stability, Coordination and Governance (TSCG) so-called Fiscal compact was signed by EU member states.
The data seem to confirm the Court persistently supports central government measures affecting regional finance issues. This can reasonably be attributed to the fact that the Court systematically allows central government to adopt financial coordination measures that are conditioned by obligations imposed by the European Union aimed at safeguarding the stability of the public finances (Filippetti & Tuzi, 2020).

V. THE FINANCIAL CRISIS IN 2008 AND THE EVOLUTION OF SOME KEY INDICATORS

Article 117 of the Constitution, as amended in the 2001 law, provided for the central government’s competences on public finance coordination by committing the regions and local governments to contribute to public finance targets. More explicit obligations were provided for by the novel formulation of Article 119 of the Constitution, as amended by Constitutional Law No. 1/2012, which was aimed at introducing the principle of a balanced budget. The latter, in addition to specifying that the financial autonomy of territorial entities (municipalities, provinces, metropolitan cities and regions) is ensured by the balance of their budgets, provides that subnational governments contribute to ensuring compliance with the economic and financial constraints that arise from Italy’s membership of the European Union. The possible ways in which subnational governments contribute to public finance can differ (e.g., cutting central transfers, spending reviews, obligations to contain specific items of expenditure, etc.). To meet its European commitments under the Growth and Stability Pact, central government pursued the goal of improving the sustainability of public finance. Among the goals to be achieved were to bring the ratio of public debt to a level where it does not exceed 60% of GDP.

The next figure (4) shows the trend in the ratio of public debt to GDP for two levels of government; e.g., central government and the regions, since the early 2000s. The dynamics for central government show a steady increase after 2008. The process of
progressive reduction of this ratio, undertaken in the first years after the signing of the Maastricht Treaty, ceased abruptly with the outbreak of the crisis in 2008, at which point the ratio started to grow again. The recent health crisis led to a further increase in the debt/GDP ratio, and was substantially related to the contraction of production due to the economic crisis generated by the pandemic. The data for the regional governments exhibits a different pattern. In fact, the debt/GDP ratio of the regions increases significantly in the first decade of the 2000s until the crisis erupted in 2008. After that it reduced significantly in response to the tightening up of the local stability pact, which was enhanced by central government.

**Figure 4. Debt as percentage of GDP (%)**

All countries experienced a decline in GDP after the financial crisis struck. By 2014, Italian GDP per capita was 15.6 percent lower than it pre-crisis peak (Bozio et al., 2015). The recent health crisis and subsequent economic crisis, both of which caused significant contractions in production worldwide, further increased the debt-to-GDP ratio. As for the subnational levels of government, the upward trend in the debt-to-GDP ratio was interrupted soon after the crisis, due to the introduction of very severe central government regulatory measures for the regions and local governments, who were seeking to keep debt under control.

During the years of the economic crisis, the requirement for public resources to cover debt and contain budget deficits meant that successive governments developed economic-financial measures that severely affected regional autonomy, which is responsible for providing the majority of services to people (Mangiameli, 2013).

The Italian decentralization process has adopted characteristic features that differentiate it from that of other countries. The trend in central government spending has not declined consistently with the decentralization process; on the contrary, the curves for the ratio of spending to GDP by central and local governments tend to diverge (fig. 5). This is in contrast to what happened in other countries, where the process of decentralization led to a clear substitution effect between the two levels of spending (Tuzi, 2016).
Expenditure on obligatory social security and welfare benefits, charged by central government, is the largest item affecting public finance, and is constantly increasing. For this reason, obligatory social security has been the subject of legislative measures aimed at reducing its impact on public finance over time. Contributing heavily to social security spending are welfare benefits, such as civil disability, accompaniment, social allowances, war pensions, and additional welfare benefits that supplement the social pension, such as minimum wage supplements, social surcharges, additional amount, and fourteenth month pay, which also depend on the inefficiency of the administrative apparatus.

Meanwhile, the requirement to participate in achieving public finance targets led the regions to engage in considerable financial efforts to contribute to the country’s financial balance. Exemplifying this was the case of the contribution made by regions with ordinary statutes in terms of expenditure reduction in the post-crisis period. As shown in Figure 6, in the period 2010-2015, current spending fell by only about 2 percent, whereas the decrease in capital spending was significant, contracting by about 32 percent. Thus, regions with ordinary statutes coped with public finance manoeuvres by minimally reducing spending, implementing the largest cuts to investments.

---


---

Figure 5. Consolidated public expenditure by administration (as % of total public expenditure)
Figure 6. Regional spending trend (as % variation from 2010)


The results of these cuts has been that all reductions achieved in public spending in Italy have been achieved through cuts in spending on public services, leading to a decrease in the level and quality of the services provided (Bozio et al., 2015). Through a peculiar interpretation of the concurrent subject matter “coordination of public finance” during the crisis, every form of central government intervention in terms of resource cuts was legitimized to the point of preventing regions from performing the administrative functions assigned to them. The direction of this economic policy was maintained over the following years, thereby weakening the financial capacity of the regions.

VI. CENTRAL GOVERNMENT TRANSFERS AND THE REGIONS’ OWN REVENUES

The complete implementation of financial autonomy should have involved overcoming central government transfers to the regions, except in cases where these had an institutional justification. To better understand the complex path towards financial autonomy since the beginning of the economic crisis of 2008, the ratio between current financial transfers from the central government to the regions and own revenues over the 2008-2020 period as well as the performance of the same aggregates during the pandemic period is analysed here.

Data regarding central government transfers and own revenues of the regions were extracted from the SIOPE (Information System on Public Entities Operations), which is an information system that tracks public administration cash receipts and payments. The SIOPE survey constitutes the main source of information for monitoring public accounts, through real-time recording of the cash requirements of public administrators, and the acquisition of information necessary for the timely preparation of national accounts statistics. Launched in 2003, SIOPE has undergone subsequent modifications and improvements, and today the system integrates accounting information relating to both cash inflows (receipts) and outflows (payments) and the stock of financial assets of institutions belonging to the public administration sector. Cash management (which is the object of SIOPE's monitoring) can provide a reliable view of the actual financial situation of the regions for the purposes of this study, because the results
SIOPE is broken down into management codes that can allow the analysis of specific items. Consequently, the dataset was elaborated by aggregating, for each year and for each region, current transfers, capital transfer and own resources. Included in current transfer are all collected codes associated with cash inflow relating to sums transferred by central government to the regions to fulfill running costs; capital transfers comprises all codes associated with cash inflow related to sums earmarked for investment. Similarly, all codes related to cash inflow are connected to the regions’ own revenues (i.e., regional tax on production activities, regional surtax on personal income tax, motor vehicle taxes, regional tax on motor gasoline…) and were aggregated to obtain the total value of their own revenues.

The dataset obtained allowed reconstruction of time series data for each regions’ central transfers and own revenues. The analysis below refers only to own revenues and current transfers, because the latter type of resources, covering running costs, better highlights the weight of central fund transfers to the regions, especially during times of crisis, such as the pandemic period (e.g., health care expenditures).

Figure 7 shows the absolute value in millions of Euros of current transfers provided by the central government and the regions’ own revenues over the period 2008 to 2020 for each region. Current transfers show values higher than own revenues, especially in some southern regions (Campania, Sicily, Apulia), highlighting the importance of central government funds to these regions.

**Figure 7. Trend in current transfers and own revenues x region (million Euro)**
The next figure (8) shows absolute value in millions of Euros of current transfers provided by central government and the regions’ own revenues over the period 2008 to 2020 by macro area. In the case of the southern regions, the total amount of current transfers increased significantly in the post-financial crisis years, i.e. from 2011 to 2016.

**Figure 8. Trend in current transfers and own revenue x macro area (million Euro)**

![Graph showing trend in current transfers and own revenue by macro area](image)


Below, the trend in ratio of current transfers to own revenue measures each regions’ fiscal autonomy. The higher the value of the index, the greater the magnitude of the current transfers relative to own revenues, and the lower the financial autonomy of the region.

Figure 9 shows the index is higher in the case of the southern regions, confirming the importance of government funding for these regions. This is even more evident in the next figure (10), where the trend in the ratio of current transfers to own revenues by macro area is shown.

Dependence on central government is marked, especially for the southern regions: in the most severe phase of the financial crisis, transfers account for more than 100 percent of own revenues, reaching 140 percent in 2016. Conversely, in the case of the northern and central regions this share always largely remains below 50%.
Figure 9. Trend of ratio current transfers versus own revenues by region (%)


Figure 10. Trend of current transfers versus own revenue x macro area (%)

VII. CENTRAL GOVERNMENT TRANSFERS DURING THE PANDEMIC

The lockdown phase linked to the pandemic emergency had extraordinary repercussions for economic activity, with a contraction in gross domestic product that was unprecedented since World War II. This led to a fall in tax revenues, which was compounded by various central government measures that allowed the deferral of tax payments. This led to a fall in taxable income at the central level, as well as at regional and local levels.

Figure 11. Trend of current transfers versus own revenue per region (%)

![Figure 11: Trend of current transfers versus own revenue per region (%)](image)


Figure 11 shows the trend in the index given by the ratio of current transfers and own revenues in the pandemic period. A generalized increase in the index during 2020, as compared to the previous year in all the regions is marked; the amount of current central government transfers then declines again in 2021, and consequently the index also fell. Differences between geographic areas in the values of the index given by the ratio of current transfers to own revenues persist and widen proportionally, with the southern regions remaining the largest recipients of transfers from the central government (fig. 12).

Table 1 shows how the increase in central transfers is linked significantly to the increase in funding for the National Health Fund (NHSF). In fact, notably, although in 2020 the share of transfers for the SNF increased for all geographic areas, it was the northern regions that showed the largest increase (+ 87 percent compared to 2019), followed by the central regions (+ 33 percent compared to 2019). While data for 2021 reveals a contraction in National Health Fund funding for regions in the Centre and South compared to 2019, the Northern regions continued to receive higher funding (+48% compared to 2019). This seems to reflect the geographic distribution of the pandemic, which was heavily concentrated in those regions, especially during the first wave.
The first conclusion to be drawn from the analysis presented here is that regional financial autonomy as introduced by the 2001 reform of Title V of the Italian Constitution was never fully implemented. The trend in central government spending has not declined consistently with the decentralization process, as happened in other countries. Attempts to foster financial autonomy have also been partially eroded by legislation following on from the financial crisis, with respect to which no progress has been made in recent years.

Low regional fiscal autonomy is reflected by the ongoing significant dependence on central government financing. The dependence of regional budgets on central transfers has not fallen, but has rather tended to increase since 2008, especially for the southern regions. Consequently, regional fiscal autonomy has reduced over the same period.
The data presented are consistent with a process of re-centralization of legislative space and financial autonomy by central government beginning in the 2011-12 season, characterized as the so-called legislation of the crisis. With the financial crisis of 2009 and the sovereign debt crisis in Europe in 2011, the season of re-centralization began, sending the pendulum of regionalism back to the opposite, unitary extreme. Specifically, starting with the technical government led by Mario Monti in 2011, a series of measures were implemented introducing some regulatory tools of regional (and local government) autonomy back into the sphere of the central government budget and public finance coordination. That also occurred because of the introduction of European Union’s Stability and Growth Pact, which imposed new financial constraints, especially on member countries with high public debt.

The very high and persistent debt-to-GDP ratio, linked to the continuing contraction of economic activity worsened by the 2009 crisis and meaningful interest spending, significantly deteriorated the situation of Italian public finance. Consequently, the series of central government measures implemented since 2010 have affected regional public financing, as well as the discipline of fiscal federalism. The requirement to participate in the achievement of public finance targets led regions to require considerable financial effort to contribute to the country’s financial balance in terms of expenditure reduction in the post-crisis period, thereby impacting on the level and quality of the services provided.

The process of bringing regionalism back under the umbrella of central government, and coordination of public finance takes on a constitutional level with Law No. 1 of 2012, which allowed central government law to intervene, even in regional matters where financial issues were involved. The coordination of public finance thus ended up representing “the cornerstone of the entire public finance system” and allowed “recessive interpretations of decentralized financial autonomy” (Salerno, 2012, p. 8). The result has been a retreat from the form of regional financial autonomy that overlooked the fiscal federalism provisions of the Law No. 42. Today fiscal federalism remains largely unimplemented.

The pandemic crisis increased the need for central government involvement, in some ways highlighting the dependence of the regional system on central government, even for what had been considered fundamental function of the regions, such as health care. At present, regional finance remains part way between regional fiscal autonomy and central governance, as the government retains strong control over regional taxation.

The territorial divide that characterizes Italy also tends to be reflected in the implementation of fiscal federalism, as is evident for example in the strong dependence of the southern regions upon central transfers. This dependence, in the case of the southern regions, also seems to be reflected in their ability to efficiently manage public services and in general all the functions over which the regions have competencies. Health care is only the most macroscopic example, but to this can be added other functions, which are crucial for economic development, such as training and productive activities. This suggests how the resolution of the socio-economic gap between Italian regions is linked to the effective and efficient implementation of fiscal federalism and regionalism more generally.

Moreover, this also relates to the process of asymmetrical decentralization. Already beginning in 2006, some regions (i.e., Veneto and Lombardy), on the strength of the provision of Article 116 third paragraph of the C, began to articulately advance to the government requests for greater autonomy on certain areas of particular importance. New impetus came from referendum initiatives in late 2017 put forward by Veneto, Lombardy and Emilia Romagna, aimed at initiating negotiations with the government to recognize new and broader conditions of autonomy. The process toward greater space for autonomy, which was then halted by the pandemic, is today back at the centre of political debate (Mangiameli et al., 2020; Arabia et al., 2020; Palermo, 2019). The outcome of this process will inevitably be intertwined with the long and still unresolved journey of fiscal federalism.
REFERENCES


Nigeria: Federalism in the COVID-19 Period and Beyond

by Dele Babalola
Canterbury Christ Church University

ABSTRACT

Nigeria, a three-tiered federation, provides an intriguing example of how the 2008 and 2016 global financial crises, as well as the COVID-19 crisis, have had a significant impact on the practice of federalism in the country. These crises precipitated severe global economic downturn, and Nigeria was not exempt, putting the country’s fiscal system to the test. As a significant oil exporter, Nigeria was impacted by the global oil price decline of 2008. Similarly, the 2016 financial crisis, which was precipitated by falling oil prices, exacerbated Nigeria’s struggling economy, as the federal government struggled to maintain its expenditures, resulting in a reduction in revenue allocations to the states of the federation. Nigeria’s oil-generated revenue is exclusively concentrated in the centre and shared among the three levels of government according to some agreed formula. The COVID-19 pandemic revealed additional flaws in Nigeria’s federal system, highlighting the disparate crisis response capabilities of states and local governments. In its attempt to manage the pandemic, the federal government adopted a top-down strategy, illustrating the overcentralised character of the federal system, which is the result of decades of military rule and excessive oil dependence. The management of these crises reignited the debate about the efficacy of federalism in Nigeria, and this article is a contribution to that debate, contending for a non-centralised federal system in which state governments cease to operate as extensions of the federal government. In addition, it argues for fiscal federalism in accordance with the federalism principle requiring each level of government to have the financial capacity to operate independently.

Keywords: Nigeria, federalism, fiscal federalism, COVID-19, centralisation.
I. INTRODUCTION

This article examines how the 2008, 2016, and COVID-19 global crises affected Nigeria’s economy and the country’s practice of federalism. In doing so, it explores the vertical and horizontal intergovernmental relations throughout the periods, especially during the pandemic, as well as the complexities surrounding which level received what percentage of national revenue. There is no doubt that the 2008 and 2016 global financial crisis had a devastating impact on Nigeria. However, this article focuses more on the COVID-19 crisis, which also had an impact on Nigeria’s revenues, particularly oil-generated revenues, because the effects of this crisis are still being felt worldwide, including in Nigeria. The aim of the article, therefore, is to use both primary and secondary data to examine Nigeria’s response to global financial crises and the COVID-19 pandemic through the fiscal system of the country’s federal framework. Nigeria is a federation made up of a Federal Capital Territory (FCT), 774 local governments, and 36 states, and the country’s population is estimated to be 200 million. The governors of each state serve as the chief executives of their respective states under Nigeria’s executive presidential system, which is modelled after that of the United States. The federal legislature is bicameral, while state legislatures are unicameral. While a state legislature is referred to as the House of Assembly, the federal legislature, which consists of the Senate (upper house) and the House of Representatives (lower house), is referred to as the National Assembly.

Due to the high level of poverty and inadequate health infrastructure in Africa, there were numerous pessimistic forecasts regarding the potential effects of COVID-19 (Babalola, 2021; Ihonvbere, 2022; Onapajo & Adebiyi, 2020). The overwhelming majority of Africans live in absolute poverty, but the effects of the virus on the continent were not as catastrophic as anticipated. This is not to say that countries such as Nigeria, South Africa, Morocco, and Tunisia, among others, did not experience the socioeconomic effects of the pandemic, which exacerbated poverty on the continent. Nigeria confirmed its first case of COVID-19 on February 27, 2020, in Lagos, the country’s former capital and commercial centre, when an Italian national who works in Nigeria tested positive for the virus (Babalola, 2021). Following the identification of the index case, the federal government moved swiftly to curb the spread of the virus. The federal government took the lead in providing care for those infected and putting in place social welfare programmes to support low-income earners while state governments collaborated with the federal government in the distribution of relief materials. The local governments were, however, less visible during the crisis. The pandemic brought into sharp focus the overcentralised nature of Nigeria’s federal system.

This article is organised into nine sections, one of which is the introduction. The second section discusses the nature of Nigerian federalism. For a thorough comprehension of the operation of the country’s federal system, it is necessary to understand the system’s excessive centralisation. In the third section, a general overview of Nigeria’s fiscal system is provided. The section concentrates on the country’s distribution of centrally generated revenues, such as oil revenues. While the fourth section focuses on the impacts of the global financial crises of 2008 and 2016 on Nigeria, the fifth section examines the contribution of the federal government and its agencies to the struggle against the COVID-19 virus. During the crisis, the federal parliament and a few federal institutions

---

1. Nigeria started as a federation of three constituent units – Northern, Western, and Eastern Regions. The number increased to four in 1963, when the Mid-Western Region was separated from the Western Region. At the onset of the civil war in 1967, the Yakubu Gowon regime (1966 – 1975) partitioned the federation into twelve states, while the Murtala Mohammed regime (1975 – 1975) added seven states to the extant twelve, bringing the total to nineteen. The Babangida military regime (1985 – 1993) further created two states in 1987 and another nine in 1991, and the Abacha military regime (1993– 1998) transformed the country into its current 36-state structure (Babalola, 2019, pp. 136-138; Onapajo & Babalola, 2021, p. 67).
played crucial roles, which cannot be overlooked. Likewise, the sixth section discusses the respective contributions of state and local administrations. In the seventh section, we examine the cooperation and conflict that characterised vertical and horizontal intergovernmental relations throughout the pandemic. The eighth section examines the continuity that has characterised Nigeria’s fiscal federalism since the pandemic while the final section argues that management of the pandemic exposed the excessive centralisation of Nigeria’s federal system. The section also contends for a system reform.

II. THE CHARACTER OF NIGERIAN FEDERALISM

Federalism is the ‘method of dividing powers so that the general and regional governments are each, within a sphere, co-ordinate and independent’ (Wheare, 1963, p. 10). Following on from this definition, King (1982, p. 74) also defines federalism as a political principle which involves the constitutional diffusion of power between the central and constituent governments. At the core of these definitions is the notion that, in a federation, the division of governmental power is guaranteed by the constitution. In addition, Wheare’s idea of ‘independence’ implies that both the federal and state governments have independent functions, and neither has authority over the other. This differentiates a federation from a confederation, which is also an association of states, but in which the central government is dependent on the regional governments (Wheare, 1963, p. 32). It is essential to note, however, that it is impractical for the federal government and regional governments not to depend on each other in some capacity. Nonetheless, the exclusive centralisation of power in Nigeria’s federal system violates Wheare’s fundamental principle of independence, which explains why the state, local governments, and FCT depend significantly on the centre for sustenance.

Unlike in established federations such as the United States or other ‘coming together’ federations, the Nigerian federal government created the states. According to William H. Riker, federalism is ‘a bargain between prospective national leaders and officials of constituent governments’ (1964, p. 11), typically for the purpose of territory consolidation. At the time of Nigeria’s federal formation, the constituent units lacked the requisite bargaining power to negotiate a federal union, so there was no political bargaining between two groups of legislators. This partially explains why state governments in Nigeria lack autonomy and sometimes exist at the whim of the federal government. In Nigeria, states are predominantly created for political, not economic, reasons. According to Babalola (2015, p. 84), state creation in Nigeria is in many ways about accommodating ethnic minority groups or giving them access to the country’s distributive system. The politics surrounding the creation of states in the country are well documented and will not be revisited here (Babalola, 2019; 2015; Babalola & Onapajo, 2019; Onapajo & Babalola, 2021; Osaghae, 1998; 2003; Suberu 1998; 2001).

Babalola and Onapajo (2019, p. 44) note that state and local government creation was a major feature of Nigeria’s federalism during the military era, supporting Martin Dent’s (2000, p. 162) claim that Nigeria’s ability to subdivide states and local government units is comparable to the subdivision of cells in a growing organism. As provided for in the Constitution, states are supposed to be independent of the federal government, and local governments are supposed to be independent of federal and state governments but in practice, local governments are subordinate to state governments (Babalola, 2019, p. 106). The Constitution of Nigeria provides for exclusive, concurrent, and residual legislative lists (FGN, 1999). The exclusive list includes responsibilities assigned solely to the federal government, such as defence, currency, foreign policy, and so forth, while shared responsibilities, such as education, are assigned to both the federal and state governments. Residual responsibilities are delegated to the state governments. This was the case at the outset, when regional governments were permitted
to pass laws regarding any matter that is not included in the exclusive legislative list (the 1954 Constitution, cited in Suberu, 2022, p. 5). In the event of a conflict on the concurrent list, it is essential to note that federal law takes precedence. Local governments’ constitutional responsibilities include the provision of services that benefit the local populace, such as primary and secondary education, waste disposal, birth registration, etc. (Babalola, 2019, p. 106).

Nigeria’s federal system was ‘bottom-heavy’ at its inception in 1954 and prior to the military takeover in 1967, as subnational units enjoyed extensive political and financial autonomy (Babalola, 2019; Nolte, 2002). According to Suberu (2022, p. 4), the 1954 Constitution, which aimed to accommodate the country’s sub-nationalisms, established a strong central authority while granting substantial autonomy to the country’s three constituent units – the Northern, Eastern, and Western Regions. The military era coincided with the beginning of the 1970s oil boom, and the increased inflow of oil rents into Nigeria’s economy ushered in a new era of a politically and economically powerful federal centre (Babalola, 2019, p. 5), or what Suberu (2001; 2022) refers to as ‘hyper-centralisation’, which is presently the defining characteristic of Nigeria’s federal system. This explains why all ‘eyes are on the centre’ (Babalola, 2019, p. 159). The command structure of the military, the requirements of the Civil War (1967–1970), and the management of the oil economy ensured the federal government’s economic pre-eminence. The military institutionalised a system typified by ‘tightly centralised controls’ (Suberu 2001: 1), resulting in a dominant federal government and economically impotent states. This contradicts the federal principle, which requires each constituent unit to be financially independent. For instance, Wheare (1963, p. 51) emphasised the significance of the constituent units’ economic viability to the formation, operation, and survival of a federation. In other words, states are expected to be able to support themselves economically.

As scholars of federalism have argued to varying degrees, federalism is not only about the division of powers, but also about ensuring that powers are diffused among numerous centres. According to Elazar (1987, p. 34), federal polities ‘are characteristically non-centralised’. However, by the time democratic rule was re-established in Nigeria in 1999, the system had shifted from being ‘bottom-heavy’ to ‘top-heavy’ (Babalola, 2019; Suberu, 2001; Elaigwu, 2002). As oil rents continue to flow into the country’s revenue account, the federal system remains centralised, and the states remain economically dependent on the federal government (Babalola, 2019).

III. NIGERIA’S FISCAL FEDERALISM IN CONTEXT

The practice of fiscal federalism varies from federation to federation, but revenue distribution between levels of government is a defining characteristic. Both the general and constituent governments compete for the federation’s limited resources (Babalola, 2019, p. 79), making revenue sharing in a federal state a cumbersome task. Similar to other federal states, fiscal federalism in Nigeria emphasises the distribution of the federation’s fiscal resources. In Nigeria, revenue sharing takes the form of conditional and unconditional grants, which play crucial roles in the country’s fiscal operations. According to Watts (1999, p. 43), grants can enable or restrict the exercise of constitutionally mandated government responsibilities. In other words, the importance of fiscal federalism lies in the fact that financial resources: play a large part in determining the relative political and economic roles and influence of the different governments within the polity; are a major means for facilitating flexibility and adjustment; and shape public attitudes about the costs and benefits of the activities of different governments (Watts, 2003, p. 2).
Section 162(1) of the Nigerian Constitution stipulates that the federal government deposits all centrally collected revenues into a general pool, known as the Federation Account, to be shared between itself, the state, and local governments according to an agreed formula, while Section 162(3) stipulates that the federal government makes regular, unconditional grants to states annually to enable them to carry out their constitutional responsibilities. Figure 1 depicts the vertical allocation formula for sharing the contents of the Federation Account.

Table 1: Nigeria’s current vertical revenue allocation formula

<table>
<thead>
<tr>
<th>Recipient</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Government</td>
<td>48.5</td>
</tr>
<tr>
<td>State Governments</td>
<td>24</td>
</tr>
<tr>
<td>Local Governments</td>
<td>20</td>
</tr>
<tr>
<td>Special Funds</td>
<td>7.50</td>
</tr>
</tbody>
</table>


This sharing formula demonstrates the federal government’s dominance in the fiscal sphere. In addition to these unconditional statutory allocations, the federal government also makes non-statutory allocations to states. Non-statutory grants, which may be conditional or for a specific purpose, are typically given to a state facing an emergency, such as natural disasters, terrorist acts, infectious diseases like COVID-19, and similar problems (Babalola, 2021, p. 144; Babalola, 2019, p. 85). Clearly, conditional grants provide the necessary financial support for subnational entities, but they tend to restrict the independence of the recipient as is the case in Nigeria. According to Babalola (2019, p. 84), these grants amount to encroachment in the recipient government’s affairs and may result in the recipient becoming subordinate to the federal government. Currently, oil-producing states receive additional 13% of oil revenues from their state in addition to whatever revenues they receive from the Federation Account. This is founded on the principle of derivation. In the Nigerian context, “derivation” refers to the method of distributing centrally generated revenues to states of the federation in proportion to their respective contributions to the country’s overall revenue (Babalola, 2019, p. 8).

Scholars of federalism have argued that a federation must possess the capacity to operate itself, and both the general and subnational governments must possess sufficient economic resources to maintain their territories (Maddox, 1941, p. 1125; Wheare, 1963, p. 36). Wheare (1963, p. 93) specifically argued that if the federal principle is to operate in law and practice, both the general and regional governments must possess adequate financial resources to enable them to perform their functions optimally. In Nigeria, however, the federal government collects ‘juicy’ taxes such as import and export duties, corporation tax, value-added tax (VAT), excise duties, mining rents and royalties, petroleum profit tax, and personal income tax from the armed forces, police, and residents of the Federal Capital Territory (FCT), which it shares with the states, according to the formula in figure 1 (Babalola, 2019, p. 91). This explains why state and local governments are perpetually dependent on the federal government. The reliance of states on federal financial transfers during the global crises of 2008, 2016, and the COVID-19 became evident.
IV. THE 2008 AND 2016 GLOBAL FINANCIAL CRISIS, AND NIGERIA’S FISCAL FEDERALISM

The 2008 global financial crisis, which precipitated a global recession, had a significant impact on the economies of all countries in the world, including Nigeria, which is a major oil producer and exporter. Indicative of the decline in the global price of oil was the movement from a peak of approximately $147 per barrel in July 2008 to a low of approximately $50 per barrel in December 2008 (cited in Ayam, 2010, p. 72). The public finances of the federal and state governments in Nigeria were negatively impacted. Given that Nigeria’s fiscal system is characterised by revenue sharing between the federal government and state governments, it is anticipated that a contraction in the national economy would have an impact on revenue allocation to states. Nigeria’s tax revenue decreased as a result of the global recession, which also reduced the country’s economic activity. Nigeria relies significantly on oil revenue to fund its public expenditures, but the crisis had resulted in a significant decline in oil prices, which had an effect on Nigeria’s export earnings (Ayam, 2010). Due to the global nature of the crisis, Nigerians in the diaspora were unable to make appreciable remittances, which affected the disposable income of Nigerians who rely significantly on transfers from relatives abroad. To bridge the fiscal gap, Nigeria was forced to borrow, resulting in a rise in public debt, which strained the country’s public finances. As a result, the global financial crisis triggered an economic recession in Nigeria, resulting in a decrease in revenue allocation to states, thereby limiting the fiscal capacity of state governments to carry out their constitutional responsibilities, such as the provision of public services.

Similar to the 2008 crisis, the global financial crisis of 2016 was caused by a decline in global commodity prices and a downturn in China’s economy, and it had a significant impact on national economies worldwide. During the oil price crash of the 1980s and 2008, the country faced a comparable circumstance. Like what occurred in those periods, the collapse in crude oil prices in 2016 resulted in a decline in the country’s foreign exchange earnings, which led to a severe economic hardship. According to a World Bank report, the average price of crude oil fell from approximately $112 per barrel in 2014 to approximately $45 per barrel in 2016 (World Bank, 2018). As experience shows, whenever the global oil price declines, Nigeria’s crude revenue declines, as do the country’s expenditures. Over two-thirds of the states in Nigeria were on the verge of bankruptcy as a result of a massive reduction in federal expenditure and a sharp drop in federal allocations and had to be bailed out by the federal government, which was also in a financial mess (Babalola & Okafor, 2019). As Nigeria is a mono-product economy, the decline in oil revenues caused a recession that led to a slowdown in economic growth, high inflation, and an increase in government debt. The World Bank reported that Nigeria’s inflation rate increased from 9.6% in January 2016 to 18.55% in December 2016 (Premium Times, 2017). To close the fiscal gap, the federal government had to resort to borrowing. Nigeria’s Debt Management Office (DMO) reports that Nigeria’s total debt increased from 12.6 trillion in 2015 to 17.4 trillion in 2016 (DMO, 2016, p. 16). The country’s current debt accounted for 23.4% of GDP in 2016 (see figure 1).
Figure 1: Nigeria’s Gross Debt-to-GDP Ratio

Sources: World Economics (n.d); and Statista (n.d).

The global financial crisis of 2016 and the COVID-19 pandemic have combined to plunge Nigeria into significant debt, which has a negative effect on the performance of both the federal and state governments. By 2022, Nigeria’s total public debt had increased to 46.25 trillion naira ($103.0 billion) from 39.56 trillion naira a year earlier, as the federal government stepped up borrowing to finance its budget deficit (DMO, cited in Reuters, 2023).

V. FEDERAL GOVERNMENT’S RESPONSE TO THE COVID-19 CRISIS

Similar to previous crises, the Nigerian federal government viewed the pandemic as ‘a national challenge’ and responded with a coordinated response (Ihonvbere, 2022, p. 162). It aimed to reduce morbidity and mortality associated with COVID-19, mitigate pandemic-related impacts on social, economic, and health infrastructure and systems, and facilitate post-pandemic recovery and rehabilitation operations (FGN, 2020, p. 6). On March 9, 2020, President Muhammadu Buhari established a 12-member Presidential Task Force (PTF) to coordinate and supervise the multi-sectoral inter-governmental efforts aimed at containing the spread of the pandemic in the country (NCDC, 2020). The PTF comprised of, among others, the Director-General of the country’s national public health institute, the Nigeria Centre for Disease Control (NCDC), the Secretary to the Government of the Federation, the country representative of the World Health Organisation (WHO) in Nigeria, the Federal Minister of Health, and representatives of other several federal ministries and agencies. Despite the goal of providing a coordinated ‘inter-governmental’ response, state governments were not represented on the PTF. The federal government also relied on the Quarantine Act of 1926 when it issued the COVID-19 Regulations of 2020, which declared the virus to be a ‘dangerous infectious disease’ (Abdulrauf, 2022, p. 360). The NCDC collaborated closely with the Presidency and the PTF to supervise treatment in isolation centres across the country and to provide daily press briefings with pandemic updates and scientific expertise (Babalola, 2021).

On March 29, 2020, the President proclaimed a nationwide closure of schools and universities, followed by a lockdown of Lagos state, neighbouring Ogun state, and the FCT Abuja, initially for 14 days, and then for an additional 14 days. Entertainment centres
and non-essential enterprises, such as churches and mosques, were closed, and international air travel was prohibited. It is essential to note that the President acted in accordance with the COVID-19 Regulations, which permitted the federal government to act in the national interest, even though he did not consult with the federal legislature. This appears to undermine state sovereignty, but the President’s action was lawful, and this was not the first time a federal government had exercised emergency powers. In Nigeria, the federal government has the authority to act on behalf of the states of the federation in the event of a national emergency or a severe collapse in law and order. In 1962, the Tafawa Balewa-led federal government declared a six-month state of emergency in the then Western region to quell the crisis that had engulfed the region (Babalola, 2019, p. 105). Similarly, in 2004, President Olusegun Obasanjo used this authority to declare a state of emergency in Plateau State due to the prevailing religious conflict (Babalola, 2019, p. 105). Also, at the start of 2012, President Goodluck Jonathan declared a state of emergency in the north-eastern states of Adamawa, Borno, and Yobe, where the reign of terror by Boko Haram was prevalent (Babalola, 2019, p. 105).

The pandemic had a devastating impact on the lives and livelihoods of people in the impoverished country. Many low-income earners, the majority of whom were petty traders, were unable to earn a livelihood as a result of restrictions of movement. To mitigate the effects, the federal government expanded its social development programme to provide cash transfers of NGN 20,000 (USD 52) to the ‘poorest of the poor’ (Ihonvbere, 2020, p. 1; Dixit, Ogundeji, and Onwudewe 2020). Additionally, the President ordered Nigeria Customs Service (NCS) to distribute confiscated bags of imported rice to those in need throughout the country. The food provisions were referred to as “COVID palliatives” and were distributed across the country. Not only were these insufficient to address the problem of hunger, but there were widespread allegations that politicians diverted palliatives to party loyalists and cronies.

It should be noted that federal legislators were not excluded from efforts to mitigate the effects of the pandemic. The National Assembly urged the federal government to immediately establish a special intervention fund to halt the spread of COVID-19 (Abdulrauf, 2022, p. 361). The House of Representatives ratified the Emergency Economic Stimulus Act of 2020 on 24 March 2020 to help businesses and individuals (Dixit, Ogundeji, and Onwudewe, 2020). In addition, Senators contributed fifty percent of their one-month salaries to the National COVID-19 Relief Fund, while House members contributed their entire March and April 2020 salaries (Ihonvbere 2020, p. 3; Ihonvbere 2022, p. 164).

The federal government’s response was as detrimental to the national economy and the people as the sit-at-home policies were to people’s mobility. The Nigerian economy is comprised of peasant labourers and labourers who rely on daily wages for survival. There is no denying that the restrictive measures were intended to adhere to WHO recommendations, but the population’s lack of trust in the federal government caused them to be viewed negatively (Onapajo & Adebiyi, 2020). Many Nigerians argued that COVID-19 was a hoax orchestrated by the country’s political establishment to create an emergency that would allow them to divert public funds. There is no doubt that the federal government made efforts to curb the spread of the disease, and it also responded to the socio-economic needs of low-income earners. However, these efforts were hampered by the corruption of state officials, who either hoarded or diverted relief supplies intended for the poor. In October 2020, during the nationwide EndSars protest, a dem-

---

2. The EndSars protest was a replication of the Black Lives Matter protests in the United States, United Kingdom, France, and many other countries, and was organised by the youths to express their displeasure with Nigeria’s feared police, the Special Anti-Robbery Squad (SARS), due to harassments and killings that target the youth constituency.
onstrators in nine states, including Lagos and the FCT, Abuja, discovered warehouses containing food items labelled as COVID palliatives. Some Nigerians believed that COVID-19 was not a disease of the poor, but rather a disease of the wealthy who travel internationally (Onapajo & Adebiyi, 2020). This argument may be supported by NCDC data, which reveals that the first 30 days following the confirmation of the index case revealed an elitist disease distribution, as most infected persons were returnees from abroad (Abdulrauf, 2022, p. 356). This view was also supported by the fact that known casualties included high-ranking Nigerians such as the president’s chief of staff, a senator, and a former state governor. In addition, it was also the myth that Nigeria’s climate was too intense for the virus to survive.

As was the case with many other items during the pandemic, only the federal government procured and distributed COVID-19 vaccines. Early in March 2021, the federal government acquired 3.94 million doses of Oxford/AstraZeneca vaccine via the COVID-19 Vaccines Global Access, COVAX (WHO Nigeria, 2021) and an additional 41 million doses from the African Union (Reuters, 2021). These vaccines were certified by the country’s National Agency for Food and Drug Administration and Control (NAFDAC), and the National Primary Health Care Development Agency (NPHCDA) was tasked with distributing them to the states and the FCT, Abuja. The federal government insisted that distribution was based on the number of cases recorded in each state, which explains why Lagos state received approximately 500,000 doses (Babalola, 2021, p. 143). State administrations argued that there was no clear formula for distribution, and that some states were favoured. The pandemic accelerated the centralisation of the federal system with the federal government calling the shots at every stage of the fight against the virus. This undoubtedly put a strain on its finances.

Prior to the pandemic, the Nigerian government had been contending with a sluggish recovery from the 2015 oil price shock, with GDP growth in 2019 declining to around 2.3%, and expected to further decline to 2% in 2020 (IMF, 2020). Similarly, the ratio of debt service to revenues was estimated to be 60%. Nigeria estimated that it would require $330 million to contain the pandemic. However, it raised more than $560.52 million, with more than 90% of that amount coming from the private sector and the donor/philanthropist community (Aregbeshola & Folayan, 2022). The Coalition Against COVID (CACOVID), a private-sector taskforce that was established on 26 March 2020 to collaborate with the federal government, NCDC, and WHO to mobilise resources across industries, had raised over $55.7 million as of April 6, 20203 (Aregbeshola & Folayan, 2022, p. 198). Like many things during the period, the federal government disbursed CACOVID funds. During the pandemic, the federal government determined which tier of government got what share of the national revenue.

As with other countries, the pandemic impacted the economies of Nigeria, the largest economy in Africa. The crisis affected Nigeria’s public finances in multiple ways. One significant consequence was the precipitous decline in government revenue which was due to the lockdown measures imposed by the federal government which resulted from reduced economic activity, leading to lower tax revenues and a decline in the demand for oil. Another factor contributing to the government’s diminishing tax revenue was a decline in foreign direct investment. Despite a decline in government revenue, the pandemic necessitated substantial investments in medical infrastructure, leading to an increase in healthcare expenditures (Aregbeshola & Folayan, 2022). Similarly, the federal government’s social intervention programmes led to an increase in government finance.

3. For the list of contributors to the CACOVID relief fund as of June 30, 2020, see https://www.cacovid.org/pdf/list_of_contributors_to_the_cacovid_relief_fund_as_at_30_June_2020.pdf
expenditure, which exacerbated the strain on public finances. The economic contraction caused a recession, which worsened the government’s financial difficulties. This compelled the Nigerian government to resort to borrowing to finance government expenditures, including emergency expenditures. As a result, as figure 2 shows, the debt-to-GDP ratio reached alarming levels, posing difficulties for debt servicing, and limiting the government’s ability to allocate funds to essential sectors like education.

The pandemic also affected the finances of state governments, which were also required to increase spending on healthcare infrastructure. Almost all states experienced a decline in revenue generation during the pandemic due to the decrease in economic activity and consumer spending. Similar to what occurred during previous financial crises, revenue allocations to state governments were reduced. This unquestionably affected the fiscal capacity of state governments and increased their debts. According to a report from the Debt Management Office (DMO), the total debts of Nigerian states grew substantially during the pandemic (DMO, 2020). According to Abdulrauf (2022, p. 368), there was no specific formula for disbursement during the pandemic because funds were ‘allocated to states based on the extent to which they were affected by the pandemic and the amount they had spent on critical infrastructure.’

VI. STATE AND LOCAL GOVERNMENTS’ ACTIONS DURING THE COVID-19 CRISIS

During the pandemic, state governments received cash donations from philanthropists in the states (Aregbeshola & Folayan, 2022), but these donations were insufficient, and the state governments were forced to rely on central government transfers. In a federation, the federal government has jurisdiction over the entire territory, whereas the constituent governments have jurisdiction over their respective territories. According to K. C. Wheare (1963, p. 2), a federation is:

an association of states so organised that powers are divided between a general
government, which in certain matters – for example, the making of treaties and
the coining of money – is independent of the government of the associated states,
and, on the other hand, state governments which in certain matters are, in their
turn, independent of the general government.

The response to the pandemic varied from one state of the federation to another, dependent on the resources available in each state, but the states largely followed the federal government’s directives. Lagos state’s management of the crisis merits mention. Lagos is the former capital of Nigeria, the country’s commercial hub, and a densely populated area, which explains why it was the epicentre of COVID-19. The state government established a task force to coordinate the activities of various state agencies, while the governor relied on pertinent state legislation to proclaim movement restrictions in the state (Babalola, 2021). In addition, the state government established COVID test centres in all Local Government Areas (LGAs) of the state and backed this initiative with an intensive public relations campaign (Ihonvbere, 2020). On March 26, 2020, the state legislature also enacted the Emergency Coronavirus Pandemic Act of 2020, which stipulated penalties for noncompliance with confinement regulations and authorised the governor to declare a state of emergency for up to three months (Abdulrauf, 2022, p. 363).

The Kaduna state administration was also very active during the pandemic. Even before a single case of infection was confirmed in the state, the state instituted quarantine and treatment centres (Babalola, 2021). On March 25, 2020, the state proclaimed a partial lockdown, becoming the first state to do so, even before the federal government announced its own lockdown. Also, the Borno state administration, which was
the epicentre of the Boko Haram insurgency, was proactive in announcing a partial lockdown. In general, state governments attempted to mitigate the social and economic effects of the pandemic by reversing lockdowns imposed by themselves or the federal government (Abdulrauf, 202).

Local governments were not left out in Nigeria’s response to the pandemic, assisting state administrations in conducting public awareness and education campaigns in rural areas (Abdulrauf, 2022, p. 365). In addition to this, they served as distribution points for food rations and other COVID palliatives. Ihonvbere (2020, p. 2; 2022, p. 161) observe that some local government chairmen ‘politicised the distribution only favouring their political factions or political party members.’

VII. INTERGOVERNMENTAL RELATIONS DURING THE COVID-19 CRISIS

Wheare’s conception of federalism emphasises dual federalism, which entails not only a division of functions between governments but also the autonomy of each government. Nevertheless, as Babalola (2019, p. 10) notes, some degree of interdependence and cooperation in areas affecting the lives of citizens is essential for the successful operation of any given federal system. National-state relations in Nigeria are frequently marked by conflict, but during the pandemic, Nigerians witnessed both cooperative and antagonistic federalism. According to Davis (1978, p. 183), cooperative federalism entails the cooperation of all levels of government, ‘together with all group and individual interests of society, in a complex pluralistic relationship of sharing, reciprocity, mutuality, and coordination.’ Contrary to the argument that cooperative federalism erodes state autonomy, Nigeria’s state governors took advantage of the relative autonomy of the states to implement containment measures suited to their respective states. In Nigeria, there are no distinct state constitutions, but governors utilised pertinent state laws to combat the virus. Through the Nigeria Governors’ Forum (NGF), an association of all state governors, state governors cooperated with the federal government by adhering to the PTF directives to implement interstate lockdowns. In addition to cooperating with one another, they fostered both vertical and horizontal cooperation (Abdulrauf, 2022, p. 367).

The atmosphere of cooperation was tainted when the federal government began allocating special intervention funds to the states. Lagos received the lion’s share of NGN 10 billion (USD 26.3 million) while Kano’s request for NGN 15 billion (USD 39.45 million) was denied by the federal government (Africa News, 2020). Meanwhile, Kano had previously denied reports of hundreds of COVID-related fatalities, claiming that the deaths were due to meningitis. The unequal distribution of funds strained national-state relations as the federal government was accused of favouring Lagos. However, the federal government defended itself by stating that Lagos was the most affected state and that the state ‘had invested heavily in pandemic response’ (Abdulrauf, 2022, p. 367). The federal government stated that the state began ‘on the right footing, rolling out proper plans and mobilising its funds to fight the pandemic,’ whereas the federal government needs to be convinced by what it sees on the ground in Kano state in order to determine how and what to support (Bello, 2020). In addition, Lagos state’s economic significance to the country was sufficient justification for the federal government to provide support for the state. Lagos is to Nigeria what London and New York are respectively to the United Kingdom and the United States.

Also evident was the conflict between the federal government and the opposition-held government of Rivers State. The governor of Rivers State apprehended and detained two pilots who had flown a group of expatriates into the state capital, Port Harcourt, to carry out important presidential duties. The governor asserted that he had closed
the terminals and instituted a statewide curfew to prevent the spread of the virus. In response, the Inspector General of Police (IGP), the chief of the federal police and a presidential appointee, removed the state's commissioner of police for enforcing a state law contrary to federal directives (Chukwu, 2020). In Nigeria, policing is centralised, and no federated state has its own police force. Section 214(1) of the 1999 Constitution provides that '[T]here shall be a police force for Nigeria...and... no other police force shall be established for the federation or any part thereof.' Another opposition-held state, Oyo's governor was also involved in conflicts with the federal government. First, contrary to the PTF's requirements and the NCDC's advice, the governor convened a political rally in Ibadan, the state capital, on March 19, 2020 (Babalola, 2021, p. 145). In addition, he rejected the state's allocation of COVID-19 palliative rice on the grounds that it had expired and was unfit for consumption (Babalola, 2021, p. 145). Similarly, northern state governors rejected federally mandated restriction measures based on their economic impact, arguing that states should only employ the approach that is compatible with their environment (Abraham, 2020). The governor of Cross River state also argued that the state was not 'locking down' but rather 'locking out' the coronavirus (Ihonvbere, 2022, p. 163).

National-state conflicts during the pandemic were not restricted to states governed by political parties other than the central government. For instance, the governor of Kogi State in the north-central region, a state governed by the same political party as the federal government, was embroiled in a severe dispute with the federal government. Kogi borders Abuja, which like Lagos, recorded a high number of infections, but the governor did not take the pandemic seriously. He stated that ninety percent of the clamour about COVID-19 was motivated by political, economic, or financial gain while the remaining 10% was about ordinary illness, such as the colds Nigerians commonly experience (Ofiong, 2020). In addition, the governor obstructed PTF’s activities in the state and even threatened to arrest NCDC officials who were conducting business in Kogi, accusing them of importing the virus into the state (Babalola, 2021, p. 145). Similarly, northern state governors rejected federally mandated restriction measures based on their economic impact, arguing that states should only employ the approach that is compatible with their environment (Abraham, 2020). The governor of Cross River state also argued that the state was not ‘locking down’ but rather ‘locking out’ the coronavirus (Ihonvbere, 2022, p. 163). Cooperation between the states and the federal government was notable, as was the conflict that the pandemic sparked as some states opposed federal policies they deemed detrimental to their interests.

There were also interstate conflicts, especially in the country’s northern region. For instance, the Kano State government evacuated over one thousand almajiri pupils to their home states of Jigawa, Katsina, and Kaduna (Babalola, 2021, p. 145). The almajiris are school-age children, mostly boys aged between 8 and 15 years who have left their homes to live with Islamic teachers (malam) where they study the Islamic religion (Babalola & Ayuba, 2015, p. 275). These children are not enrolled in formal education and are left to fend for themselves, soliciting on the streets. The government of Plateau State retaliated by returning approximately 601 almajiris to their respective states. These actions reignited the Nigerian citizenship debate.

VIII. CONTINUATION OF FISCAL CENTRALISATION

The global financial crises of 2008 and 2016 and the COVID-19 crisis have had a significant impact on Nigeria’s public finances. During these periods, there was an intensification of interstate competition for the limited resources of the federation. The pandemic precipitated yet another recession in 2020, which in turn, exacerbated the federal government’s financial crisis. States also encountered a significant fiscal hiccup
during the pandemic, and the federal government had to come to the states’ aid with a USD 150 million stabilisation fund, using a portion of a USD 3.4 billion International Monetary Fund (IMF) emergency loan (Abdulrauf, 2022, p. 368). The decline in oil and tax revenues, as well as the escalation of public debt, continue to pose significant challenges to federal and state expenditures. Management of these crises exposes the complexities around the practice of federalism in the country. Federalism is about ‘the constitutional diffusion of power’ between the central and the constituent governments to achieve ‘self-rule and shared rule,’ (Elazar, 1987, p. 5) and according to Macmahon (1962, p. 4), the division of powers should be done such that the powers assigned to the sub-national units ‘must be substantial and not merely trivial.’ In contrast to these assertions, the Nigerian federal government was at the centre of the federation’s response to the global financial crises and the pandemic, revealing the weakness of the states, which acted like extensions of the federal government. The federal and state administrations worked together to combat the pandemic, but the states were financially incapable of playing significant roles and had to rely on the federal government which is the sole allocator of national revenue.

Given the national revenue-sharing formula, the immense constitutional responsibilities of state governments, and their low internally generated revenue, it is easy to understand why the states lacked the necessary resources to respond to the crisis. During the crisis, the so-called grassroots governments – local governments – were less visible. Local governments in Nigeria constitute the third tier of government according to the country’s constitution, but in practice, they exist at the whim of the state governments. Similar to state governments, local governments’ internally generated revenues are usually insufficient to fulfil their constitutional responsibilities. During the pandemic, the Federal Capital Territory’s (FCT) absence of autonomy was also exposed. Constitutionally speaking, the FCT is neither a state nor a local administration. A federal minister appointed by the President administers it. In response to the pandemic, the FCT administration established an Expert Advisory Committee, which was overseen by the FCT Minister and tasked with coordinating the crisis management within the FCT. In addition, the Federal Ministry of Humanitarian Affairs Disaster Management and Social Development directly supervised the distribution of COVID relief supplies in the Federal Capital Territory, Abuja. (Babalola, 2021: 147). This lack of autonomy reignited the call for the capital city to have an independent mayoral status.

During the financial crises and especially during the pandemic, the influence of the federal government was felt throughout the country, but the near neglect of the state and local levels drew criticism from many Nigerians. This absurdity contributes to the intensification of the calls for restructuring, which have been defined in many ways (Babalola, 2019; Babalola & Onapajo, 2019; Babalola & Okafor, 2022; Onapajo & Babalola, 2021). In Nigeria, restructuring generally refers to the reconfiguration of the country’s federal structure and a review of the present revenue-sharing formula, in which the federal government receives the lion’s share of national revenue. We concur at this juncture that the excessive centralisation that promotes the overbearing influence of the federal government will continue if the call for restructuring is continuously ignored.

IX. CONCLUSION

Scholars of Nigerian federalism have consistently argued that Nigeria’s constitutionally entrenched over-centralisation is the main anomaly inherent in the system (Babalola, 2019; Babalola & Onapajo, 2019; Babalola & Okafor, 2019; Elaigwu, 2002; Suberu, 2001). The federal government of Nigeria’s response to COVID-19 was successful due to the efficacy of the deployed federal instruments. In addition, the national-state cooperation that was observed during the pandemic contributed to its management. However,
it could be argued that the country would have fared better under a non-centralised system in which state and local governments played a greater role. During the pandemic, Nigeria functioned as a unitary state, with the federal government deploying the NCDC, the National Assembly, and federal ministries and agencies, while the states and local governments were largely disregarded. It could be argued that Nigerians witnessed the practice of cooperative federalism during the pandemic, as neither the federal nor state governments were able to combat the virus on their own. However, state governments were less visible and local governments were rendered ineffectual. According to Ihonvbere (2022, p. 163), state and local governments ‘sat back and waited for federal leadership’ to provide direction. This does not imply that the two tiers, particularly state governments, did not find the ‘space to assert their autonomy’ within their respective jurisdictions (Abdulrauf, 2022, p. 362), but this was largely insignificant.

During the pandemic, the federal government exerted near-absolute control over the affairs of the entire federation, similar to what occurred during the global financial crisis. It did so by bringing other levels of government under its authority. As a result of Nigeria's revenue allocation system, the federal government receives the largest portion of national revenue. This is at the core of the fiscal dominance of the federal government and the financial weakness of the states that is the defining characteristic of Nigeria's federal system. Clearly, the management of the global financial crises and the pandemic revealed the overly centralised nature of the country's federal system and the financial frailty of state and local governments.

The agitation to reform the current system, which has been characterised as ‘facade federalism’ (Abdulrauf, 2022), has persisted despite Nigeria's successful response to the pandemic. Most of the demands have focused on reversing federal dominance in fiscal matters. If state and local governments are to become responsive in the future, reform is necessary. The fiscal system must be decentralised so that states have greater control over the revenue generated within their jurisdictions. Undoubtedly, the crises discussed in this paper have highlighted the need to diversify the economy and increase the states' share of the national wealth. These can help to mitigate the effects of future economic disruptions.
REFERENCES


JOURNAL INFORMATION
INDEX
INTRODUCTION


by Mikel Erkoreka
Ituna Center for Basque Economic Agreement and Fiscal Federalism Studies (UPV/EHU)

by Mario Kölling
UNED and Fundación Manuel Giménez Abad

by Mireia Grau
Institut d’Estudis de l’Autogovern

To cite this article:

ABSTRACT

The 2008 financial crisis and the 2020 health crisis have profoundly disrupted Spain’s public finances and multi-level governance system. The aim of this article is to analyse the evolution of the regional public finances and decentralisation system in Spain during the 2008 financial crisis and the 2020 health crisis. In light of the asymmetrical funding system that governs Spain, the article analyses and contrasts the evolution of the finances and indebtedness between the autonomous communities of the common and foral regime. The article concludes that both crises have driven a process of recentralisation, reinforcing the central government’s role in fiscal and financial matters.

Keywords: Spain, fiscal decentralisation, asymmetric federalism, regional policy, regional funding system, tax autonomy, subnational debt, economic crisis.

¹This research is part of the research activity of the following research groups and projects: Cliobasque (ref. IT1523-22); Biografía colectiva y análisis prosopográfico más allá del Parlamento (ref. PGC2018-095712-B-100) and Reformas institucionales en sistemas multinivel: Paradigmas, limitaciones, procesos y resultados (PID2020-116659GB-I00).
I. INTRODUCTION

Over the last forty years, Spain has evolved from a unitary to a highly decentralised state. Decentralisation has mainly benefited the autonomous communities (henceforth ACs), which emerged as new political entities around 1980. The Spanish model of territorial decentralisation is organized in 17 ACs and the autonomous cities of Ceuta and Melilla. The decentralisation process was not gradual, but responsibilities were transferred in several “waves”. Moreover, the process characterised by a structural tension between symmetry and asymmetry. In this regard access to self-government took place through different paths and speeds. While the Basque Country, Catalonia, Galicia and Andalusia already assumed during the 1980 important spending responsibilities, other ACs could only later on assume these responsibilities (Tudela, Kölling 2020).

The process of decentralisation received a decisive boost in the early 2000s, when powers on health and education were transferred to all the ACs. From this moment on, we can observe substantial homogeneity across expenditure powers among all ACs. Devolving health and education resulted in a substantial and gradual increase in the ACs public expenditure from then onwards. The system of revenue assignments to ACs also decentralised gradually, in an asymmetric and complex fashion. Overall, the degree of decentralisation in the field of revenues has been more modest in comparison with the expenditure side (Lago-Peñas et al., 2017).

Although the decentralisation process in Spain has been quite successful, questions related to the regional financing system have occupied a large part of the debates on the territorial organisation of power in Spain. The 2008 crisis first and the COVID-19 crisis afterwards have put great pressure on the public finances (De la Fuente, 2022). They have also exacerbated the shortcomings of the regional funding system, evidencing its limitations (Martínez, 2020b). The renewal of the regional funding system has been under consideration and debate for a decade, with no success to date.

As regards the political landscape, Spain has been in crisis-mode for a decade. The 2008 economic and financial crises have led to the so-called crisis of representative institutions in which there has been a huge loss of popular confidence in aspects of the democratic system (Erkoreka et al., 2021). The economic instability and the climate of political tension and polarisation prevented fundamental reforms to correct and improve the functioning of the decentralisation system – including the regional funding system.

The aim of this article is to analyse the state of art and future of the regional public finances and decentralisation system in Spain after the impact of the two great crises of the first quarter of the XXI century: the 2008 financial crisis and the 2020 health crisis.

The article uses the tools of fiscal and budgetary analysis to approach the subject, relying mainly on budgetary statistics and official fiscal and financial data. In addition, primary and secondary sources will be used to complement the analysis and integrate the political and institutional dimension. On the basis of the available information, the analysis ends in 2021 as it is when the effects of the pandemic on public accounts were already remitting. Where statistical sources have permitted this, statistical series have been elaborated from the 1990s, with the aim of developing the long-term perspective.

The article is structured in six sections. The first section contextualizes the evolution of the political and institutional framework during the 2008 financial crisis and 2020 health crisis. The second section explains the characteristics of the asymmetrical system of regional financing in Spain. The third and fourth sections analyse the evolution of subnational public revenue and expenditure. The fifth section analyses the evolution of subnational public debt. The sixth and last section draws some conclusions.

1. The 2008 financial crisis

The main cause of the 2008 crisis in Spain was the housing bubble and the accompanying unsustainably high GDP growth rate. The Spanish government faced the critical development by relaxing supervision of the financial sector. The balloononing tax revenues from the booming property investment and construction sectors kept the Spanish government’s revenue in surplus, despite strong increases in public expenditure, until 2007 (Royo, 2020). While Spain started the crisis period with a relatively modest public debt of 36.2% of GDP, it sunk into a great economic depression as the consequences of the crisis were devastating (Martí & Pérez, 2016). After having completed substantial improvements over the second half of the 1990s and during the 2000s, which put a few ACs on the brink of full employment, in October 2008, the unemployment rate increased strongly, exceeding by far the unemployment surge of past economic crises like 1993. In spring 2012, Spain’s unemployment rate reached 24.4% and Spain’s public debt stood at 72.1% of GDP. The crisis and several corruption scandals (most cases had their origins in the housing bubble years) had a profound impact on public trust in democratic institutions and the model of territorial decentralisation. At the same time, the financial crisis coincided with the escalating secessionist conflict in Catalonia since 2012, which culminated in 2017 with a unilateral declaration of independence.

Moreover, the financial crisis seems to have contributed to polarise and fragment the party system. From the mid-1980s to the mid-2010s, Spain’s party system was dominated by a straightforward competition between the social democratic Spanish Socialist Workers Party (PSOE) and the liberal-conservative People’s Party (PP). Since 2014, however, the leftist Podemos party and the centre-right liberal Ciudadanos have entered the national arena, the moderate nationalist Catalan forces have collapsed, and a radical-right populist party, Vox, has emerged with strength. As a result, since 2015 no party has been able to form a stable governmental majority after elections.

2. The 2020 health crisis

Spain was one of the countries around the world most affected by COVID-19, both in terms of the number of infections and number of deaths. In this sense, data on zero prevalence and mortality indicate a very uneven spread of the pandemic during 2020 (Erkoreka & Hernando, 2022). The first two epidemiological waves affected ACs like Madrid or Castilla-La Mancha more intensely. Other ACs like Andalusia, Murcia or the two archipelagos presented figures that evince a lower level of incidence and diffusion of the disease. Although economic growth and job creation remained solid since 2014, Spain was still in political and institutional crisis mode. The fragmentation of the party system intensified since the November 2019 general elections, and polarisation proved to be a significant obstacle to cross-party agreement. 22 parties obtained representatives in the Congress of Deputies in 2019 - the lower house of the Spanish parliament. In January 2020, a minority left-wing coalition government consisting of the PSOE and Unidas Podemos (‘United We Can’) came to power. It was the first Spanish-wide coalition government since the Second Republic (1931–1939). Despite concerns about the stability of the coalition, the government pushed an ambitious legislative reform agenda through parliament while fending off a wave of hostility from the political right.

With the outbreak of the COVID-19 pandemic in spring 2020, the Spanish government opted for an initial response based on a centralised control, one that rapidly unveiled
the institutional weaknesses of the intergovernmental system. But the growing political contestation, the logistical inefficiencies derived from centralisation and the improvement of health indicators, brought a change of perspective (Erkoreka et al., 2021). In that way, the ACs gradually recovered the powers and functions that had been centralised, giving way to a scenario of co-governance, in which the central government and the ACs share responsibilities in the decision-making and management of the pandemic (Carmona, 2021).

The pandemic revealed the weakness of the healthcare system, both in terms of public health policy and patient care (Mattei & Del Pino, 2021). Funding cuts to healthcare following the 2008 crisis have led to increasing variability in the quality of healthcare services across the ACs that are responsible for the delivery of healthcare. The COVID-19 crisis has also revealed the structural weaknesses in and cyclical problems of the Spanish territorial model (Erkoreka & Hernando, 2022). It has become especially clear that intergovernmental coordination instruments and joint decision-making bodies were unable to respond to the crisis appropriately (Kölling, 2020). Moreover, tensions between the constitutionally determined framework legislation of the central government and the reality of a model consisting of heterogeneous regional healthcare systems became apparent. Due to institutional weaknesses, decisions were taken very late and slowly. However, as the crisis unfolded, intergovernmental coordination improved, and representatives of the various health authorities met frequently to exchange information and reach common agreements.

Still, it should be stressed that the model of decentralised organization has not in itself been a handicap when confronting the pandemic in Spain (Erkoreka & Hernando, 2022). The results of their management facing the pandemic differed significantly between ACs. There were some ACs that performed satisfactorily within the established framework of decentralisation. Irrespectively of the unequal territorial incidence of the virus, the key factor for analysing and evaluating these differences between ACs has not been the model of organization, but the sufficiency of resources and the quality and orientation of the public management developed by the different levels of government, both prior to and during the pandemic.

The pandemic has also shown the vulnerabilities of the Spanish economic structure (De la Fuente, 2021a; Felgueroso et al., 2021). At the beginning of 2020, Spain displayed weak productivity growth, while private investment in R&D continued to be low. Spain's business structure is highly fragmented. Moreover, Spain has been hampered by an excessive dependence on tourism, which prior to the COVID-19 crisis contributed to around 13% of GDP and employed three million people. Since the beginning of the pandemic the GDP declined by 10.7% in 2020 and recovered by 8% in 2021. The unemployment rate in the first quarter of 2020 was 14.4%, with more than 3.3 million people unemployed. Although the Temporary Lay-off Plans (ERTE) for companies affected by the coronavirus crisis cushioned the impact of the crisis on the labour market, the unemployment rate increased to 16.13% at the end of 2020. But thanks to the economic recovery, the unemployment rate fell again to 13.3% by the end of 2021.

III. THE ASYMMETRICAL SYSTEM OF REGIONAL FINANCING

As has been noted above, the system of financing the ACs in Spain has an asymmetrical character and is regulated by two differentiated types: the common and the foral types. The common type is applied uniformly in all the ACs on the peninsula, except for the Autonomous Community of the Basque Country and the Foral Community of Navarre. Based on historical and political circumstances, these two ACs have preserved a singular and exclusive system of financing of a federal type, which is rooted in the pre-constitutional “historical rights” of the foral territories. Both funding types work completely different and are independent of each other. The characteristics of both funding systems are summarised below.

1. The revenue structure of common regime ACs

The common financing system is regulated through the regional financing Law (Ley Orgánica de Financiación Autonómica – LOFCA), which is negotiated multilaterally between the ACs and the central government. The LOFCA was established in 1980 and was amended in 1986, 1992, 1996, 2001 and 2009 (León 2015). The completion of the process of decentralisation of education and health at the beginning of the 21st century made it necessary to update and strengthen the common regime’s system of regional financing. In this way, in the year 2001 a new Law of regional financing was approved that strengthened the revenues and the tax autonomy of the ACs.

In 2009, the Spanish government promoted a new law on regional financing. Although it was approved amid the economic crisis, the bases of the law clearly ignored such a context as it provided broad resources to the ACs. The law envisaged a revision of the criteria in five years-time, that is, in 2014, as a measure to correct possible imbalances and shortcomings. But the gravity of the economic situation and the growing political tensions resulted in the revision being placed on stand-by, a state in which it has remained up to the present.

According to the 2009 Law of regional financing, in addition to the debt, the sources of income of the ACs is based on three pillars: inter-governmental transfers, equalisation grants and conditional transfers; shared taxes, and own taxes (see Kölling, et al. 2023).

Inter-governmental transfers, equalisation grants and conditional transfers. These are designed to guarantee that all ACs have the same level of resources to provide public services. There are four such payments: the Guarantee Fund for Fundamental Public Services, the Global Sufficiency Fund, the Competitiveness Fund and the Cooperation Fund. The Guarantee Fund for Fundamental Public Services is the main equalisation instrument. It is calculated as the difference between the expenditure needs of each AC in the fundamental public services (education, health and social service) and 75 percent of their fiscal capacity, which is the potential revenue collected from shared taxes (taxes on income and VAT, see paragraph below) plus some fees and charges. According to de la Fuente, while the Guarantee Fund generates sizable horizontal flows from rich to poor ACs and greatly reduces regional disparities in terms of financing per adjusted head, the vertical transfers are distributed across ACs according to a large number of often conflicting criteria (de la Fuente et al. 2016). In general terms, the vertical Global Sufficiency Fund is calculated for each AC as the difference between the expenditure needs and the tax revenues and the transfers from the Guarantee Fund. However, the main objective of the Fund is the preservation of
the status quo at the time of the 2009 reform of the system, meaning that revenues for ACs are maintained by this Fund with respect to the year of reference, 2007.

To reduce the standard deviation of financial resources across ACs, the 2009 regional financing Law created two unconditional grants: the Competitiveness Fund, which offers resources for ACs that are below the national average or with a financing index below an adjusted index of fiscal capacity, and the Cooperation Fund, which provides additional financing for ACs with low income per capita, slow population growth or low density of population. In addition, ACs receive conditional grants from the central government to finance certain regional policies or joint projects (Instituto de Estudios Fiscales, 2018, p. 35). Lastly, some ACs receive grants from the Inter-Territorial Compensation Funds and conditional grants from the European Regional Development Fund, to reduce regional disparities in income.

**Shared taxes.** They are the taxes partially or totally ceded. Completely ceded taxes are taxes over which the AC governments are responsible for the collection and management, and over which they can apply regulatory modifications. This includes Property Transfer and Stamp Tax, Inheritance and Gift Tax, Special Tax on Certain Means of Transport, Taxes on Gambling, Special Tax on Hydrocarbons and Tax on Electricity. Partially ceded taxes are taxes over which the central government retains responsibility for collection and management, but over which ACs can increase rates and decide on tax deductions. We cannot designate ceded taxes as own-source because AC governments can marginally adjust rates, they do not determine the tax base or sharing formula. It was not until 1997 that ACs were allowed to set the tax rate and to establish tax credits and allowances. The 2001 reform expanded the proportion of shared taxes as the main source of revenue for ACs: 33.3% of the personal income tax was shared and based on AC regulation. The reform also included the sharing of VAT (35%) and excise tax (40%). The 2009 reform increased the regional share to 50% of personal income tax and 50% of VAT (López Laborda, 2010).

**Own taxes.** These are those over which ACs have the power to introduce and abolish the tax, to define the tax base and rate, and to grant tax deductions (Blöchliger, Rabesona 2009). Moreover, the revenue from own taxes belongs entirely to ACs. There exists a broad constitutional basis for the establishment of ‘own’ taxes (Fernández Llera 2021). However, there is an important constraint: ACs cannot impose a tax on a base that is controlled by central or local governments. Since these two bodies had established taxes on most bases, there was in practice little tax room left to ACs (Zornoza, 2014). Moreover, the regional financing Law prohibits ACs from imposing barriers to the functioning of the internal market and further constraints are set by the EU competition law that interprets certain taxes as a state-aid. The establishment of own taxes has given rise to a high level of jurisdictional conflict, with frequent appeals to the Constitutional Court and the European Court of Justice (López Pérez, 2018).

Shared and own taxes are the main source of funding for the ACs. But they exercise limited regulatory and managerial capacity over these revenues (own taxes account for less than 15% of revenue). In this way, most of the resources of the ACs depend on decisions taken exclusively by the Central government, which is also responsible for managing the bulk of the tax collection (Vilalta, 2020).

In addition, the system of intergovernmental transfers also affects the budgetary and financial autonomy of the ACs. Each year the ACs of the common regime receive in advance the funds from the regional financing system in application of the forecast existing at the time the draft bill for the general state budget is drawn up. These instalment payments are settled two years later on the basis of the definitive budgetary
results. If the settlement proves to be negative, the ACs must return the excess quantity they had received in advance.

The system of financing of the common regime has not resulted in the ACs developing a solid and decisive tax autonomy (Martínez, 2020a; Martínez-Vázquez & Lago-Peñas, 2020). The ACs continue to be notably dependent with respect to instalment payments and transfers by the central administration when drawing up their budgetary policies. Under this system of financing the ACs of the common regime suffer from a huge dependency with respect to the decisions of the central government – above all in circumstances of budgetary urgency that require a swift response – to the evident detriment of their financial autonomy. Similarly, the evaluation of the exercise of fiscal responsibility and accountability by the different administrations is also diluted and made more difficult (Comité de personas expertas, 2022; Instituto de Estudios Fiscales, 2018; Martínez-Vázquez & Lago-Peñas, 2020).

2. The revenue structure of foral system

Within the system of foral financing, the Basque Country and Navarre function under a regime that is completely different from, and independent from the common system. The instrument that regulates the system of financing and the framework of tax and financial relations between these two territories and the central administration is called the Economic Agreement Law, in the case of the Basque Country, and the Economic Covenant Law, in the case of Navarre. Both laws are negotiated and updated bilaterally between each of the regional governments and the central government.

In contrast to the ACs of the common regime, the foral institutions of the Basque Country and Navarre exercise a broad tax, financial and budgetary autonomy. Within their respective territories, the foral treasuries manage and collect practically all taxes, both direct and indirect - including personal income tax, corporate income tax, taxes on inheritances and donations, and VAT (Zubiri, 2010). Foral institutions have regulatory capacity over most direct taxes. In this way, the Basque public sector is financed almost exclusively through autonomously managed tax revenues – the proportion of transfer from the central government or other administrations is residual. Foral institutions are amongst the sub-state entities with the greatest tax and financial power in Europe (Erkoreka, 2021). As a counterpoint, the Basque and Navarrese institutions pay an annual quota to the state in order to finance competencies and services that have not been transferred or decentralized and are developed by the central administration to the benefit of the Basque Country and Navarre. Consequently, it is the subnational government that transfers funds to the central treasury and not vice versa (Pereda, 2019). The system of foral financing assumes a high degree of fiscal responsibility and is governed by the principle of unilateral risk (Rubí, 2016). Under this principle, the foral institutions assume the risk of eventual lower tax revenues, whether as a result of the economic conjuncture, their fiscal and budgetary policies, or for any other exogenous or endogenous reasons.

The confluence of two such different regimes of financing within the frontiers of the same state, makes Spain into an interesting laboratory for tests that analyse the sustainability and contrast the behaviour of the subnational public finances between highly disparate funding systems in terms of tax autonomy and fiscal responsibility.
IV. THE EVOLUTION OF SUBNATIONAL PUBLIC EXPENDITURE

In light of the progress in the decentralisation process, subnational public expenditure maintained an upward trend since the second half of the 1990s. The decentralisation of spending powers in Spain has relied heavily on bilateral intergovernmental relationships. If the central government and AC agreed on the amount of resources needed to provide a new spending responsibility service (the so-called coste efectivo), then the central government commits to cede them in the form of (larger) unconditional transfers. Due to political and institutional restrictions established in the early 1980s, the existence of separate political cycles in some territories, and the need of the central government to respond to some centrifugal forces, the whole process has been quite asymmetric. As a result, while some ACs started to manage important services such as education and health in the mid-eighties, others started doing so in 2002. Currently, more than 40% of public expenditure is managed between the ACs and local governments. These expenditures are mainly focused on health and education, the two largest components of the regional public expenditures (Lago Peñas, et al. 2017).

The 2008 financial crisis slowed this trend. At first, the pronounced deterioration in public finances due to the economic crisis of 2008 did not affect the budgets of the ACs due to the configuration of the new regional financing Law passed in 2009: initially, the central government chose not to transfer the effects of the fall in tax revenues to the instalment payments. In this way, the ACs were able to maintain their pre-crisis spending capacity (De la Fuente, 2022).

The ACs were brought down to earth from 2010 onward. The deterioration of public accounts due to the prolongation of the crisis and the coming to power of the liberal-conservative party (PP) in 2011, opened the door to a period of austerity and adjustments in public finances. Additionally, in the context of the European bailout of the Spanish banking system and the reform of Article 135 of the Spanish Constitution, the Spanish parliament approved a new Law on Budgetary Stability and Financial Sustainability (henceforth, LBSFS) in 2012. The aim of the LBSFS is to guarantee the budgetary stability and financial sustainability of all of the Spanish public administrations (Ruiz & Cuenca, 2012).
Thus, although with different intensity and orientation depending on the needs and political preferences of each government, regional and local administrations had to implement budget cuts to comply with the rules and policies of austerity and budgetary control. These cuts were reflected in sensitive areas such as health and education. Funding cuts to healthcare following the 2008 financial crisis have led to increasing variability in the quality of healthcare services across the ACs (Erkoreka & Hernando, 2022). The level of expenditure stabilised between 2013 and 2016.

Thanks to the economic recovery and also influenced by the change in the central government in 2018 (the Socialist Party returned to power), public spending increased again gradually since 2017. From this date, the central government gradually relaxed policies and measures of austerity and control of public expenditure. It should be noted that until 2020 the regional public expenditure ceiling reached in 2009 was not exceeded.

The COVID-19 crisis did not initially affect the evolution of subnational public expenditure. On the contrary, the latter increased in 2020 and 2021. The central government and the Social Security (which has a centralized character) assumed the greater part of the costs of the crisis, granting extraordinary resources to the ACs to finance their necessities and the increase in socio-health expenditure (AIReF, 2021).

If we analyse the evolution of public expenditure as a whole, we can appreciate the impact of the crises on the decentralisation process in Spain (see Figure 2). In the fiscal and financial sphere, the 2008 and 2020 crisis slowed down the process of decentralisation of public expenditure that had been developing since the 1990s. The central government (including social security) has strengthened its role during the management of the 2008 and 2020 crises, assuming greater intervention on expenditure and economy.

Figure 2. Distribution of public expenditure, by administrations (1995-2021) (in percentages)

Source: OECD Fiscal Decentralisation Database, Consolidated government expenditure. Elaborated by the authors.
V. EVOLUTION OF SUBNATIONAL PUBLIC REVENUES

Prior to the 2008 crisis, the Spanish economy enjoyed a period of economic growth, to a great extent stimulated by a large real estate bubble. In this context, and although the expenditure side also increased significantly as a result of the new powers transferred to the ACs, the finances of the ACs evolved positively and their level of indebtedness was in general reduced. The severe economic crisis that broke out in 2008 marked a turning point.

As explained above, the crisis did not initially affect the public accounts of the ACs because the central government chose not to transfer the effects of the fall in tax revenues to the instalment payments. The new Law of regional financing approved in 2009 deliberately ignored the state of crisis, providing broad resources to the ACs and thus removing the incentive for the latter to adjust their accounts in line with the change of economic cycle. This Law gave rise to inter-regional imbalances in matters of financing, which were aggravated as the economic crisis became prolonged over time.

The ACs received the impact of the crisis in 2010, when their revenues dropped above 10%. The settlement of the 2008 and 2009 fiscal years, together with the worsening of the economic crisis, resulted in some of the ACs experiencing a severe liquidity crisis (Martí & Pérez, 2015). As a result of the crisis, the deficit of the central government and the ACs shot up.

Figure 3. Net lending (+) or net borrowing (-), by administrations (1995-2021) (as % of GDP)

Source: OECD Fiscal Decentralisation Database, Balances and debt of state and local government. Elaborated by the authors.

Facing the severe liquidity crisis experienced by some ACs, and the difficulties they encountered in being able to finance themselves on the financial markets, the central government decided to create the regional liquidity fund in 2012 (Fondo de Liquidez Autonómico) (Herrero-Alcalde et al., 2019). In this way, the central government extended a line of credit to the ACs so that they would be able to refinance their debt in very favourable conditions without having to turn to the market. Technically, having recourse to the liquidity funds was not considered to be a bailout, but the fact that access to the fund required serious readjustments in return, makes it possible to
assimilate the operation to an implicit bailout (Fernández-Llera, 2015). To participate in these mechanisms in support of liquidity, the ACs had to apply budgetary conditions and commit themselves to fulfil adjustment plans, negotiated and monitored by the central government. In this context, as will be studied in detail later, the foral ACs of the Basque Country and Navarre were the only ones that opted not to become indebted to the central government, turning to the financial market to finance themselves – albeit on less favourable terms – in order to safeguard their financial and political autonomy.

The liquidity fund was created as an extraordinary and temporary measure. It was assumed that the accounts of the ACs would be restructured and consolidated once the crisis had ended, making use of the revision of the regional financing system envisaged for 2014. But although its name and functioning has been adapted, the liquidity support mechanisms continue to be in effect at present (De la Fuente, 2020).

With the financing system still awaiting updating, in 2020 the COVID-19 crisis broke out. Prior to the pandemic, the Spanish economy had managed to achieve a six-year period of economic growth in GDP (2014-2019), thus escaping from the long shadow cast by the crisis of 2008. The economic recovery was reflected in the increase in tax collection and public revenues. But the pandemic altered deeply the growth forecasts and the policies for consolidating the public accounts implanted prior to the arrival of the virus.

**Figure 4. Evolution of the subnational public revenues in Spain (1995-2021) (in million euros at current prices)**

Measures taken by the central government to overcome the crisis caused an exceptional deterioration in Spain’s public finances in 2020 and 2021 (Lago-Peñas, 2022). The public deficit reached 10.13% and 6.87% of GDP respectively in 2020 and 2021. In a similar way to 2008, the central administration (including social security) assumed the greater part of the deficit and public debt during 2020 and 2021 (AIReF, 2021). During the 2020 fiscal year, the central government brought forward payment of the settlement of the regional financing system for the 2018 fiscal year, established instalment payments with respect to 2020 on the basis of the pre-pandemic forecasts of 1.6% of the GDP (when the GDP fell by more than 10%, deliberately ignoring the effects of the crisis), and granted extraordinary resources to the common regime ACs to finance their socio-health costs and necessities (Lago-Peñas, 2021). Aside from the system of regional financing, the central government approved the creation of the COVID-19 Fund. This was the main extraordinary fund created by the central government in
2020 with the aim of supporting the ACs in financing expenditures deriving from the pandemic. The fund was endowed with 16,000 and 13,486 million euros respectively for 2020 and 2021. It had a non-repayable and unconditional character.

Thanks to the budgetary policy implemented by the central government, the revenue of the ACs not only did not fall during 2020 and 2021, but even increased; enabling them to increase their expenditure. The common regime ACs have not only had available a record level of resources to confront the pandemic, but, in addition, they closed 2020 with the best budgetary balance since 2006. Thanks to the financial safety net provided by the central government, the ACs as a whole showed a budgetary deficit of 0.21% of the aggregated GDP in 2020 – nine ACs obtained a surplus – considerably improving on the result of 2019, which closed with a deficit of 0.57% of the GDP. In 2021 they even improved their outcome, approaching the budgetary balance. This extraordinary injection of liquidity provided a short-term solution to the financing problems of the ACs of the common regime during the pandemic, postponing them until the settlement of the regional system of financing for 2020 and 2021 (De la Fuente, 2021b).

Although the behaviour on the expenditure side between the common and foral regimes ACs has been broadly similar, the evolution and management of the revenue side has been completely different. The ACs of the Basque Country and Navarre do not participate in the schema of flows and transfers of the system of financing of the common regime, nor do they receive instalment payments or advance payments from the central administration. The foral institutions, like the state, mainly depend on the tax revenues that they manage directly to finance themselves. Thus, the impact of crises has an immediate effect on their public accounts. For example, the tax collection of the Basque treasuries fell above 6% and 12% respectively in 2008 and 2009 (Erkoreka, 2021, p. 130). Similarly, it fell above 9% in 2020 due to COVID-19 crisis.

In spite the deep disturbances provoked by both crisis in the framework of decentralised governance of the ACs in Spain, the tax regulatory power and autonomy of tax management of the foral institutions were not affected (Erkoreka, 2021). The foral institutions have employed their fiscal and financial autonomy to meet the financing needs generated by both the 2008 and 2020 crises with their own resources. Among others, during the 2008 crisis, the foral institutions approved major tax reforms to increase their revenues, implemented anti-fraud measures to optimise tax collection and adjusted their expenditure policy. Regarding the COVID-19 crisis, the foral tax administrations took into account the OECD’s roadmap and recommendations when designing and implanting their fiscal policies, including measures with both a normative and a management character (Martínez-Bábara, 2020). In 2021, tax collection was fully recovered, exceeding even the level of revenue reached in 2019.

In contrast to the 2008 crisis, during the COVID-19 crisis, the foral ACs participated in the main extraordinary instrument implemented by the central government, albeit partially due to their singular tax regime: the COVID-19 Fund. Since this was an extraordinary fund, independent of the common system of regional financing, the Basque Country and Navarre participated partially in the COVID-19 Fund in 2020 and without restrictions in 2021. In addition to fiscal policy, as we will study below, the foral institutions had to take recourse to the debt market to cover their public deficit.
VI. THE EVOLUTION OF SUBNATIONAL PUBLIC DEBT

Prior to the financial crisis of 2008, the level of indebtedness of the Spanish public sector was reduced. The indebtedness of the ACs was in general residual. As a consequence of the economic crises of 2008 and 2020, the public debt increased sharply. General government debt reached 120.4 % of GDP in 2020 and fell to 118.3 % of GDP in 2021 (Forte-Campos et al., 2022). As shown in the Figure 5, the central government has assumed the largest indebtedness. Still, the debt of the ACs has also increased considerably.

Figure 5. Evolution of the general government debt according to the excessive deficit protocol in Spain (2002-2021) (as % of GDP)

![Figure 5. Evolution of the general government debt according to the excessive deficit protocol in Spain (2002-2021) (as % of GDP) (Source: Bank of Spain, General Government Statistics. Elaborated by the authors.)](image)

At the close of the 2021 fiscal year, the debt ratio of the ACs reached 25.9% of the GDP, placing Spain amongst the countries with the greatest ratio of subnational debt/GDP of the OECD (Lago-Peñas, 2023). Nonetheless, this figure requires two important nuances. Firstly, there are important differences amongst the ACs: the ratio debt/regional GDP is situated between the 14.7% of the AC of Madrid and the 47.8% of the Valencian AC.
These differences between regions respond to different factors, amongst which the following can be underscored: the imbalances generated by the financing system approved in 2009; the disparate impact of the crisis of 2008 resulting from inter-regional economic inequalities; and the orientation and quality of the political management of each region.

Secondly, it is worth underscoring that a large part of the accumulated debt of the ACs of the common regime since 2012 has been covered through liquidity support mechanisms at very low cost, made available by the central government. As a consequence of the liquidity support mechanisms, at the close of 2021, 57.5% of the accumulated debt of the ACs as a whole was in the hands of the central government.

Source: (Forte–Campos et al., 2022, p. 15). Elaborated by the authors.
This certainly paternalistic response by the central government had repercussions on the financial and political autonomy of the ACs, diminishing the principle of fiscal responsibility (De la Fuente, 2020). These liquidity mechanisms could become a potential source of moral hazard in the future, in case the central government decide to cancel part of the debt in order to make the system operational again and facilitate the return of the ACs to the financial markets (Lago-Peñas, 2023; Zabalza, 2021).

The comparative behaviour of public debt evinces a clear disparity between the ACs of the common and foral regimes. In contrast to the ACs of the common regime, the foral institutions immediately assumed the repercussions on the foral treasuries of lower revenues and deficit provoked by the 2008 and 2020 crises, and had to take recourse to indebtedness for this purpose:

**Figure 8. Inter-annual variation of the debt of the ACs of the common regime and the foral regime (2003-2021) (in %)**

During the 2008 crisis, the Basque Country and Navarre were the only ACs that opted not to become indebted to the central administration through the liquidity support mechanisms and turned to the financial market to finance themselves – albeit on less favourable terms (Erkoreka, 2021). Thus, besides safeguarding their financial and political autonomy with respect to the central government, they also sought to show economic and political coherence in the application of the principles of fiscal responsibility and unilateral risk that govern the foral model of fiscal federalism. Similarly, it also supposes a message of strength and confidence facing the financial markets.

During the COVID-19 crisis, the governments of the Basque Country and Navarre bilaterally negotiated to update and increase the deficit and public debt targets with the central government (Erkoreka, 2021). In this way, the foral institutions assumed, with immediate effect, the repercussions on their public treasuries of the lower tax revenues and the deficit provoked by the COVID-19 crisis, taking recourse to the debt market to cover their needs of financing.
In the rating actions developed by the main international credit rating agencies after the COVID-19 crisis, the debt of the foral ACs maintained a qualification that was higher than or equal to that of Spain, as sovereign state. This circumstance, which is certainly unusual at the international level, is not found repeated in the common regime ACs. Apart from the macroeconomic, political and management variables, the main reason put forward by the credit agencies Moody’s and S&P to qualify the debt of the Basque Country and Navarre above that of the sovereign is the strength of their institutional model and the characteristics of the foral model of fiscal federalism (Erkoreka & Ugalde, 2023). Exercising and safeguarding a high level of fiscal autonomy together with compliance with the principles of fiscal responsibility and unilateral risk stands out as the cornerstone for justifying that the foral subnational debt rating can be situated above that of the sovereign state.

Management of the public debt in circumstances of emergency and fiscal crisis is a key indicator when evaluating the principle of fiscal responsibility in the response of the systems of federalism and/or fiscal decentralisation (Herold, 2018). The application of the principle of unilateral risk is an incentive for guaranteeing the principle of fiscal responsibility. If we analyse Figure 8 on the evolution of the debt, it can be seen that the ACs of the foral regime have applied a policy with a counter-cyclical character, reducing their debt in the cycles of expansion to strengthen their solvency and margin for action facing the crisis. Fiscal and financial autonomy is an indispensable tool for designing and implanting their own long-term policies in debt questions, assuming future commitments and respecting the legal fiscal frameworks established by the European Union and the central government (Lago-Peñas, 2023). But the exercise of fiscal responsibility not only responds to the greater capacity of fiscal and financial self-government practiced by the foral institutions, but also to the risk that they assume in relation to the evolution of their finances.

Conversely, the ACs of the common regime must operate in a much more restricted framework of fiscal and financial autonomy, which limits their effective capacity to design and apply medium and long-term budgetary policies. In fact, the debt has in part been employed to compensate for, or cover the structural shortcomings of the common regime’s system of financing (Zabalza, 2021). This system provides neither sufficient tools nor incentives to reward the exercise of fiscal responsibility by the subnational governments. The systematic non-compliance with the rules of fiscal discipline by certain ACs of the common regime reflects an important deficiency entailed in the common regime’s system of financing.

In this sense, the confluence of two such different regimes of financing within the same state means that Spain is a laboratory of interesting tests for analysing and comparing the system of incentives and the behaviour of long-term subnational debt between highly disparate funding systems in terms of tax autonomy and fiscal responsibility.

VII. CONCLUSIONS

The 2008 and 2020 crises had different origins and consequences for the Spanish economy and political landscape. Moreover, the starting points for dealing with the crisis were quite different. However, both crises put pressure on public finances. In the context of the 2008 and 2020 crises, the decentralisation system has undergone a process of recentralisation. Likewise, the crises of 2008 and 2020 together with other factors such as the political conflict in Catalonia or the crisis in the judiciary, have led to a deterioration of the institutional system and a political polarisation. The economic instability and the climate of political tension and polarisation prevented fundamental reforms to correct and improve the functioning of the decentralisation system.
In the fiscal and financial sphere, the 2008 crisis slowed down the process of decentralisation of public expenditure that had been developing since the 1990s. The central government (including social security) has strengthened its role during the management of the 2008 and 2020 crises, assuming greater intervention on expenditure. In addition, following the adoption of the Law on Budgetary Stability and Financial Sustainability in 2012, the central government has strengthened its capacity to monitor and intervene on subnational finances.

Both crises exposed the cracks and dysfunctionalities in the system for financing the ACs of the common regime and underscored their dependence on central government transfers in circumstances of budgetary urgency. The crisis of 2008 also caused an uneven but pronounced increase of the regional debt. But, as a consequence of the liquidity support mechanisms, at the close of 2021, 57.5% of the accumulated debt of the ACs as a whole was in the hands of the central government, with repercussions on the financial and political autonomy of the ACs, and diminishing the principle of fiscal responsibility.

Both crises underlined the need to renew urgently the regional financing Law to correct the imbalances of the system, strengthen the fiscal autonomy and responsibility, improve transparency and put the common regime ACs finances in order following the severe crises of 2008 and 2020. In addition, it is also necessary to articulate a solution to the liquidity support mechanisms in order to make the system operational again, facilitate the return of the ACs to the financial markets and safeguard the political and financial autonomy of regional governments. But as with other issues awaiting reform, economic instability and the current climate of political tension sketch a future panorama that is not favourable to providing a solution to this question which has been dragging on since 2014. The uncorrected imbalances of the financing system have given rise to inter-regional differences in matters of financing, prejudicing some regions while favouring others. These imbalances, and the deficit in transparency from which the system suffers, have helped to make the question of regional financing into a further issue of political confrontation, stirring up a partisan fight between regional governments, central-regional governments and political parties.

Under the asymmetrical funding system that governs Spain, the evolution and behaviour of public finances and debt in the foral ACs of the Basque Country and Navarre has been completely different. In spite of the deep disturbances provoked by both crisis in the framework of decentralised governance of the ACs in Spain, the tax regulatory power and autonomy of tax management of the foral institutions were not affected. In contrast to the ACs of the common regime, the foral institutions immediately assumed the repercussions on the foral treasuries of lower revenues and deficit provoked by the 2008 and 2020 crises. The foral institutions have employed their fiscal and financial autonomy to meet the financing needs generated by both crises with their own resources. On the one hand, the foral institutions approved major tax reforms and adjusted their expenditure policy. On the other hand, they also had to take recourse to indebtedness to cover their needs of financing. During the 2008 crisis, the Basque Country and Navarre were the only ACs that opted not to become indebted to the central administration through the liquidity support mechanisms and turned to the financial market to finance themselves—albeit on less favourable terms—, in order to safeguard their financial and political autonomy. Similarly, during the COVID-19 crisis, the foral governments negotiated to update and increase the deficit and public debt targets with the central government in order to cover their needs of financing in the financial markets.

The confluence of two such different regimes of financing within the frontiers of the same state, make Spain into an interesting laboratory for analysing, comparing and contrasting the behaviour, system of incentives and sustainability of the subnational public finances and debt between highly disparate funding systems in terms of tax autonomy and fiscal responsibility.
REFERENCES


- De la Fuente, Á. (2021a). The economic consequences of Covid in Spain and how to deal with them. Applied economic analysis, 29(85), 90-104.


JOURNAL INFORMATION

INDEX

INTRODUCTION


THE FISCAL EQUIVALENCE TRAP – DON’T DECIDE, DON’T PAY - HOW A PRINCIPLE OF FISCAL FEDERALISM MOTIVATES STATE INACTION

by Eva Maria Belser
Chair for Constitutional and Administrative Law at the University of Fribourg,
Co-Director of the Institute of Federalism Fribourg, UNESCO Chair for Democracy and Human Rights

by Géraldine Cattilaz
PhD student and Research Assistant at the Chair for Constitutional and Administrative Law I at the University of Fribourg

To cite this article:
Belser, Eva Maria; Cattilaz, Géraldine (2023): The fiscal equivalence trap – don’t decide, don’t pay - how a principle of fiscal federalism motivates state inaction, Cuadernos Manuel Giménez Abad, Special Issue 9.
DOI: 10.47919/FMGA.CM23.0119

ABSTRACT

Two questions are crucial in emergency situations: Who has the right – or duty – to act and who must finance emergency measures. In this contribution, we examine the effects of the Swiss emergency powers on the financial system – and vice versa –, and argue that Switzerland’s reactions and, as importantly, its inactions can best be explained by examining the distribution of tasks and costs jointly – and not separately as is often the case.

We first briefly recall the essential elements of the Swiss power and resource sharing system, elaborating on the principles of subsidiarity and fiscal equivalence, before presenting the Swiss emergency regime and its controversial use during the Financial Crisis of 2008 and the Covid-19 pandemic. Comparing the two recent examples of extensive use of emergency powers, we show that the Financial Crisis mainly raised democratic issues regarding the horizontal distribution of powers while the Covid-19 crisis also had a strong federal component. We then explain the federal struggles over competences during Covid-19 with a phenomenon we call “Fiscal Equivalence Trap” – a situation in which both (or all) tiers of government refrain from or hesitate to adopt urgently needed measures due to financial considerations.

Keywords: Fiscal federalism, federal power and resource sharing system, principle of fiscal equivalence, emergency powers, crisis management, covid-19 pandemic, financial crisis.
I. INTRODUCTION

Most emergencies are complex, their resolution, however, does not seem to allow for complexity. Famously, emergencies are hours of the executive – one executive, not many. In federal systems, power concentration hence typically occurs not only horizontally (weakening parliaments and courts) but also vertically (disempowering regional units and local governments). In the interest of effective crisis management, complexity in decision-making must yield. Most federal systems provide for such power concentration in cases of emergencies. However, they often leave the question of fiscal federalism open. How does decision-making by the executive affect the parliament’s right to decide on public finances? And how are the costs of emergency replies, taken at the centre but often implemented by the regions, divided by the different tiers of governance? Such financial unclarities and ambiguities, we believe, are important but understudied reasons for constitutional systems to stumble, stutter or become irrelevant in stress situations.

In this contribution, we investigate how the emergency powers of the Swiss federal system affect the emergency financial system of the country. We claim that the country’s reactions – and inactions – in emergency situations can best be explained by examining the distribution of tasks and costs jointly – and not separately as is often the case. By stipulating the principle of fiscal equivalence – “who decides, pays” – the Swiss constitutional system links the two elements in an inseparable way. The principle is undoubtedly well-suited to incentivize cautious budgeting and spending: As acting is costly for each governance tier, acting beyond one’s competences and tasks is not too tempting to government actors. But what happens if costly state action is urgently needed to deal with an emergency? If one tier has exclusive competences, there is a clear answer to what actor has the responsibility to act – and finance the action. However, if two tiers of governance enjoy concurrent competencies, as is most often the case, or have controversial views about their respective responsibilities, both might shy away from taking costly measures and hope for the other tier to decide and pay. Based on this observation, we claim that Switzerland has suffered from such negative conflicts of competences and that the Swiss fiscal federal system has caused inaction when action was required. This fiscal equivalence trap, as we call it, has thus hampered the country’s pandemic reply. However, it is felt and experienced more generally and can lead to illegitimate inaction wherever both tiers enjoy concurrent competencies but prefer not to act. Such can be the case when there is an obligation to take adequate measures to protect and fulfil human rights (only their – passive – respect is generally free) and also when it comes to protecting the climate and mitigate climate change. We hence believe that the problem of the fiscal equivalence trap reaches way beyond crisis management.

To substantiate our argument, we will proceed as follows. We will first briefly recall the essential elements of the Swiss federal system and the principle of fiscal equivalence which constitutes a binding guideline when allocating tasks and costs (chap. 2). We will then present the Swiss emergency regime (chap. 3.1) and its controversial use during the financial crisis (chap. 3.2). In 2008, the Federal Council extensively referred to emergency powers, in particular to bail-out the private Bank UBS. In contrast to the Covid crisis, however, these emergency decisions raised few federal and mostly democratic questions. Correspondingly, the Swiss legislator’s initiatives to learn from the financial crisis focused on strengthening the role of parliament in urgent financial matters. However, these learnings from the UBS rescue have, as we will show, not prevented the CS takeover in 2023. We will then turn to the Covid pandemic and the use of emergency powers in that context, examining the distribution of competences and resources according to the Epidemics Act (chap. 3.3), before discussing the fiscal equivalence trap in more detail (chap. 4). In our conclusions, we will show that there is much to learn from these recent crisis situations and discuss some suggestions for improving the financial emergency arrangements (chap. 5).
II. THE SWISS FEDERAL POWER AND RESOURCE SHARING SYSTEM

Switzerland’s federal system relies on a complex and dynamic distribution of powers and resources (2.1). In the two fields which have proved to be crisis-prone in the past – economic policy and health – the constitutional distribution is very differently organised (2.2), leading to dissimilar federal emergency dynamics. The overall regime is guided by the constitutionally guaranteed principle of subsidiarity and of fiscal equivalence. Both principles are not justiciable and only partially implemented (2.3).

1. The Power and Resource Sharing Regime

As in numerous other federal systems, the residual power is vested with the subnational units of Switzerland, the cantons, which exercise all rights not delegated to the Confederation (article 3 of the constitution). The federal tier is hence only empowered to perform a task insofar as such a task is assigned to it by the federal constitution itself (article 42 of the constitution; Biaggini et al., 2021, p. 154 ff.; Malinverni et al., 2021, p. 380 ff.; Tschannen, 2021, p. 287 ff.).

Competences assigned to the federal level differ with regards to their extent as well as their effect on the cantonal competences. Federal competences can allow the federal tier to extensively regulate an area – so-called comprehensive competences –, they can be limited to specific aspects – so-called fragmentary competences – or only permit the Confederation to lay down principles – so-called framework competences (Häfelin et al., 2020, pp. 353 ff.; Tschannen, 2021, p. 302-304).

As to their extent, federal competences can be exclusive, concurrent, parallel or subsidi­ary. Concurrent competences are the rule. Cantons then preserve their competences even in fields delegated to the federal tier and can still make and apply their own laws, as long as and to the extent that the federal competency has not been made use of comprehensively (Häfelin et al., 2020, pp. 354-357; Martenet, 2021, pp. 157-160; Tschannen, 2021, pp. 300-302). Whenever competences are concurrent, it thus often occurs that both the federal and cantonal tiers are allowed (and sometimes even obliged) to act. Cantonal acts must not violate national and international norms (article 49 of the constitution) but may complement, supplement and refine them.

The extent and effect of federal competences is often far from clear and must be determined by constitutional interpretation (Häfelin et al., 2020, p. 349). In most policy fields, a complex system of coexisting, juxtaposing and interrelated federal and cantonal competences exists (Biaggini, 2015, Art. 3 of the constitution, pp. 74 ff.; Malinverni et al., 2021, p. 402-405; Martenet, 2021, pp. 162-164). Where concurrent federal and cantonal competences coexist, only the interpretation of federal and cantonal acts in light of the constitution can answer the question of whether the federal norms leave room for cantonal additions and whether a canton is actually complementing or rather contracting federal law.

In the field of resource sharing, the Confederation is vested with a number of exclusive competences (such as customs duties, value added tax, and special consumption taxes; articles 130-134 of the constitution). In contrast, direct taxes on the income of private individuals and the net profit of legal entities are parallel competences of all tiers of governance (article 128 of the constitution). The federal, cantonal and local tiers thus autonomously levy and spend taxes, leaving the cantonal — and local — tiers with significant financial autonomy.

Consequently, the Swiss fiscal federalism regime leads to considerable differences: Taxpayers pay different tax rates depending on the canton and commune taxing them, and cantons and communes find themselves in different financial situations depending on their tax levels and resources. It is for the latter inequality that the regime of fiscal federalism is complemented by a regime of financial equalisation (article 135 of the constitution; see for
a more detailed account e.g. Hänni, 2021, pp. 270 ff.). Its main aims are to reduce the differences in financial capacity among the cantons and to guarantee all cantons a minimum level of financial resources (article 135 para. 2 lit. a and b cst.). The equalisation of financial resources is mostly horizontal (see article 135 para. 3 and article 4 para. 1 and 2 of the Federal Act on Resource and Burden Equalisation [FiLaG]) and enforces solidarity between resource-rich and resource-poor cantons. Resource equalisation is not full (see article 3a para. 2 FiLaG) as it aims at maintaining tax competition and incentives for poorer cantons to develop economically. The equalisation of burdens, in contrast, is mostly vertical. The Confederation compensates mountainous regions for special burdens linked to geo-topographic challenges (article 7 FiLaG) and metropolitan areas for extra burdens linked to socio-demographic factors (article 8 FiLaG).

2. The Power Sharing Regime in Economy Policy and Health

In the two fields which have proved to be crisis-prone in the past, economic policy and health, the constitutional distribution of competences is very differently organised:

The Confederation is solely responsible for money and currency and enjoys exclusive competences in the field of currency policy which are implemented centrally by the independent Swiss National Bank (article 99 cst.). In the field of economic policy more broadly, the Confederation is vested with comprehensive but concurrent competencies to take measures to achieve a balanced economic development, and to prevent and combat unemployment and inflation. Consideration and cooperation duties compensate the cantons for their loss of competence: When using its powers, the federal tier must consider the economic development in individual regions of the country and cooperate with the cantons (article 100 para. 1 and 2 cst.). Such concurrency also exists in the field of banking. The Confederation is obliged to legislate on the banking and stock exchange system and may legislate on financial services in other fields. By issuing the federal Bank Act and the Financial Market Supervision Act and by mandating the Swiss Financial Market Supervisory Authority to supervise banks, securities markets and investment funds, the federal tier has made extensive use of its constitutional powers in the field. It has, however, taken account of the special function and role of the cantonal banks (article 98 cst.).

In the health sector, the federal competences are much more limited. The constitution obliges the Confederation to legislate on health insurance (article 117 cst.) but otherwise only provides for very limited parallel and fragmented federal competences. Generally speaking, the health sector is governed by the cantons. One of the few fragmentary federal competences relates to the combating of communicable, widespread or particularly dangerous human and animal diseases (article 118 para. 2 lit. b) on which the federal Epidemics Act is based (see chap. 3.3).

Thus, in the financial sphere, as a rare exception, even implementation is centralised. In contrast, the health sphere is almost entirely in the realm of the cantons which are obliged to implement the few acts the central tier has adopted based on its skeletal set of competences and, for the rest, make and implement their own health policies.

3. The Principles of Subsidiarity and of Fiscal Equivalence

The attribution of tasks and responsibilities to the different government tiers and the way competences are used is refined – amongst others – by the principle of subsidiarity (article 5a cst.). This principle – like the principle of fiscal equivalence which it is closely related to – has been introduced into the constitution in the context of the reform re-organizing the division of competences and the financial equalization scheme in 2004 (Federal Dispatch on the NFE, FG 2002 2291; see also Federal Dispatch on the New
Constitution, FG 1997 I 1). It is codified as a binding guideline and stipulates that the higher tier of government must only interfere by legislating if unity is required, it must limit legislative unification to the strictly necessary, and it must leave implementation to the lower tier and allow for maximum margin of appreciation in the application of federal acts (instead of many: Biaggini, art. 43a Cst., 2015, N 11 ff.; Tschannen, 2021, pp. 291 f.; Waldmann, 2015, pp. 3-9). The Confederation hence only intervenes – and only to the extend – that a task either overburdens cantons or requires uniform regulation (article 43a para. 1 cst.). Cantons thus enjoy far-reaching autonomy in so-called original matters (issues not delegated to the federal tier) and considerable margin of discretion in so-called delegated matters (issues harmonised by federal acts but autonomously implemented and adjudicated by cantons, article 46 cst.; see also and amongst others: Malinverni et al., 2021, p. 384; Martenet, 2021, pp. 160-162). Even if unity is considered necessary (and the federal constitution amended accordingly), the country typically opts for harmonisation only and accepts cantonal differences even in spheres of federal competences. As the principle is not justiciable, it is, however, regularly disrespected by the constitution-maker itself, by the federal parliament and the federal executive. It has hence only partially fulfilled its aim of serving as a break to ongoing centralisation trends (Bellanger, 2021, N 17; Waldmann, 2015, p. 15).

The same is true for the principle of fiscal equivalence which emanated from the field of economics and was constitutionalised as part of the federalism reform (Tiefenthal, 2021, p. 589; Waldmann, 2015, p. 13). According to the principle of fiscal equivalence, the collective body that benefits from a public service bears its costs and the collective body that bears the costs of a public service may decide on the nature of that service (articles 43a para. 2 and 3 cst.). Somewhat simplified, the principle is often referred to as “who pays, decides – who decides, pays”-principle (Waldmann, 2015, p. 13). Its underlying idea is that those who benefit from a state service must, on the one hand, finance the service (through taxes or fees) and, on the other hand, have a (democratic) say in the determination of the service (Biaggini, 2015, art. 43a cst., N 26). Such triple congruency – maximizing democratic accountability and limiting financial transfers – intrinsically links the distribution of powers to the distribution of resources. Since its introduction into the constitution, the principle of fiscal equivalence has been controversial discussed (critical e.g. Biaggini, 2015, article 43a cst., N 26; Waldmann, 2015, p. 15; favourable e.g. Schweizer, 2020, N 7; Tiefenthal, 2021, p. 583). It has not fully been implemented in the first place, and has often been transgressed in the second (KdK, 2017; see also Waldmann, 2015, p. 15). Moreover, it is limited by the constitution itself: As the federal competences are most often limited to law-making, cantons must implement federal laws and finance their implementation. While cantons therefore bear the costs of their policy decisions, the Confederation does not necessarily (see e.g. Biaggini, 2015, article 43a cst., N 29). The result is that the principle has a very unequal impact on the federal actors: While cantons tend to shy away from taking on costly tasks, it is a temptation for the Confederation to make laws and ask the cantons to finance their implementation.

In addition, the principle of fiscal equivalence only deploys its hoped-for outcomes when a task benefits a clearly defined territory and when such territory matches a territorial unit (Tiefenthal, 2021, p. 592; Waldmann, 2015, p. 13). This condition is obviously not given in the case of a pandemic and the principle of fiscal equivalence hence ill-designed to deal with rapidly spreading viruses not respecting local, cantonal or any other borders. Furthermore, scholars insist that it might be reasonable in some cases – for reasons of effectiveness or others – to issue national regulations and to provide and finance the corresponding public services at the cantonal level (Tiefenthal, 2021, p. 593). In case of a major health crisis, such arguments are particularly significant and, during the Covid 19 crisis, provoked endless and frustrating debates about the ideal bearer of
costs for testing, tracing and quarantining – debates which delayed effective actions. Regrettably, the constitution and its principles were not helpful in preventing conflict and saving time by clearly sorting out the financial matters (see chap. 4).

III. THE EMERGENCY REGIME AND ITS USE DURING THE FINANCIAL AND COVID-19 CRISIS

The Federal Constitution provides for an emergency regime allowing for power concentration (3.1). The Financial Crisis of 2008 (3.2) and the Covid-19 Crisis (3.3) are two recent examples in which these emergency powers have been used extensively. In both situations, the emergency regime has been criticized, although for very different reasons: In the first, the decision of the Federal Council to bail out the private bank UBS raised the question of whether such crisis legitimized the use of emergency acts and whether the bypassing of parliament was acceptable – and thus was concerned with the horizontal separation of powers; in the second, federal matters of power and resource sharing – matters of vertical distribution of competences and obligations – were at the forefront.

1. The Constitutional Emergency Regime

In case of an emergency, the Federal Assembly and the Federal Council acquire special powers. If extraordinary circumstances so require, the parliament can take measures to safeguard the external security of the country, its independence and its neutrality, and measures to safeguard internal security (art. 73 para. 1 let. a and b cst.). Such measures can include federal emergency acts which are exempted from the usual optional referendum that would otherwise delay parliamentary laws from entering into force (article 165 cst.; see for a more detailed account e.g. Belser, 2021, p. 127 f.). The parliament is also empowered to adopt federal emergency acts in fields of cantonal competences. Such acts which do not rely on a constitutional provision establishing a federal competence and hence amend the constitutional power sharing regime must be approved by the people and the cantons within a year (and otherwise be repealed). So far, these parliamentary emergency powers have not been very relevant (Belser, 2021, p. 127). A bicameral parliament relying on numerous mechanisms to seek compromise and make consensus-based laws (Belser, 2018, pp. 168 ff.) is not ideally suited to work under stress.

In contrast, the slightly more restrictive emergency powers of the federal executive are frequently deployed (Belser, 2021, p. 127). To counter existing or imminent threats of serious disruption to public order or internal or external security and to safeguard the interests of the country, the Federal Council may issue ordinances and rulings (articles 184 and 185 cst.). The emergency ordinances must be limited in duration and necessary to protect fundamental legal values such as peace, life, and public health (paras. 3 of articles 184 and 185 cst.). In recent times, the Federal Council has used its emergency powers on several occasions, in particular to enforce international sanctions, to deal with the crisis of the airline Swiss and other international and economic concerns. Most recently, the emergency powers were used extensively to deal with the financial crisis (see 3.2) and the Covid-19-pandemic (3.3).

2. The Financial Crisis

Switzerland was not as hardly hit by the financial crisis as many other countries. It did not escape unscathed but was only slightly affected by recession, quickly regained considerable growth rates and avoided amassing huge debts (Swiss Financial Statistics 2011 and 2012; OECD, 2017, p. 8).

When the financial crisis started to unfold, Switzerland was considered particularly vulnerable as its two largest private banks, UBS and Credit Suisse, were particularly
exposed in the US subprime bubble. Soon, the Swiss banking sector, in particular the UBS, fell victim of its own high-risk strategy of expansion in the US market and was about to go bankrupt. To avoid this, the Federal Council, using emergency powers, adopted a comprehensive program to support the Swiss finance system and – together with the Swiss National Bank – rescued UBS. The aid plan consisted of a government contribution of 6 billion Swiss francs to restore the banks own funds and a contribution from the National Bank of 54 billion Swiss francs allowing UBS to transfer illiquid securities into a special stability fund (resulting in the National Bank taking over UBS's toxic assets; see CC, 2010). The state intervention was justified by the argument that UBS was “too big to fail” (Federal Dispatch on measures to strengthen the Swiss financial system, FG 2008 8943; see also: Kley, 2011, pp. 133-134).

The use of the executive emergency powers in 2008 was most controversy discussed. In essence, it was viewed critically that the claimed emergency was economic – and private – in nature, and it was disputed whether the bankruptcy of a bank qualified as a serious threat to national security (Belser, 2021, p. 128). At the end, the judiciary took a stance on the issue. When the case was brought to the Federal Supreme Court, the latter decided that the use of the federal emergency powers was not limited to serious threats to peace, life, and public health. Rather, economic and social crises could justify their use as well (Federal Court Decision, BGE 137 II 431, paragraph 4.1.). This decision was criticized by various scholars, who argued that it allowed the use of emergency powers too widely (Belser, 2021, p. 128, with further references).

The (contentious) use of emergency powers has resulted in a number of legislative changes, in particular the adoption of a Federal Act on Safeguarding Democracy, the Rule of Law and the Capacity to Act in Extraordinary Situations, which entered into force in 2011. According to the new rules, the Federal Council now has to immediately inform Parliament – or rather the competent parliamentary commission – when it uses emergency powers (Government and Administration Organisation Act [GAOA], article 7e para. 2). Furthermore, emergency ordinances cease to apply if the Federal Council fails to submit them to Parliament within six months (article 7d para. 2 GAOA). However, not all ambiguities have been removed by the amendments. While it was mostly undisputed that emergency powers do not allow the Federal Council to violate the Constitution, it was controversially discussed whether they allow the Federal Council to go against or amend parliamentary laws (Belser, 2021, p. 128; with further references to: Saxer, 2014, N 101-104; Stöckl, 2020, pp. 24-25). The emergency regulations of the recent past, however, have taken a clear stance in the matter: They frequently amended parliamentary laws, most clearly in the recent decisions providing for the rescue of the bank Credit Swiss by its acquisition by UBS.

Following the financial crisis, the Swiss legislator also promulgated special rules for the stabilisation, restructuring or liquidation of financial institutions which are of a systemic importance to the point that their failure jeopardises the entire Swiss economy. These too-big-to-fail (TBTF) regulations, included in the Banking Act in 2012, oblige systemically important banks to comply with higher capital requirements, increased liquidity requirements and higher requirements in terms of resolvability. The TBTF buffers aim at strengthening the crisis resilience of big private banks. Moreover, they allow for the continuity of systemically important functions in Switzerland in the worst-case scenario of bankruptcy by spinning off the Swiss business arm (Federal Dispatch on the too big to fail regulation, FG 2011 4717; see also: Fact Sheet on the too big to fail regulation, 2023). These new legislative measures, however, were not implemented in 2023 when the Federal Council and the National Bank, based on constitutional emergency powers, decided on a takeover of CS by UBS thereby creating a bank even bigger and even more likely bailed out in a future crisis. In a few days time, the Federal Council had arranged a deal providing for the takeover of CS by UBS. The Federal Council officially
“welcoming” this move, but really had designed it and extensively used emergency law to make it happen. The Council allowed the Swiss National Bank to provide substantial additional liquidity assistance and gave a default guarantee for liquidity assistance. In order to reduce the risks for UBS, the Federal Council also granted a guarantee of 9 billion to assume potential losses arising from certain assets USB was taking over from CS (Special dispatch on guarantee credits [CS takeover], 2023). According to the new rules, such emergency measures had to be accepted by the finance commission of parliament and be submitted to the federal assembly. While the finance commission “urgently” gave its approval on Sunday, 19 March 2023, the National Council, quite spectacularly, decided to deny parliamentary approval (National Council, Official Bulletin 2023 N 714 f.). Several factors motivated the members of parliament to express their deep dissatisfaction: the TBTF-regulations provide for a worst-case scenario of bankruptcy (not bailout) in which only the sector crucial for Swiss business would be allowed to continue. The management of the crisis thus contradicted the rules provided for in such a scenario. The effects of the parliaments refusal to approve the emergency credits have been and are still controversially discussed. While some claim that such subsequent decision must be considered as a symbolic protest of parliament, others insist that the parliamentary budgetary powers are at the heart of democratic power control and that therefore all financial promises of the Federal Council must be stopped from being transformed into financial commitments (see e.g. Biner & Gerny, 2023; Gerber, 2023, pp. 5-11). As (most) of the financial commitments have (probably) already been made, the parliamentary power of approving the credit (and of not approving it), raises further unsolved issues. Seen the open questions, the charges and allegations, it does not come as a surprise that parliament has decided – for the fifth time in the country’s history – to establish a parliamentary commission of inquiry. This is the most powerful instrument the Federal Assembly has at its disposal to hold the federal executive accountable (and has been labelled the Swiss variation of a vote of non-confidence).

3. The Covid Crisis

While the difficulties associated with the use of emergency powers during the financial crisis were mainly related to democratic concerns about the horizontal division of powers, they also involved a federal component in the context of the covid pandemic. This is due to the far-reaching cantonal competences in matters of health, the complex and dynamic power sharing regime established by the Federal Epidemics Act, and the parallel deployment of legislative and constitutional emergency powers – to take epidemic measures on the one hand and to cushion their economic and social effects on the other.

Based on its fragmentary and concurrent competence to deal with epidemics (article 118 cst.), the Federal Assembly has issued an Epidemics Act [EpidA] introducing a three-stage-model to deal with health emergencies (Bernard, 2020). In “normal” situations, it is up to the cantons to prevent and control diseases, but the federal tier – in consultation with the cantons – determines aims and strategies (Belser, 2021, p. 126; Bergamin & Mazidi, 2020, pp. 15–16; Stöckli, 2020, pp.18–19). When the situation is declared “extraordinary” by the Federal Council, the latter may take any measure required for the entire country or some parts of it (art. 7 EpidA). When the situation is declared “extraordinary” by the Federal Council, the latter may take any measure required for the entire country or some parts of it (art. 7 EpidA). In such situation, competences are thus not only shifted horizontally (from parliament to government), but also vertically (from the cantons to the confederation) as well. In an extraordinary situation, it is not mandatory according to the Epidemics Act – albeit still mandated by the Constitution to the extent possible – to consult the cantons prior to ordering measures (Belser, 2021, p. 126). This extraordinary situation – in which the country found itself between 17 March and 19 June 2020 – is foreseen but not regulated by law and leaves numerous questions open (Bergamin & Mazidi, 2020, N21–22; Bernard, 2020; Stöckli, 2020, pp. 19–21). In particular, it is unclear how far the federal competences reach and whether the cantons are allowed to go beyond the federal rules (Belser, 2021, p. 134).
Even more controversial is the “special” situation which applies when the epidemic conditions are no longer normal but not (yet or no longer) extraordinary. The Epidemics Act defines a situation as “special” when the ordinary enforcement agencies are unable to prevent or control the outbreak and spread of communicable diseases, and when there is either a high risk to public health or the economy or other sectors, or when the World Health Organization (WHO) has announced a public health emergency of international concern and this emergency poses a risk to public health in Switzerland (article 6 para. 1 EpidA). In such a “special” situation – in which the country found itself during most periods of the Covid crisis – the Epidemics Act empowers the Federal Council with an extra set of competences to take – such as banning events or closing schools –, which would otherwise lay within the competence of the cantons (art. 6 para. 2 EpidA; see also: Belser, 2021, p. 126). However, the Federal Council may order such measures only after consulting the cantons (art. 6 para. 2 EpidA). This duty to consult the cantons compensates the latter for the loss of their autonomy and ensures that their know-how about the situation on the ground informs federal decision-making (Bergamin & Mazidi, 2020, N17–20; Kley, 2020, p. 272; Stöckli, 2020, p. 19). At the beginning of the second wave of the Covid-pandemic, however, it soon became apparent that the special situation was only insufficiently regulated and that the concurrent competencies, combined with the absence of joint bodies monitoring the disease and coordinating actions, raised the risk of negative conflicts in competence (Belser, 2021, p. 126). As it was mostly during this time that the fiscal equivalence trap deployed its effects, we will further explore this situation below (chap. 4).

The specific system of health and epidemic competences established by the Federal Epidemics Act is complemented by the general constitutional emergency regime – and vice versa. Indeed, epidemic measures, such as the testing requirement or the banning of events, were issued by federal and cantonal governments based on the dynamic shifting of competences provided for by the Epidemics Act. In contrast, other (mostly economic) emergency measures, such as financial relief packages, were adopted referring to the constitutional emergency powers of the federal (and cantonal) constitutions (chap. 3.1). As a result, two parallel emergency regimes unleashed unprecedented executive powers at the federal level. These executive powers altered in their nature, their extent and their effect on parliamentary and cantonal powers depending on the measure at stake and the urgency involved. Ambiguities and controversies were not only linked to the constitutional and legal situation, the competences of the federal parliaments and the cantons, and the nature and necessity of measures taken, but also to factual difficulties, in particular the handling of scientific data. Overall, and in international comparison, the country has probably not coped too badly with the crisis; but because in the midst of serious threats there were persisting arguments about responsibilities and duties between the Confederation and the cantons, precisely when there seemed to be no time for such conflicts, the reputation of federalism has nevertheless suffered considerable damage.

IV. THE FISCAL EQUIVALENCE TRAP

The complexity of the division of powers and duties – in the context of emergency situations in particular – can lead to problematic effects and delayed state action. We believe that the principle of fiscal equivalence significantly contributes to these difficulties, in particular, by disincentivising measures which would have been required (4.1), a phenomenon which we call “Fiscal Equivalence Trap”. We argue that the fiscal equivalence trap has been manifest in the context of the management of the Covid-19 pandemic (4.2), but that it is not limited to the context of health emergencies, but can rather cause (or aggravate) negative conflicts of competences in other policy fields as well.
1. The Principle of Fiscal Equivalence and the Problem of Negative Conflicts of Competence

Conflicts of competences are common in federal systems, be they under stress or not. Most systems are well-equipped to deal with the – seemingly – more common form of such conflicts: positive conflicts of competences. In such situations, both tiers of government deem themselves to be competent, make laws or take other actions. The federal institutions, in general, can deal with such conflicts, mostly by empowering an apex court to adjudicate and invalidate laws and decisions which go beyond the respective competences (ultra vires) and are hence unconstitutional.

Conflicts of competences can, however, also be negative. Such situation exists when none of the government tiers claims a competence in a field and both remain inactive (infra vires). Inactivity can stem from ambiguous competences that both actors try to escape and from concurrent competences that both actors prefer to leave to the other tier – in general, in fields that require costly action. Few constitutional regimes explicitly deal with such conflicts and, generally, find it more difficult to mandate due action than to prevent undue action. The fact that constraining state power is, historically, at the heart of constitutionalism, should, however, not blur the circumstance that inaction can be as problematic for the rights and freedoms of citizens. Especially in situations where rapid state action is required to prevent harm, such as the rapid spreading of a disease or the breakdown of a health system, emergency action is not a right but a duty of the state. Indeed, in such situations, the controversy over who must decide and act may lead to critical delays or inaction, and by the time the conflict of competence is solved, it might already be too late to (sufficiently) mitigate negative consequences.

The principle of fiscal equivalence has the potential to exacerbate the problem of inaction and the threats linked to it. Indeed, if the consequence of being competent to decide on a matter is that the respective state level has to pay the costs of its decisions and their implementation, both the federal and the cantonal state actors tend to be less inclined to claim competences. The occurrence and relevance of negative conflicts of competences is hence increased by the principle of “whoever decides, pays”, as it can be more appealing not to decide and not to pay. The principle of fiscal equivalence, too, is thus tailored to positive conflicts of competences. It meaningfully contributes to establishing a cooperative partnership between the Confederation and the cantons: Acting beyond one’s competences is less tempting when costly. However, when pricey action is urgently required, the principle of fiscal equivalence can lead to a fiscal equivalence trap. When the competences of one tier or the other are clear and exclusive, some legal remedies – and numerous political ones – are at hand. However, when the respective duties of the tiers are concurrent or ambiguous, one’s inaction can easily be legitimized by pointing to the other tier.

2. The Fiscal Equivalence Trap in the context of the Covid-19 pandemic

Shortly after the first Covid-19 case in Switzerland on 25 February 2020, the Federal Council declared a “special situation” under the EpidA. From then on, measures to prevent the spread of the virus where taken at the national level. Cantons had to respect and implement these measures, but were still left with their own set of competences to deal with the crisis. At the beginning, for instance, the Federal Council banned large-scale events involving more than a thousand people; the Cantons were obliged to implement the ban, and competent to issue additional health measures relating to such events, or to ban even smaller events.

Despite these measures, the infection rate increased exponentially, which is why in March 2020, stricter rules where introduced on the federal level, before the Federal
Council declared an “extraordinary situation” according to the EpidA on 6 March. Following this declaration of the extraordinary situation, a set of strict rules and measures was issued and continuously amended at the federal level, the cantons being left with only a minimal set of competences, such as taking their own economic relief measures, and considerable implementation duties. The Federal Council also adopted comprehensive economic relief measures to cushion the effects of the lockdowns. During this stage of the Covid-19 pandemic, even though the concentration of power at the federal level was – after some time of shock unity – not completely undisputed, the vertical distribution of competences did not lead to negative conflicts of competence. Indeed, it was clear that the federal authorities where the main actor and that the role of cantons was reduced to implementing the national pandemic responses.

There was, however, a debate whether cantons more heavily affected than others or more willing to lockdown activities were still allowed to issue their own emergency regulations. The fact that the federal authorities declared their regime to be exhaustive did not silence the controversy. The negative effects of the conflict of competences on the pandemic reality nevertheless remained minimal. After all, the federal measures at this point were relatively strict and did not leave a large regulatory vacuum the cantons were not permitted to fill. However, the cantons were affected differently by the pandemic, and some cantons, such as the Ticino and many French-speaking cantons, strongly argued in favour of them being able to issue stricter rules, an argument that was supported by scholars (Belser et al., 2020, p. 4-7; Belser & Mazidi, 2020). Furthermore, the fact that the cantons were less involved in the making of the federal measures as was usually the case led to the introduction of some measures that were found to be difficult to implement by the cantons (Belser, 2021, p. 134). Hence, some disputes about the vertical distribution of competences did arise after all. These disputes, however, took the (more usual) form of positive conflicts of competence in the sense that both the federal states and (some of) the cantons wanted to act.

The federal decision not to allow cantons to issue stricter lockdowns than the federal executive was presumably motivated by financial concerns. Cantons issuing complementary measures (and their populations) were expected to ask for more financial support from the national emergency relief arrangement (Belser et al., 2020, p. 4-7; Belser, 2021, p. 134). Thus, financial considerations, in particular disputes about financial responsibilities corresponding to the respective competences, already played a role at this stage of the pandemic response (Belser, 2021, p. 134).

The vertical distribution of competences did start to be very controversial and disputed when the Federal Council declared the downgrading from the extraordinary to the special situation on 19 June 2020. Indeed, the special situation is characterized by the coexistence of federal and cantonal competences and, hence, particularly prone to negative conflicts of competences. Contrary to what has been the case in the first phase of the pandemic, the federal government now no longer considered itself to be the main actor of the pandemic management and called on the cantons to act (Belser, 2021, p. 135). Thus, financial considerations, in particular disputes about financial responsibilities corresponding to the respective competences, already played a role at this stage of the pandemic response (Belser, 2021, p. 134).

This is when a negative conflict of competence became manifest – both the federal and the cantonal authorities being reticent to take measures. The Confederation, exhausted by costs and critics, was quite willing to hand over responsibility, the cantons, however, unwilling to take it up. After all, while pandemic measures seemed urgently required as temperatures went down and infection rates up, the perspective of issuing cantonal restrictions was unattractive – politically and also financially. Indeed, according to the fiscal equivalence principle, taking measures (“decide”) meant bearing the costs
of the measures ("pay"). Both tiers therefore remained passive while the second wave of the pandemic started to badly hit the country. At that time, federalism was blamed for failing the citizens – and it did. It was also at that time, when the Confederation and the cantons insistently blamed each other for inaction, that a journalist coined a new term for federalising, ‘föderalen’, meaning to shift responsibility and guilt to the cantons when it is inexpedient to act (Karpiczenko, 2020).

3. The Effects of Fiscal Equivalence on Federal Finances

One could wonder whether the principle of fiscal equivalence – and the trap it can lead to – had effects on the financial situations of the different federal actors. Looking, firstly, at the development of the financial situation in Switzerland more generally, one finds that the financial situation in Switzerland has been relatively stable over the years. Indeed, data consolidated by the OECD on the evolution of debt and public expenditure in Switzerland during the 1999-2021 and 1995-2021 period respectively shows that these economic indicators have remained relatively stable, even during and in the aftermath of the 2008 financial crisis. A significant rise in government expenditure and debt affecting all three levels of government can be identified in 2020 due to the Covid-pandemic. The data for 2021, however, already indicates a return to financial normalcy.

### Consolidated government expenditure as percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cant.</td>
<td>31.39</td>
<td>31.27</td>
<td>31.86</td>
<td>31.60</td>
<td>31.22</td>
<td>31.79</td>
<td>31.32</td>
<td>31.21</td>
<td>31.03</td>
<td>31.06</td>
<td>31.89</td>
<td>31.54</td>
<td>31.98</td>
<td>31.83</td>
<td>31.59</td>
<td>31.08</td>
<td>31.36</td>
</tr>
<tr>
<td>Local</td>
<td>38.44</td>
<td>38.22</td>
<td>38.63</td>
<td>37.93</td>
<td>37.27</td>
<td>36.91</td>
<td>36.86</td>
<td>37.08</td>
<td>37.32</td>
<td>37.21</td>
<td>36.89</td>
<td>36.29</td>
<td>36.00</td>
<td>35.94</td>
<td>36.44</td>
<td>36.91</td>
<td>36.86</td>
</tr>
</tbody>
</table>

### Debt as percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cant.</td>
<td>26.43</td>
<td>26.73</td>
<td>26.48</td>
<td>26.32</td>
<td>26.04</td>
<td>25.87</td>
<td>25.14</td>
<td>25.72</td>
<td>24.94</td>
<td>27.71</td>
<td>27.13</td>
<td>27.13</td>
<td>27.07</td>
<td>27.27</td>
<td>27.57</td>
<td>27.39</td>
<td>27.27</td>
<td>27.13</td>
<td>27.13</td>
<td>27.07</td>
<td>27.27</td>
<td></td>
</tr>
</tbody>
</table>

Source: OECD Fiscal Decentralisation Database.

Looking at the context of the covid-19 pandemic a bit more closely: The Swiss Financial Statistics expected the gross debt of government – which was stable between 2012 and 2019 – to rise significantly in 2021 due to funding requirements caused by the measures of the pandemic management (Swiss Financial Statistics 2021, p. 10). It was also predicted that the Confederation would be most affected as it had carried the main financial burden of supporting enterprises as well as sports and cultural event organisers in 2020 and 2021 while the contribution of the cantons and local governments remained comparatively small (Swiss Financial Statistics 2021, p. 4). Despite these extra costs burdened by the federal tier (in a first phase of the pandemic at least), the Swiss Financial Statistics expect a debt reduction for the Confederation between 2022 and 2025, but an increase of the gross debt of the cantons and the communes (Swiss Financial Statistics 2021, p. 5 and 10).

One year later, the Swiss Financial Statistics of 2022 confirm that the Confederation was more heavily affected in 2020 – when it was leading the pandemic reply – and slightly less in 2021, when cantons reacquired concurrent competences and were asked to use them. The federal government’s participation in the Covid-19-related expenditures amounted to 16.7 % in 2020 and was reduced to 15.6 % in 2021. The opposite applied to the cantons whose participation was lower in 2020 (2.7 %) but significantly higher in 2021 (6.7 %) (Swiss Financial Statistics 2022, p. 10). However, and in contrast to the estimates of 2021, the 2022 financial statistics estimate the government’s gross debt to peak at the end of 2023 only, after which it is expected to steadily decline (Swiss Financial Statistics 2022, p. 13).
The financial situation of the cantons is (not yet) fully conclusive. A study elaborated in 2021 by PwC in close cooperation with the Swiss Association of Cities on the financial impacts of the pandemic on the Etats of the cantons, cities and municipalities, in which 15 cantons were analysed more closely, indicate that the cantonal debts will rise significantly in 2021, 2022 and 2023 (Schegg & Engeler, 2021, p. 12). However, the study also shows that it is the municipalities that are likely to suffer the greatest financial impact, their debt rising substantially more significantly than the cantonal debts. When looking at specific cantons, however, the situation is diverse. To illustrate this, we will have a closer look at the financial situations of the cantons of Vaud, Ticino and St Gallen, cantons not only representing the three linguistic regions but also cantons particularly hit during the second wave and choosing very different approaches to managing the crisis.

The canton of Vaud was amongst the cantons asking for the competence to implement stricter measures during the extraordinary situation and then one of the cantons actually implementing bans and closures relatively early during the special situation in summer 2020. Even though the canton assumed high expenditures to manage the pandemic, it posted a financial surplus in 2020 and in 2021 and its public debt did not increase in those years (Annual Accounts VD, 2020 and 2021). In 2021, it was even one of the donor cantons in the fiscal resource equalisation – which wasn’t the case in the years before and after. The situation was quite different in the canton of Ticino. As was the case in the canton of Vaud, the canton of Ticino was particularly affected and was amongst the cantons issuing (strict) measures earlier than others. Contrary to what has been the case in the canton of Vaud, these circumstances were also reflected in the canton of Ticino’s financial results. Indeed, it posted a negative annual financial result in 2020 and the cantonal debt increased notably (Financial Report TI, 2020, pp. 35 f., 48, 52 and 58 in particular). The canton of St Gallen – even though particularly hit by the second wave – opted against autonomous cantonal pandemic replies and limited its actions to implementing the measures mandated by the federal level. Even so, it had to shoulder extra expenditures – mostly due to the financing of the (cantonal) implementation of the federal measures –, but was able to cover them without increasing its cantonal debt (Annual financial account SG, 2020, pp. 10 f., 14 f. and p. 42 in particular).

These results show a diverse picture that is not easy to interpret. Some of the cantons particularly hit by the pandemic issued stricter measures than the Confederation and carried the costs of their decisions (in addition to the costs caused by federal measures) but did not suffer financially, i.e. the canton of Vaud. Others, acting in similar ways, suffered from considerable financial hardship, i.e. the canton of Ticino. The canton of St Gallen, which decided against a cantonal tightening of federal measures (and the obligation to finance such measures), reported large covid-related expenditures but did not suffer an increase of cantonal debts. The (financial) effects of cantonal strategies to deal with Covid – and the financial impact of the principle of fiscal equivalence – thus remains controversial and requires further research. The financial data nevertheless suggests that the fiscal equivalence principle had an effect on financial results: When the Confederation extensively used its emergency powers to manage the crisis, issued extensive economic relief measures and even shouldered some cantonal implementation costs (e.g. by contributing 50% to costs linked to testing), it suffered from significant financial impacts which decreased when the cantons were required to issue and finance their own measures. The results, however, are far from being unequivocal – especially when looking at specific cantons which were very differently affected by the crisis, not least because of their very different economic starting points, different economic sectors that are important for the cantons, and different exposure to foreign pandemic measures.
V. CONCLUSIONS

There is no doubt that unclear attribution of competences and financial obligations can lead to inaction and delays which are highly problematic when (timely) action is necessary. When taking rapid action leads to unplanned costs, acting is awfully unattractive and can lead to responsibility- and blame-shifting whenever competences are concurrent or otherwise blurred. This is not only true in the context of the management of the Covid-19 pandemic, but (potentially) applies to other policy areas as well.

Hopefully, the recent experiences will motivate a more general rethinking of the federal finances and the principle of fiscal equivalence. The Covid-19 crisis has raised awareness for the fact that the principle of fiscal equivalence can be an appropriate tool to deal with positive conflicts of competence and disincentivise cantons (and communes) to act (and pay) beyond their tasks. It is ill-suited, however, to prevent costly measures to be taken by the Confederation which can turn to the cantons for their implementation. More generally, the principle of fiscal equivalence can hamper cantonal and local action and motivate hesitation and inaction, and blame-shifting in cases of concurrent competences. It is hence in the interest of effective governance to clarify the distribution of (financial) responsibilities whenever costly action is required to comply with costly state tasks stemming from national or international law.

The conference of the cantonal governments, in its own evaluation report, also concluded that the Covid-19-pandemic questioned the principle of fiscal equivalence (KdK, 2020, p. 18). The cantons were most critical about the financial arrangements during the extraordinary situation. Their main complaint was that the federal government, during the period classified as extraordinary situation, issued numerous costly measures in spheres which would normally fall under cantonal responsibility, without defining (or debating) the financial implications with the cantons. In many ways, the conclusions of the conference of the cantonal governments confirm the existence of a fiscal equivalence trap: The respective financial responsibilities – regarding the direct costs of implementing health measures and the indirect social and economic follow-up costs – repeatedly led to conflicts that were detrimental to the interaction between the two levels of government (KdK, 2022, p. 11). The cantons hence recommend that the Confederation and the cantons agree on clearer principles regarding the sharing of the financial burdens linked to crisis management. They urge all actors to sort out financial responsibilities (who has to pay the costs of testing, quarantining, lockdowns, etc.) at the moment such (costly) measures are adapted or as soon as possible – and not only subs equently (KdK, 2022, p. 11). More generally, the cantons suggest that a chapter on financial responsibilities (and financial aid) is added to the Federal Epidemics Act, guiding and framing the (vertical) distribution of financial responsibilities and competences by setting out objectives, criteria and procedures with regards to special health costs (KdK, 2022, p. 12). The ongoing revisions of the Federal Epidemics Act will hopefully sort out ambiguities by either making it clear that the Confederation covers the costs of epidemiological measures, in total or in part, or by stating that cantons carry the cost of implementation in normal, special as well as extraordinary situations. Either solution will help the actors involved to plan accordingly – and to act in case of need. However, it remains to be seen whether the revised Epidemics Act will take up these recommendations.

Overall, it seems clear that the principle of fiscal equivalence must be complemented by other mechanisms. It is ill-suited to distribute burdens when the benefits of state measures are not limited to the territory of a canton or a commune – and the costs of inaction also easily spread across borders. The role of the principle of fiscal equivalence must hence be reconsidered when it comes to dealing with epidemics – or other situations such as climate change – that (potentially) incentivize free-riding. In addition, it is not sure that the Swiss version of executive federalism should be linked to cantonal
obligations to not only execute – but also finance – federal decisions. The full implementation of the principle of fiscal equivalence, in fact, should rather lead to a federal obligation to finance the implementation of federal acts – and to burden the cantons only with the costs caused by cantonal variations of implementation.

The Covid-19 crisis management revealed further weaknesses – other than the principle of fiscal equivalence – of the Swiss pandemic management. Among the shortcomings which negatively affected the crisis reply and trust in governance more generally are the lack of information and the numerous communication hiccups between the different actors of the federal tier, the cantons, intercantonal conferences and the communes. During the pandemic, the escalation from the normal and the special epidemiological situation to the extraordinary situation and, more importantly, the transition back to special and normal could have worked more smoothly, if the different tiers would have communicated better (KdK, 2020, p. 10).

More generally, a look at recent events makes it clear that the country finds it difficult to return to a normal mode of governance. Before one emergency fades out, the next kicks in – as has been shown not only by the CS-takeover in spring 2023, but also by the energy crisis which hit the country while it was still phasing out from and evaluating its crisis management after the pandemic. Such a situation – in which crisis management becomes the “normalcy” – makes it even more important to examine Swiss crisis governance and its impact on democracy, federalism, and the rule of law. Currently, emergency measures limit the power of parliament and the competences of the cantons and lead to horizontal and vertical power concentration. The recent attempts of the federal parliament to regain control (by adapting its own emergency regulations) have not proved very successful. It hence does not come as a surprise that new measures to strengthen the role of parliament during emergency are currently debated. Future improvements must be twofold: Find news ways and instruments to uphold democracy and power-sharing under stress and, as importantly, increase the resilience of all actors in order to strengthen their capacity to act under pressure and decrease the necessity to refer to emergency law.
REFERENCES


• Federal Council (FC) (2008). Dispatch on measures to strengthen the Swiss financial system. Federal Gazette (FG) 2008 8943. (cit.: Federal Dispatch on measures to strengthen the Swiss financial system, FG 2008 8943)


JOURNAL INFORMATION

INDEX

INTRODUCTION


LARGE SCALE BUT TEMPORARY: HOW THE FEDERAL GOVERNMENT'S RESPONSES TO THE GREAT RECESSION AND COVID-19 (MOSTLY) MAINTAINED CONTINUITY IN AMERICAN FEDERALISM

by John Kincaid
Robert B. and Helen S. Meyner Professor of Government and Public Service and Director of the Meyner Center for the Study of State and Local Government at Lafayette College

by J. Wesley Leckrone
Distinguished University Professor of Political Science at Widener University

To cite this article:
Kincaid, John; Leckrone, J. Wesley (2023): Large scale but temporary: how the federal government's responses to the great recession and Covid-19 (mostly) maintained continuity in american federalism, Cuadernos Manuel Giménez Abad, Special Issue 9. DOI: 10.47919/FMGA.CM23.01120

ABSTRACT

This article examines the effects that federal legislation designed to address the Great Recession and COVID-19 pandemic affected American federalism. Some other crises in American history have resulted in moves toward enduring centralization. Despite unprecedented federal spending, neither of the two major crises of the early twenty-first century resulted in more power being concentrated permanently in Washington, DC. Rather, in an effort to pump money into the economy expeditiously, the federal government mostly followed a traditional model of funding stimulus, while leaving implementation to state and local governments.

Keywords: Fiscal Federalism, American Federalism, Federal Economic Stimulus, Federal Grants
I. INTRODUCTION

Responses to major crises such as the Civil War (1861-65) and the Great Depression (1929-33 and 1937-38), have sometimes resulted in permanent centralization in the American federal system (Kincaid, 2019). Like Winston Churchill, who said in 1946: “Never let a good crisis go to waste,” federal politicians, especially presidents, sometimes seek to use crises to employ cooperative, coercive, and preemptive policy instruments in order to enter, or more fully occupy, policy areas traditionally reserved to the 50 states. This paper gives an overview of fiscal federalism in the United States and then examines whether federal fiscal responses to the Great Recession and the COVID-19 pandemic resulted in greater enduring centralization.

The federal government typically provides the bulk of financial stimulus to the United States economy during downturns. Spending during the Great Recession and the COVID-19 pandemic was unprecedented, with an estimated $1.8 trillion spent during the Great Recession and $5.99 trillion from legislative and executive actions during COVID-19 (Center for a Responsible Budget, n.d.). We argue that while the federal government used its financial largess, power to deficit spend, authority to regulate, and tools from the Federal Reserve (i.e., central bank) to engage in unprecedented spending during these two crises, there was no significant permanent power centralization. The scope of the federal government’s intervention into the economy, particularly through the 2008 Troubled Asset Relief Program’s ($700 billion) bailout of the financial and housing markets, greatly increased during the crises. However, the bulk of spending through fiscal stimulus programs such as the American Recovery and Reinvestment Act of 2009 ($787 billion), the Coronavirus Aid, Relief, and Economic Security Act of 2020 ($2.2 trillion) and the Inflation Reduction Act of 2022 ($485 billion) were mostly in traditional areas of federal authority, and when these measures extended into states’ powers, the responses were mostly cooperative in nature. Further, federal spending and programs were mostly designed to address the immediate crisis, thus not creating long-term programs that would significantly alter the federal-state balance of power. The current hyper-partisan environment in the United States has prevented large-scale policy legislation such as President Joseph Biden’s Build Back Better program ($2.4 trillion) of 2021 from passing the U.S. Senate, thus largely maintaining the status quo in the federal system. A partial exception was the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which enhanced federal regulation of securities but did not entirely displace state regulation. However, this act was passed when Democrats controlled 57% of the seats in the U.S. Senate and 59% of the seats in the U.S. House, a large majority, which has been rare in recent decades. Additionally, deficit spending during these two economic crises increased the federal debt, which have led to pressures to cut spending, thus altering the existing regime of intergovernmental transfers in the United States.

II. FISCAL FEDERALISM ACROSS POLICY DOMAINS

The federal government has always engaged in cooperative programs to help fund its priorities through fiscal transfers to the states (Elazar, 1962). However, the rising tide of policy activism from the federal government greatly increased aid to state and local governments after World War II (Kincaid, 1990). Figure 1 shows the evolution of this spending, with federal intergovernmental aid at .4% of GDP in 1946 and an estimated 4.1% in 2023. In constant-dollar terms, there was a secular trend of increased funding up to a high of $296.2 billion in 1978. State and local aid then declined for five years, increased for three years, dropped again in 1987, and then increased to a new high of $306.5 billion in 1993. Spending increased during the recessions of 1991, 2001,
2007, and 2020, with funding dipping during subsequent economic expansions. The passage of the Patient Protection and Affordable Care Act (ACA) of 2010, expanding federal healthcare assistance, vastly increased intergovernmental transfers and brought federal transfers back to 1970s levels as a share of total GDP. The ACA was significantly centralizing but was not enacted in response to either crisis discussed here.

Figures 2 through 5 show the long-term growth of federal aid to state and local governments by policy domain. As of FY 2020, Health, Income Security, Education/Training/Employment, Transportation, and Community and Regional Development received the most funding from the federal government. General government assistance spiked during the COVID pandemic, but as that funding lapses, these categories will again regain their top five status by FY 2023.
Health programs have taken on greater importance in intergovernmental aid since the enactment of the Medicaid in 1965. This shared federal-state program provides health insurance for the poor and disabled. It is an entitlement program, open to all people who meet qualification standards, and accounts for 1/6 of all healthcare expenditures in the United States. The federal formula for reimbursement to states is based on a state’s per capita income, with the poorest states receiving the highest reimbursement rates (Rudowitz, Williams, Hinton, & Garfield, 2021). For FY 2021, the federal government paid for 69.3% of the cost of Medicaid with states contributing 30.7%. Aid varies greatly by state. In FY 2024, Mississippi receiving 77.27% of Medicaid funding from the federal government, while the highest income states such as Connecticut and Maryland, received the federal minimum of only 50.0% (Kaiser Family Foundation, n.d.).

The ACA subsidized states to expand Medicaid to include people with incomes between 100% and 138% of the federal poverty level. The U.S. Supreme Court ruled that states could not be compelled to offer Medicaid expansion (Somin, 2016). However, 40 states have done so, and as a consequence, 15.3 million more people were enrolled Medicaid by FY 2019. This has led to a substantial increase in federal funding to states, particularly after 2014 when Medicaid expansion was fully in effect (Guth, Corallo, Rudowitz, & Garfield, 2021).
The adoption of the Children's Health Insurance Program (CHIP) in 1997 expanded access to children not eligible for Medicaid, but without other health insurance (Weissert and Schram, 1998). CHIP, along with its reauthorization and expansion in 2015, also contributed to the increase in federal intergovernmental aid in health policy.

Kincaid (1999) has termed these long-term trends as a shift of federal aid from places to persons, namely, from place functions such as infrastructure, schools, housing, and community development to payments for individuals for health and social welfare purposes. For example, in 1978, 67.6% of all federal aid to state and local governments was directed to place-based functions. In 2022, only 38.2% of such aid was directed to place-based functions. The shift of aid from places to persons has also contributed greatly to the rise of coercive federalism because of the regulations attached to social welfare programs and the extent to which those intergovernmental programs consume ever larger shares of state and local spending.
The federal government has historically been loath to provide unrestricted funds to state and local governments. However, General Revenue Sharing (GRS) in the 1970s, and aid during the recession of 2001 and the COVID-19 pandemic proved to be exceptions. The latter two programs were temporary, and GRS was phased out by Ronald Reagan’s administration in the 1980s.

III. TERRITORIAL DIFFERENCES IN FEDERAL FISCAL PAYMENTS

Table 1 displays the balance of payments between the states and the federal government for 2020, including COVID aid. Balance of payments is the amount of federal spending directed to a state minus the amount of money paid to the federal government by the residents and businesses of the state. The range is considerable, from $4,152 in Connecticut to $19,406 in Virginia—a difference of $15,254 (Rockefeller Institute of Government, 2021). There is a slight but not strong tendency for states with lower per-capita personal income to receive more revenue from the federal government than states with higher personal income. Notably, though, no state had a negative balance of payments in 2020 due, in large part, to deficit spending by the federal government allowing all states to receive more federal money than their residents paid to the federal government.

Whether the differences in balance of payments across the states reflect inequities is difficult to determine, in part because various factors influence the balance of payments. For example,

Table 1: Per Capita Balance of Payments Between States and the Federal Government and the 15 States with Lowest Per Capita Personal Income (X)

<table>
<thead>
<tr>
<th>State</th>
<th>Per Capita Payment</th>
<th>State</th>
<th>Per Capita Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>$4,152</td>
<td>Tennessee</td>
<td>$9,866</td>
</tr>
<tr>
<td>New Jersey</td>
<td>4,766</td>
<td>Michigan</td>
<td>10,053 X</td>
</tr>
<tr>
<td>Utah</td>
<td>4,989</td>
<td>South Dakota</td>
<td>10,096</td>
</tr>
<tr>
<td>Washington</td>
<td>5,285</td>
<td>Missouri</td>
<td>10,178 X</td>
</tr>
<tr>
<td>Colorado</td>
<td>5,843</td>
<td>Pennsylvania</td>
<td>10,181</td>
</tr>
<tr>
<td>Minnesota</td>
<td>6,152</td>
<td>Wyoming</td>
<td>10,293</td>
</tr>
<tr>
<td>Texas</td>
<td>6,563</td>
<td>Arkansas</td>
<td>10,842 X</td>
</tr>
<tr>
<td>Illinois</td>
<td>6,660</td>
<td>Oklahoma</td>
<td>10,893 X</td>
</tr>
<tr>
<td>California</td>
<td>6,646</td>
<td>South Carolina</td>
<td>11,114 X</td>
</tr>
<tr>
<td>New York</td>
<td>6,744</td>
<td>Rhode Island</td>
<td>11,241</td>
</tr>
<tr>
<td>Nebraska</td>
<td>7,023</td>
<td>Montana</td>
<td>11,715</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>7,159</td>
<td>Louisiana</td>
<td>11,746 X</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>7,337</td>
<td>Delaware</td>
<td>11,790</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>7,651</td>
<td>Arizona</td>
<td>12,212</td>
</tr>
<tr>
<td>Iowa</td>
<td>7,885</td>
<td>Alabama</td>
<td>12,448 X</td>
</tr>
<tr>
<td>Florida</td>
<td>8,202</td>
<td>Mississippi</td>
<td>12,736 X</td>
</tr>
<tr>
<td>Georgia</td>
<td>8,250 X</td>
<td>Hawaii</td>
<td>13,210</td>
</tr>
<tr>
<td>Kansas</td>
<td>8,391</td>
<td>Maine</td>
<td>13,390</td>
</tr>
<tr>
<td>Indiana</td>
<td>8,481 X</td>
<td>Vermont</td>
<td>13,869</td>
</tr>
<tr>
<td>Nevada</td>
<td>8,695</td>
<td>West Virginia</td>
<td>14,124 X</td>
</tr>
<tr>
<td>Oregon</td>
<td>8,734</td>
<td>New Mexico</td>
<td>14,805 X</td>
</tr>
<tr>
<td>Idaho</td>
<td>9,081 X</td>
<td>Maryland</td>
<td>14,831</td>
</tr>
<tr>
<td>North Carolina</td>
<td>9,160 X</td>
<td>Alaska</td>
<td>18,051</td>
</tr>
<tr>
<td>Ohio</td>
<td>9,821</td>
<td>Kentucky</td>
<td>18,407 X</td>
</tr>
<tr>
<td>North Dakota</td>
<td>9,825</td>
<td>Virginia</td>
<td>19,406</td>
</tr>
</tbody>
</table>
Virginia, which is adjacent to Washington, DC, has the country’s twelfth highest personal income but receives the highest balance-of-payments benefit. This is likely due to the large number of federal military and civilian installations in Virginia. Likewise, Maryland and Alaska have many federal installations. Although the federal government employs need-based formulas to distribute aid to state and local governments, and the largest program, Medicaid, which accounts for more than 65% of all aid, delivers considerably more money to poor states, such as Mississippi, than to wealthy states, such as Connecticut, the United States has no overall fiscal equalization program for states or localities, though most states have some type of equalization for local school districts.

IV. BRIEF HISTORY OF FEDERAL AID DURING ECONOMIC CRISSES

The federal government does not always provide direct anti-crisis financial assistance to state and local governments. The first major infusion of federal funds into state and local governments occurred during the Great Depression of the 1930s. In the six economic downturns since 1973, however, direct aid was provided on only three occasions (Government Accountability Office, 2011). Direct aid has “included unrestricted fiscal assistance, increased funding for existing programs, and new grant or loan programs” (Government Accountability Office, 2011, p. 3). There is no consistent federal policy on anti-recession aid and no policy that automatically triggers anti-recession aid to state and local governments.

State and local governments are in a particularly difficult place during economic downturns because their revenues drop, while their expenditures on social welfare programs increase. States rely heavily on sales and income taxes for their revenue, while local governments rely greatly on property taxes and income taxes. At least 46 states have constitutional or statutory balanced operating-budget requirements (National Conference of State Legislatures, 2010), although these restrictions vary in strictness from the governor proposing a balanced budget to the legislature enacting a balanced budget without deficit spending. It is difficult for the remaining four states to have a deficit because of limitations on borrowing (Reuben & Randall, 2017). States typically resort to spending cuts, tax increases, and expenditures from rainy-day funds to balance their budgets.

Consequently, state and local governments commonly reduce spending and employment during recessions, thereby creating counter-cyclical pressures that can deepen a recession. Federal aid, therefore, is usually intended to help state and local governments maintain spending and employment. Currently, state and local employment accounts for approximately 13 percent of the nation’s workforce (National Association of State Retirement Administrators, 2022).

V. FEDERAL AID DURING THE GREAT RECESSION

The housing market in the United States collapsed in fall 2007, triggered primarily by risky subprime mortgage defaults. This led to a global financial crisis and the worst economic conditions since the Great Depression. Unlike the COVID-19 pandemic, which created an immediate shock to the economy when restrictions were enacted to prevent the spread of the coronavirus, and a relatively quick recovery after the restrictions dissipated, the Great Recession developed over a period of time and the economy was very slow to recover. The
federal government took the primary role among American governments in addressing economic aid because it can run deficits. State and local governments were forced to raise taxes and fees and cut services in order to balance their budgets. However, despite huge expenditures by the federal government, the balance of power within the American federal system was not substantially changed (Kincaid, 2010). Substantial stimulus was enacted during George Bush's administration as the Republican president worked with the Democratically controlled Congress. However, the elections of 2008 saw a Democratic sweep of the federal government, with Barack Obama becoming president and the party increasing its majorities by 21 seats in the House and 8 in the Senate.

The first major legislation was the $168 billion Economic Stimulus Act of 2008, passed in February. The act provided $600 tax rebates to individuals and $1200 to couples, with an additional $300 for each child, with a phase out as a family's income rose. The U.S. Department of the Treasury, which collects taxes and distributes tax refunds, was used to distribute the checks (Herszenhorn, 2008).

The Housing and Economic Recovery Act (HERA) was passed in July 2008 as the first comprehensive law to address the mortgage crisis. The center-piece of the legislation was protecting quasi-government housing institutions such as Fannie Mae, Freddie Mac, and Federal Home Loan Banks from financial failure. They were given a new government oversight agency and the Department of the Treasury was given authority to lend as much money as necessary to keep these agencies solvent. The estimated cost of doing this was around $50 billion. HERA also authorized up to $300 billion to help delinquent homeowners refinance their mortgage and provided tax incentives to individuals to buy a home. HERA's only major direct funding to state and local governments was $4 billion to purchase abandoned and foreclosed properties provided that they be rehabilitated and sold as lower income housing (Arthur, 2009; Weiss, 2008).

Two massive spending bills were enacted to further quell the banking crisis and stabilize the economy. The Emergency Economic Stabilization Act was passed in October 2008 in reaction to the failure of several large investment banks and potential systemic risk to the banking system. The centerpiece of this legislation was the Troubled Assets Relief Program (TARP) that gave authority to the Treasury Department to purchase up to $700 billion in toxic assets, primarily in the financial and mortgage industries (Dinan & Gamkhar, 2009). TARP was widely resented by the American public as a "Wall Street bailout" at the expense of "Main Street taxpayers". The legislation helped inspire political movements on the left (Occupy Wall Street) and on the right (Tea Party) that further exacerbated partisan polarization in the United States.

Democrats consolidated power in Washington, DC, with the election of President Barack Obama in November 2008. George Bush and congressional Republicans had been reluctant to provide direct aid to state and local governments in early economic relief legislation. Obama and congressional Democrats felt differently and provided this aid, along with massive spending on other programs in the American Recovery and Reinvestment Act (ARRA) of February 2009. ARRA was the largest economic stimulus program since World War II, authorizing $787 billion of expenditures. Approximately $285 million was directed to the states, $275 billion in tax cuts, and the rest to a list of Democratic priorities such as clean energy development and broadband installation. The goal was to stimulate the economy while at the same time helping states and local governments maintain spending on programs such as Medicaid and education in the face of substantial budget pressures. In an effort to inject stimulus into the economy as quickly as possible most of the spending went through existing federal grant programs. Consequently, there was little shift in the existing types of intergovernmental programs during the Great Recession (Conlan & Posner, 2011). The federal government did tighten reporting requirements for grant recipients in an effort to avoid fraud and
misuse of ARRA funds. While this was an additional burden for states, most reported smooth implementation since the money flowed through existing grant channels with established bureaucratic communications (Wyatt, 2009).

One response to the Great Recession could have resulted in a substantial shift in power from the states to the federal government. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 overhauled financial regulation in the United States. At issue was whether the federal government would preempt state regulatory powers in a policy domain that had operated as an example of dual federalism for more than a century. The final law generally protected states’ ability to regulate consumer protection and banking, while not explicitly preempting state regulation of insurance. Partisan politics played a part in the legislation as Democrats generally support creating regulatory floors, while allowing states to enact stronger regulations, while Republicans generally would like the federal government to set national standards to prevent a patch-work of state laws. Ultimately, since the Democrats controlled the presidency and both houses of Congress, they were able to craft the legislation to their liking (Kincaid, 2010).

Additionally, Dodd-Frank created the Financial Stability Oversight Council (FSOC), a “regulatory super-committee” designed to proactively protect the financial system from systemic risk. Given state experience with regulating financial institutions, the federal government gave them, in an homage to cooperative federalism, a non-voting voice in FSOC’s decision-making. Lyons (2021) argues that this placed state interests at the decision-making stage rather than the implementation stage, thus enhancing state input into regulation. However, in practice the FSOC often ignored state input, negating the potential cooperative federalism mechanism that the FSOC could have served.

The long recovery from the Great Recession meant that large intergovernmental programs received multiple authorizations of funding. This was particularly important for Medicaid and education funding. Unemployment insurance (UI) provides a case study of these funding reauthorizations. This federal-state shared program was extended eleven times during the Great Recession. Beneficiaries are typically entitled to 26 weeks of benefits. However, under the extensions, some people were eligible for up to 96 weeks through 2013. During normal economic times, states pay most of the benefits with the federal government picking up the administrative costs. However, through the Extended Benefits (EB) program, begun in 1970, as states hit higher unemployment rates, the federal government splits the cost of benefits 50/50 with the states. The EB was triggered in many states in 2008. The American Recovery and Reinvestment Act of 2009 saw the government step in to provide 100% of the benefits through 2013. States could also borrow funds from the federal government to keep their UI systems solvent, but they were required to pay these funds back as the economy grew stronger. The federal government spent about $250 billion during the Great Recession to bolster and extend UI. However, this program was temporary, and no permanent changes were made to the structure of the program (Congressional Research Service, 2010; Congdon and Vroman, 2021).

Federal responses to the economic downturn caused by the housing and banking crises were often affected by partisan control of the presidency and Congress. Each party generally preferred different policy instruments to address the Great Recession, with Republicans favoring tax cuts and rebates, while Democrats advocated targeted expenditures in their favored policy areas. Public backlash to TARP hardened partisan differences, and Republicans’ opposition to more stimulus became entrenched with the election of Barack Obama to the presidency. Laws emerging from both parties generally followed the existing federal regime for dealing with macroeconomic crises: the federal government funded stimulus, and state and local governments implemented it through existing funding mechanisms. Federal financial reform had the most likelihood of causing centralization. However, Dodd-Frank, for the most part, preserved state regulatory powers.
VI. FEDERAL AID IN THE COVID-19 ERA

The federal government’s response to COVID-19 was much faster and extensive than to the Great Recession. Four acts were passed by large bipartisan majorities (i.e., Democrat and Republican) in spring 2020, followed by another major act at year’s end, also under President Donald Trump, and two major acts in the first two years of Biden’s presidency. The first act, The Coronavirus Preparedness and Response Supplemental Appropriations Act of 2020, provided $8.3 billion of aid for domestic and international programs to respond to the outbreak. Most of this money was designated for work by federal agencies, but $950 million was directed to the Centers for Disease Control and Prevention (CDC) to assist state and local COVID responses (Oum, Wexler, & Kates, 2020).

The Families First Coronavirus Response Act allocated $192 billion to address health, hunger, unemployment, and sick-leave policies, about half of which was distributed through existing intergovernmental programs. Most important for states was enhanced federal funding for Medicaid, with an increase of 6.2% in each state’s federal medical assistance percentage (FMAP), and waivers of state cost-sharing requirements for Medicaid and the Children’s Health Insurance Program for COVID-related health services. Funds were also distributed for large intergovernmental programs such as the Supplemental Nutrition Assistance Program (SNAP) and Unemployment Insurance. Unlike the Great Recession, the increase in the FMAP was predicated on states providing continuous coverage to enrollees throughout the course of the pandemic, thus avoiding states trying to drop people from their Medicaid rolls as the crisis progressed (Committee for a Responsible Federal Budget 2020a; Lopez-Santana & Rocco, 2021; National Conference of State Legislatures, n.d.).

In late March 2020, the federal government passed the $2.2 trillion Coronavirus Aid, Relief, and Economic Security Act (CARES), the largest federal stimulus program in U.S. history. CARES allocated funds to governments, for-profit and non-profit entities, and citizens. Among the CARES allocations most directly affecting state and local governments were $150 billion in direct aid to state and local governments, $260 billion for unemployment, $100 billion for hospitals, $45 billion for disaster relief, $30 billion for education, $25 billion for public transportation, and $8 billion for tribal governments. Altogether, Congress provided state and local governments about $280 billion (Committee for a Responsible Federal Budget, 2020c).

This aid was distributed on the basis of population, though direct aid to local governments was limited to jurisdictions having more than 500,000 residents, with states having discretion over funding to smaller local governments. Most CARES funds were distributed through existing intergovernmental mechanisms and formulas, such as the federal-state unemployment insurance program or the $1,200 payment to each adult citizen ($500 for children) earning less than $75,000 per year that was distributed by the Social Security Administration. Some of the CARES money was in the form of loans, mostly for private-sector businesses, and some loans were forgivable under certain conditions. Otherwise, CARES money had the usual spending and accountability rules and regulations attached to federal aid. Such rules can delay actual expenditures by recipients; consequently, Congress expedited spending by delivering most aid through existing channels having established rules (Kincaid and Leckrone, 2022a). CARES contained the $150 billion Coronavirus Relief Fund (CRF) providing general relief to state and local governments to mitigate health-related costs from COVID and lost revenue due to the pandemic. States had a fair amount of discretion in allocating the funds provided that expenditures were not for items accounted for in their most recent budgets (National Conference of State Legislatures, 2020). This provision was included to avoid fungibility.
The CARES Act proves instructive in showing how these formulas lead to funding going to states regardless of their need. The funds were allocated on the basis of population, with a minimum allocation of $1.25 billion per state. This formula came under scrutiny for a number of reasons. First, as illustrated in Table 2, it proved to be a boon to the 20 states that received the minimum allocation. The least populated state, Wyoming, received more than five times the per capita federal aid than California, the largest state. This small-state bias was present throughout all four major COVID relief laws passed by the federal government. One study finds that “having an additional Senator or Representative per million residents predicts an additional $670 dollars [sic] in aid per capita” in federal support (Clemens & Veuger, 2021, p. 11). Further, the epicenters of the early COVID pandemic, California and New York, received smaller allocations than some remote areas that were not hit until later in the summer.

### Table 2: Per Capita CARES Allocation by State Population

<table>
<thead>
<tr>
<th>5 Least Populous States</th>
<th>Population 2020</th>
<th>CARES Allocation</th>
<th>Per Capita CARES Allocation</th>
<th>5 Most Populous States</th>
<th>Population 2020</th>
<th>CARES Allocation</th>
<th>Per Capita CARES Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wyoming</td>
<td>577,287</td>
<td>$1,250,000,000</td>
<td>$2,165</td>
<td>California</td>
<td>39,499,738</td>
<td>$15,321,000,000</td>
<td>$388</td>
</tr>
<tr>
<td>Vermont</td>
<td>642,895</td>
<td>$1,250,000,000</td>
<td>$1,946</td>
<td>Texas</td>
<td>29,217,653</td>
<td>$11,243,000,000</td>
<td>$385</td>
</tr>
<tr>
<td>Alaska</td>
<td>728,441</td>
<td>$1,250,000,000</td>
<td>$1,707</td>
<td>Florida</td>
<td>21,569,932</td>
<td>$8,328,000,000</td>
<td>$386</td>
</tr>
<tr>
<td>North Dakota</td>
<td>778,062</td>
<td>$1,250,000,000</td>
<td>$1,605</td>
<td>New York</td>
<td>20,154,932</td>
<td>$7,543,000,000</td>
<td>$374</td>
</tr>
<tr>
<td>South Dakota</td>
<td>887,099</td>
<td>$1,250,000,000</td>
<td>$1,409</td>
<td>Pennsylvania</td>
<td>12,989,625</td>
<td>$4,964,000,000</td>
<td>$382</td>
</tr>
</tbody>
</table>

Source: Authors’ calculation from the National Conference of State Legislatures, retrieved from [https://www.ncsl.org/Portals/1/Documents/statefed/COVID_Relief_Fund.pdf](https://www.ncsl.org/Portals/1/Documents/statefed/COVID_Relief_Fund.pdf) and U.S. Census Data, retrieved from [https://www.census.gov/data/tables/time-series/demo/popest/2020s-state-total.html](https://www.census.gov/data/tables/time-series/demo/popest/2020s-state-total.html).
After months of partisan wrangling, the $900 billion Coronavirus Response and Relief Supplemental Appropriations Act was passed in late December 2020. The new stimulus was primarily a continuation of funding from earlier laws, with the biggest component being additional aid to small businesses ($302 billion). However, state and local governments helped administer much of the $121 billion in unemployment aid, $82 billion in elementary, secondary and higher education grants, $72 billion in health programs, and $44 billion in transportation funding (Committee for a Responsible Federal Budget, 2020d).

Democrats took control of Congress and the presidency after the 2020 elections. COVID relief that passed under the Trump administration focused on achieving federal objectives while using states and localities to implement programs. Intergovernmental aid was mostly in the form of categorical grants because Republicans did not want to see being bailed out state and local governments, which they believed should deal with COVID-related fiscal problems on their own. CRF funding represented the closest thing to general assistance, but even that limited spending to programs that were directly tied to the pandemic, and from the local government perspective, very few cities were eligible to receive direct funding. However, as part of the $1.9 trillion American Rescue Plan Act of 2021 (ARPA) President Biden and the Democratic Congress included a $350 billion Coronavirus State and Local Fiscal Recovery Funds program (CSLFRF). The funds were not entirely unrestricted. However, state and local governments were given wide-ranging discretion provided expenditures fell within one of four broad classifications: spending related to health and economic impacts of the pandemic, providing pay for essential workers, revenue for programs that had been hit hard by the pandemic, and infrastructure projects (Rocco and Kass, 2022, pp. 6-7). Local governments directly received $130.2 billion under CSLFRF, including special allocations for smaller cities that were not included in CARES. The remainder of the funding sought to further fund existing COVID relief for unemployment insurance, aid to schools, small business assistance, nutritional programs, assistance for families with children or elderly, Medicare and Medicaid assistance, and other human-service provisions and safety net spending important to the Democratic agenda (National Conference of State Legislatures, 2021).

The Democratic party won unified control of the White House and Congress in the 2020 elections. President Biden and congressional leaders sought to use the pandemic to pass a modern New Deal program that would increase the federal government’s presence in citizen’s daily lives. However, the ambitious Build Back Better plan was unable to clear Congress due to thin Democratic margins. A smaller agenda was passed in the $773 billion Inflation Reduction Act of 2022 (IRA), which primarily focused on climate change, prescription drug costs, and the federal deficit (Tankersley, 2022). The IRA provided incentives and grants to state and local governments, particularly to spur clean energy and carbon-reduction programs. However, it was not a sizeable shift of power toward the federal government.

Aside from fiscal matters, health-care guidance, and Trump’s funding of Operation Warp Speed to produce a COVID-19 vaccine, Presidents Trump and Biden left it to state and local governments to decide on most public health measures, such as stay-at-home orders, masking rules, social distancing, and vaccine requirements (Kincaid and Leckrone, 2020, Kincaid and Leckrone, 2022b).

VII. CONCLUSIONS

Federal actions to stem the economic crises caused by the Great Recession and the COVID-19 pandemic were some of the costliest in U.S. history. However, the numerous laws
passed to resolve the two crises mostly continued secular trends of intergovernmental fiscal policy. Seven conclusions support our argument that neither the Great Recession nor the reaction to the COVID-19 pandemic led to a broad transformation in the practice of U.S. federalism. However, the growth of the federal deficit as a consequence of unprecedented spending may have long term affects on the federal government’s ability to fund intergovernmental programs, thus affecting existing fiscal federalism programs in the United States.

1. Polarization Stifled Change

Polarization probably blunted centralization, with Republicans especially resisting financial aid to state and local governments and new regulations imposed on state and local governments. During the Great Recession, Republicans sought to stimulate the economy with tax cuts and rebates. Large-scale spending emerged during the Obama administration, but in an effort to expeditiously pump the money into the economy, funds were primarily funneled through existing intergovernmental channels rather than new programs. There was a burst of bipartisanship at the beginning of the pandemic, especially with the CARES act. However, as 2020 progressed, Republicans became more wary of large funding measures. Democrats won control of the presidency and Congress in 2020, and Republicans abandoned cooperation moving forward. Due to the Democrats’ slim margin in the Senate, with the Democratic Vice President breaking a 50-50 tie in the Senate, moderate Democratic senators from Arizona and West Virginia helped to water down large-scale new programs. Due to the filibuster, the 60-vote threshold required to pass major bills in the U.S. Senate also acts to restrain centralization because both parties resist legislation that would centralize policies they dislike.

2. Use of Existing Programs to Funnel Aid

The federal government’s fiscal responses to the Great Recession and the COVID-19 pandemic were on a scale not seen since the Great Depression. However, their long-term effects on the American federal system were limited because fiscal aid to state and local governments funded existing programs on a temporary basis to help stimulate the economy. There has been a long-term growth of federal intergovernmental aid from 1955 to the present and over the periods of the Great Recession and COVID-19. The long-term trend has been a large increase in intergovernmental transfers as a result of more Medicaid spending. Other than that secular trend, the absolute amount of federal aid in dollars and in percentage of intergovernmental aid returned to normal after these two rounds of federal economic stimulus.

3. No Expectation That Direct Federal Aid to State and Local Governments is Guaranteed

State and local governments have no expectation that the federal government will guarantee aid to their governments during a financial crisis. This matter is also partisan. Democrats are more supportive of such aid than Republicans. Some Republicans believe that the state and local governments should be allowed to go bankrupt if necessary. There is, however, some expectation that the federal government will increase its share of spending for intergovernmental social-welfare programs during financial crises, but those increases primarily benefit individuals, not state and local governments.

4. No Change in the Ad Hoc Nature of Federal Aid

There was no notable change in how the federal government allocates funding during economic downturns. The process remains ad hoc, often inefficiently targeting funding to states and recovery programs. Clemens, Ippolito, and Veuger (2021) argue that
countercyclical federal intergovernmental aid might be better allocated if the federal government adopted a scheme of automatic stabilizers to trigger aid quickly and efficiently. However, Congress showed no appetite during or after the Great Recession and COVID-19 to adopt such new mechanisms.

5. Politics and Grantsmanship Leads to Suboptimal Timing and Allocation of Fiscal Aid to State and Local Governments

Federal grants to state and local governments are generally allocated through a formula or through competition among governments. Formula grants take into account a variety of factors, including historical allocations and demographic characteristics of the recipient government (Congressional Budget Office, 2013). These formulas are often subject to political pressures and the necessity of achieving a coalition to pass legislation. This was the case in the federal government’s fiscal programs during both the Great Recession and the COVID-19 pandemic.

6. Federal Deficit Spending During the Great Recession and COVID-19 Pandemic May Affect the Ability of the Federal Government to Fund Future Intergovernmental Programs

Given that the federal government has run a surplus in only two fiscal years since 1960 (White House, n.d.), budget deficits have been the norm in contemporary American politics. However, the level of deficit spending during the Great Recession and COVID-19 was unprecedented. This boosted total federal debt from 62% of GDP at the start of 2007 to 118% of GDP at the beginning of 2023 (Federal Reserve Economic Data, n.d.). Interest payments on the national debt are consuming an increasing share of the federal budget. By 2035, debt service is projected to be 14% of the federal budget, on par with all non-defense discretionary spending (Government Accountability Office, 2022). Reckoning with this budget problem could require some mix of tax increases and spending cuts. Spending cuts might substantially reduce federal fiscal transfers to state and local governments, especially for place-based programs. How reductions will affect the balance of federal-state power is uncertain. Reductions could tip the balance of power toward the states, but they could generate centralization if the federal government substitutes the carrots of fiscal aid for the sticks of regulation in order to sustain its policy preferences in the face of fiscal austerity.

7. Fiscal Behavior is a Poor Measure of Centralization or Decentralization

Large expenditures and transfers by a federation government do not necessarily entail centralization (Dardanelli et al. 2019). Too many other factors affect centralization, including the nature of the transfer mechanisms themselves. Significant centralization had already occurred in the United States prior to the Great Recession and pandemic (Kincaid 2019). Throwing a lot of money at these crises did not substantially enhance or diminish the extant level of centralization.
REFERENCES


JOURNAL INFORMATION

INDEX

INTRODUCTION


JOURNAL INFORMATION

INDEX

INTRODUCTION


