

General Exposition of Federalism and the Rationale for Fiscal Federalism Practise

Imuetinyan P. J. Ugiagbe (PhD)¹

¹ Department of Business Administration, College of Business and Management Studies, Igbinedion University, Okada, Edo State, Nigeria.

Abstract:

This article is purely written based on theoretical phenomena. It employs the use of secondary sources of information and in particular it posits the meaning of federalism and fiscal federalism and particularly looks at the rationale behind the practice of fiscal federalism. It is imperative that the rationale for the practice of fiscal federalism is exposed in a way that people can now begin to realise that fiscal federalism practice has an adamant objective of economic growth. The article expounds that federalism and fiscal federalism are synonymous but must not be confused with decentralisation, which is the process and fiscal federalism is one element of that process, although it was used amiably by (Oates 1972) as "Decentralisation Theorem". It also reveals that fiscal federalism in federal developing countries of the world has not been successful relative to its unitary counterparts.

Keywords: Federalism, synonymous, Fiscal federalism, rationale.

1. Introduction

Almost every country in the world decentralises their operation at one point or another. In Ethiopia nearly all aspect of operation in that country is decentralised (Monge, 2007). The term Fiscal Federalism is sometimes misused by many people to mean the same thing as decentralisation. Decentralisation may be synonymous with fiscal federalism in that like fiscal federalism it involves the decentralisation of operations been it fiscal, administrative, or personnel. Therefore fiscal federalism is one element in the decentralisation mix; hence Oates (1972) depicts his theory on fiscal federalism "Decentralisation Theorem".

Throughout the hemisphere, nations are turning to decentralization, with the belief of improving the performance of their public sector (Tanzi, 1996) for example the USA central government has turned a significant portion of federal authority for a wide range of programs to the state, including Medicaid, legal services, welfare, housing and job training (Sharman, 2005). The type of government that is

adopted by a country, whether it is federal, unitary or confederation has political, economic and social implications, therefore among the different tiers of government; fiscal arrangements must be worked out properly to ensure the fiscal balance in the context of macroeconomic stability. Federalism and fiscal federalism are two different things but they are synonymous in that all federal countries are fiscally federal but not all countries that decentralise their operation are fiscally federal.

Some federal countries such as Nigeria, has fiscal federalism that is tied to their constitution. It is not surprising that 62 countries out of 75 countries of the world's developing in 1997 embarked on decentralisation of different sorts (World Bank 1977). According to Musgrave, (1967) fiscal federalism has a salutary effect on the economy expansion. Every country would want to see a fall in unemployment rate, interest rate, inflation, stable balance of payment, all indices of robust economy. This was strongly echoed by Musgrave, Oates, Samuelson, when the theory of fiscal federalism first came to the fore. Fiscal federalism is not a new terminology and many literatures are abounding on it. What is however not clear and therefore should be subjected to scrutiny is why nearly all developing countries are still practicing it in spite of the gloomy reports made by researchers that fiscal federalism in developing countries leads to all sorts of crises. (Wibbels 2000, Sorensens 2008, Sagay 2008, Davoodi and Zheng –Fu 1998). This apparent failure was confirmed by literature on fiscal policy in Nigeria, determining that fiscal federalism has been ineffective, Anderson (2007), Central Bank of Nigeria (2007), Alm and Boex (2002). Wibbels (2000) in particular, single- handily carried out hypotheses test that confirms what fellow positivists said about fiscal federalism practice in developing federal countries of the world. Wibbels (2000) findings were quite strong and contend that federalism makes a positive and a highly significant contribution to all kinds of crises. Wibbels (2000) modelling statistics shows that fully federal systems have 21%, 25% and 21% predicted probability of experiencing inflation and debt crises. By contrast, unitary system countries have 3%, 13% and 14%

predicted probabilities of the same crises (Wibbels 2000). His experimental research was conclusive that fiscal federalism in federal developing countries leads to all sorts of crises such as inflation, unemployment, budget deficits and fluctuation in the balance of payment. The rationality behind the practice of fiscal federalism would give an indicative reason why many countries still practice fiscal federalism. Therefore the author will posit below federalism and fiscal federalism and will consequently mirror the rationale behind the practice of fiscal federalism by many countries.

2. Federalism

According to Arowolo (2011) it is important to understand the concept of federalism because federalism is synonymous with fiscal decentralization and it is also the operational context within which fiscal federalism is situated. In other words, it is an integral part of federalism. "Federalism refers to a political system where there are at least two levels of government. In such cases, there is the juxtaposition of two levels of power of a central government otherwise called the federal government and other states labelled variously as states, regions, republics, cantons, customs or unions" (Ajayi, 1977: 150).

The term federalism derives from the Latin word "foedus" meaning covenant (Arowolo, 2011: 4). It is a political concept in which different groups or members of different backgrounds with different ethnic, political, social, cultural, and religious background are bound together by a covenant with a governing representative head. The term according to Arowolo (2011), is also used to describe a system of government in which sovereignty is constitutionally divided between a central governing authority and constitutional political units, that is, states and provinces. Federation is a system in which the power to govern is shared between national and state governments, creating what is often called federation (Akindele, 2005).

Also, Sagay (2008, A11) sees fiscal federalism as "an arrangement within a multi-national country where resources are shared between federal government and component units in such a way that each unit, including the central authority, exists as a government separately and independently from others, operating directly on persons and properties within its territorial area and with its own apparatus for the conduct of affairs and with an authority in some matters exclusive of others". Arowolo (2011) posits that analysis of this purview shows that each unit of government within a federation exists, not as an appendage of another government, but as an

autonomous entity capable of conducting its own affairs free from directive by any other government.

Wibbels (2000), one of the well-known researchers on fiscal federalism, describes federalism as a political system in which two conditions are present: first, provinces are represented in the national legislative body; and second, provinces have an elected legislature of their own. This definition was hailed by Duchacek (1970) Watts (1969). Federation, according to Akpan (2007), implies the existence in one country of more than one level of government, each with different expenditure responsibilities and taxing powers. In the case of Nigeria as a federation, this consists of central government (federal government) 36 States, and a Federal Capital Territory, and also 774 local governments (1999 Nigerian Constitution, schedule 1). Aiyede (2009) suggests that the character of state-society relations does matter for the workings of the federal system for economic development. As such federalism can be seen as more or less an institutional framework of state; society relations, in which, citizens and civil society at both local and national levels exist in order to deepen interaction and enhance state capacity.

Theoretically, fiscal operations can be viewed from two extreme terms, 'on the one hand there exists total centralization in which the central government takes total responsibility for the economic activities of the public sector and therefore no other tier of government participates in the economic life of the country. At the other extreme, the fiscal system is highly decentralized, and in this case the other tiers of government perform virtually all economic functions. In reality, there exists some element of decentralization in all economies. Consequently some obligations and economic activities are seen as obligatory to the states and others to the central government. In Nigeria the obligations and economic activities of the central government/state are spelled out in what is termed the 'Exclusive Legislative List and for the state in what is called the 'Concurrent List' (1999, schedule 1, Nigerian Constitution). This obligation is seen as crucial as some states within the federation have no economic activity or resources that can act as the economic mainstay and are consequently incapable of surviving on their own, for example, Gombe and Zamfara states (Annual Abstract of Statistics, 1977)

The intricacies of federal government were emphasized by Asobie (1985, 26). He identifies two broad areas in which federalism co-operates. The first relates to the capacity of citizens as individuals and groups to relate to each other federally, that is as partners respectful of each other's integrity while cooperating for the common good in every aspect of life, not just in the political realm. The second area

views federalism as a social phenomenon which emphasizes the existence of essentially permanent religious, cultural or social groups, camps or pillars, around which a polity is organized.

The type of government that is adopted by a country, whether it is federal, unitary or confederation has political, economic and social implications, therefore among the different tiers of government; fiscal arrangement must be worked out properly to ensure the fiscal balance in the context of macroeconomic stability. The fiscal arrangement among the different tiers of government in a federal structure is often referred to as fiscal federalism; in other types of political structure it is known as intergovernmental fiscal relations (Tanzi, 1996). It is depicted by Oates (1972) as decentralization theorem). Therefore fiscal federalism, intergovernmental fiscal relations and centralization are generally referring to the same notion.

3. Fiscal Federalism

According to many researchers fiscal decentralization, even in a developed society has become well practiced (United Nations, 2008, Shah 2005, Oates 1999 Tanzi, 1996). Fiscal federalism is concerned with “understanding which functions and instruments to be best centralized and which is best placed in the sphere of decentralized government” (Oates, 1999: 1120). In other words, according to Arowolo (2011) it is the study of how competencies (expenditure side) and fiscal instruments (Revenue side) are allocated across different (vertical) layers of administration. An important element of its subject matter is the system of transfer payments or grants by which a central government shares its revenues with the lower levels of government.

Fiscal federalism can be explained as an arrangement that involves intergovernmental fiscal relations in a federation’s country, but fiscal federalism is not a peculiarity of federal nations as its element can be found in semi or quasi federation, confederation and unitary states. Therefore the concept of fiscal decentralization should not only be associated with federal countries but also with non-federal states with no formal federal constitutional government, in the sense that they encompass different levels of government which have de facto decision-making authority (Ademolekun, 1983). However, this does not mean that all forms of governments are “fiscally federal” but it does mean, however, that the principle can be ascribed to all countries that are attempting “fiscal decentralization” (Arowolo, 2011.p.2). In fact, according to Oates (1999) “fiscal federalism is a general normative framework for assignment functions to the different levels of government and

appropriate fiscal instruments for carrying out these functions” (p.1120)

It is clear from the above that the rationale for fiscal federalism or inter-governmental transfers should be determined by equity and efficiencies considerations in order to support local governments in providing differentiated public goods to heterogeneous populations while ensuring an even distribution of basic services across all regions. Although empirical evidence by researchers such as Case (2001) Johansson (2003) have posited that political variables representing electoral incentives of public agents are a significant determinant of the variation in fiscal transfers to sub-regional jurisdiction within countries. This notion of equity, efficiency and ensuring even distribution to all jurisdictions regarding inter-governmental transfer or fiscal federalism within a country has led many countries to rationalize their governmental structure either in the form of centralization or decentralization (Tanzi, 1996).

Therefore, at any point in time, any government whether it is a federal or unitary system would decentralize its operation at one point or another, to achieve the best provision of public goods and services to its people. Tanzi (1996) enthuses that revenues transfer from the central government to the subunits are usually not sufficient for providing the public goods hence the central government must make additional funds, for example grants or lump sums, available in the form of equalization to ensure that no sub unit is find wanting. In addition to this, the sub governments are equally assigned a tax base from where the sub government units can raise taxes in addition to what comes from the central government which are used to ensure that an equitable provision of public goods are provided to the local jurisdictions. With assignments responsibility come expenditure responsibility. The revenue transfer takes the form of vertical and horizontal transfers.

The revenue which is transferred from federal government to the state is called ‘vertical’ while the transfers from state to local government are referred to as ‘horizontal’ (Alm and Boex, 2002). In most federal countries, for example in Nigeria, transfer is guided by the constitution and the mode of sharing the federally collected revenues, like any fiscally decentralized country, is by an agreed formula (Salami, 2011).

However no one country adopts the same formula as another, which is dictated by the environment and the policy decision making of the country. In Nigeria, revenue collected federally is paid into what



is called the Federation Account after first charge payments have been effected by the federal government. For example, 65% of federally collected revenue was paid into the Federated Account in 2011 (Salami, 2011), from where the revenue would be shared among the tiers of government, which hopefully should lead to improve the standard of living, hence alleviation of poverty for the jurisdictional populace.

4. Rationale for practice

The rush to embrace fiscal federalism or inter-governmental fiscal relations as it is often called was fuelled by the initial theory on public goods by Kenneth Arrow, Richard Musgrave, and Paul Samuelson's important papers (1954-1955) which laid the initial basic foundation of the theory of fiscal federalism.

Arrow's discourse (1970) on the roles of public and private sectors and Musgrave's book (1959) on public finance, provided the framework for what became accepted as the proper role of the state in the economy. Within this frame work three roles were identified for the public sector: these were, correcting various forms of market failures, ensuring an equitable distribution of income and thirdly, seeking to maintain macroeconomic stability and full employment (Musgrave, 1959).

This theoretical framework was basically a Keynesian one, which advocates for states to intervene in economic affairs (Keynes, 1964). Therefore the government is expected to step in where market mechanisms failed due to various forms of public goods characteristics. Economists teach us that public goods will be under provided if they are left to private individuals because the gain or benefits accruable to him or her would be far lower than the benefits to society. Therefore governments and their officials were seen as the custodians of public interest who would seek to maximize social welfare based on their kindness or benevolence, or the need to ensure electoral success in democracies.

If we allow for a multi-level government setting, this role of the state in maximizing social welfare then provides the basic ingredients for the theory of fiscal federalism. Each tier of government is seen as seeking to maximize the social welfare of its jurisdiction. The multi-layer quest becomes very important where public goods exist, as the consumption of it is not national in character but localized. Thus, in such circumstances, local outputs targeted at local demands by respective local jurisdiction clearly provide higher social welfare than one provided by national or central provision. This

principle which Oates (1999) formalized, into the "Decentralization Theorem" constitutes the basic foundation for what may be referred to as the first generation theorem of fiscal decentralization (Bird, 2009).

The theory focuses on situations where different levels of government provide different levels of outputs of public goods "for those goods whose benefits were encompassed by the geographical scope of their jurisdiction "(Oats, 2004: 5). Such situations according to Olson (1996) came to be known as "perfect matching" or fiscal equivalence that can be achieved by traditional Pigouvan subsidies requiring the central government to provide matching grants to lower tier government so that it can therefore internalize the full benefits. Therefore, on this assumption, the role of government in maximizing social welfare through the provision of public goods came to be assigned to the lower level of government. The other two roles of income distribution and stabilization were, regarded as suitable for the central government (Arowolo, 2011).

However fiscal federalism, though have been successful in advanced countries such as the USA, Canada, Australia but in federal developing countries of the world fiscal federalism practice has not been successful relative to its unity counterparts (Wibbles, 2000), Davoodi and Zou-Fu (1987) Sorensen (2004).

5. Expectations

As earlier indicated, Tiebout (1956) and Oates (1977) work contributed immensely to the need to decentralise across the developing world. It suggests that decentralisation has salutary effects on the public sector because autonomy at this level creates competition among sub national jurisdictions to provide the most efficient policies for their electorates. Subsequently researchers such as Marlow (1988), Grossman (1989) have theorized that fiscal decentralization should influence the size of public sector, inflation rates; Tiebout (1996) and government deficits; Flornasari, Webb and Zou, (1998).

Therefore, there is a link between fiscal federalism and development and this can be determined within the context of political structure and economic performance. One very important reason for the formation of a federal state, asserts Kincaid (2001), "is the need to create a common market." (p.88). With federalism, argues Lohmann (1998), Qian and Roland (1999), states can police the inflationary and deficit bias of central officials and Lohmann (1998) argues that, "federalism countries are more likely than unitary countries to develop politically

independent, inflation averse central banks that refuse to provide accommodating monetary policy” (p.17).

6. Summary

Federalism is synonymous with fiscal decentralization and it is also the operational context within which fiscal federalism is situated. Wibbels (2000) one of the well-known researchers on fiscal federalism describes federalism as a political system in which two conditions are present: first, provinces are represented in the national legislative body; and second, provinces have an elected legislature of their own. The fiscal arrangement among the different tiers of government in a federal structure is often referred to as fiscal federalism; in other types of political structure it is known as intergovernmental fiscal relations. The rationale for fiscal federalism is based partly on political consideration and most especially on economics. It is hoped that fiscal federalism has a salutary effect that would lead to macroeconomic expediency.

7. Conclusion

Based on the rationale of fiscal federalism, the role of government in maximizing social welfare through public goods provision came to be assigned to the lower tiers of government. The other two roles of income distribution and stabilization are however, regarded as suitable for the central government. Therefore the role of assignment which flow from the theory of fiscal federalism can be summarized to be that the central government is expected to ensure equitable distribution of income, maintain macroeconomic stability and provide public goods that are expected to concentrate on the provision of local public goods with the central government providing targeted grants in cases where there are jurisdictional spill-over associated with local public goods.

The next stage once the assignment of role has been carried out is the determination of appropriate taxing framework and in deciding this attention must be paid to distortion resulting from decentralization taxation of mobile tax bases. Accordingly, provision of public goods by different tiers of government is expected to bring optimum provision of goods and services to the local jurisdictions and consequently in order to be able to provide the services required the different tiers of government require tax raising powers. It is also recognize that some jurisdictions low fiscal capacity than others because they may lack the natural resources and the population and for these reason central government uses the process of

equalization, in form of grants and lump sum to bring about equitability in the jurisdiction.

In providing goods and services to the populace, the profit that private enterprises would realize if it were to be left to them to provide will be too marginal that no private individuals would comprehend doing it apart from the benevolent government that would like to appease the electorate for election purposes. Therefore sub governments are in better position to provide the public goods for their jurisdictions because they are in best position than the central government to know the needs and preferences of their jurisdictional population (Oates 1999).

Therefore fiscal federalism was seen as a great Macroeconomic adjustment measure that would result in the expansion of the economy that was received with salutary effect by all countries of the world. This hope has never been more hyped than in federal developing countries of the world where the upsurge of fiscal decentralisation has gained momentum in recent years. However fiscal federalism according to researchers such as Wibbels (2000) has not been very successful in federal developing countries relative to their unitary counterparts. But many federal developing countries are still practising it despite the gloom reports.

8. References

- Adeamolekun, L . (1983) “Administrative Mechanism in Managing IGR” In Public Administration: A Nigeria and Comparative Perspective. Adeamolekun, L. ed. Lagos, Longman Ltd.
- Aiyede , E. R. (2005) Tax Assignments, Revenue Sharing and Political Reform: Nigeria Comparative Perspective.”in Warisu, O. Alli (ed). Political Reform Conference, Federalism and National Question in Nigeria. Abuja: Nigeria Political Association.
- Ajayi, B. (1997) “Federation and Unitarism” in Reading in Political Science. Kalawole ed), Ibadan: Dekaal Publishers, pp. 149-165.
- Akidele, S. T. and Olapa, A. (2002) “Fiscal Federalism and Local Government Finance in Nigeria: An Examination of Revenue, Rights and Fiscal Jurisdiction” in Contemporary Issues in Public Administration, Omotoso, F. ed. Lagos: Bolabay Publications.
- Akpan, , H. E. (2007) Intergovernmental Fiscal Relations. The Nigerian Experience: Paper Presented at the 10th Annivarsary of the Financial Commission of South Africa, Capetpwn International Convention Centre, Capetown, South Africa, 10-12 August, 2004



- Alm, J and Boex, J (2002) An Overview of Intergovernmental Fiscal Relations and Subnational Public Finance in Nigeria. Andrew Young School of Policy Studies. Georgia State University.
- Arowolo, O. (2011) Fiscal Federalism in Nigeria: Theory and Dimension. Afro Asian Journal of Sciocial Science. Vol2. No. 2.2Quarter 11 2011
- Arrow, K. J. (1970) The Organisation of to the Choice of Market versus Non-Market Allocation. " In Joint Economic Committee. The Analysis and Evaluation of Public Expenditures'. The PPS System, Vol 1.Washington. DC: US. GPC
- Bird, R. M. (2000) Rethinking subnational tasks: a new look at tax assignment. Tax Notes International 20 (May8) 2069-2098,
- Case, A. (2001) Election goals and income redistribution: recent evidence from Abania. European Economic Review 45,., 405-23.
- Davoodi, H. and Zheng-fu, H. (1998) Fiscal decentralisation and economic growth: A Cross Country Study. Journal of Urban Economics 43, 244-257.
- Duchacek, I. D. (1970) Comparative Federalism: The territorial Dimension of Politics . Lanham: University Press of America.
- Grossman, P. J. (1989) Fiscal Decentralisation and Government bSize: An extension. "Public Choice".
- Johnson, E. A. (2003) Intergovernment Grant as a Tactical Instrument: Emperical Evidence from Sweeden Municipalities. Journal of Public Economics 87. 883-915
- Keynes, J. M. (1964) The general theory of employment, interest and money. New York: Harcourt Brace.
- Kinkaid, J. (2001) "Federalism and Economic Policy Making: Advantages and Disadvantages of the Federal Model". International Social Science Journal 167: 85=92.
- Lohmann, S. (1998) "Federalism and Central Bank Independence: The Politics of German Monetary Policy. 1957-92", 2World Politics 50; 401-46.
- Marlow, M. L. (1988) B"Fiscal Decentralisation and Government Size". Public Choice 56: 259-269.
- Moges, A. G. (2003) "An Economic Analysis of Fiscal Federalism in Ethiopa. North East African Studies . Vol. 180, pp 111-140
- Musgrave, R. A. (1959) The Theory of Public Finance. New York, McGraw- Hill
- Musgrave, R. A. (1967) Harmonisation of Direct Business Taxes: A Case Study Service (Edit-Eur)
- Oates , W. E. (1972) Fiscal Federalism. New York: Harcourt, Brace, Jovanovich.
- Oates, W. E. (1999) ' An Essay on Fiscal Federalism' . American Journal of Economic Literature. Jstor 37 (3): (1120-49.
- Oates, W. E. (2002) Fiscal and Regulatory Competition: Theory and Evidence Perspelltiven der wirtschaftspolitik, Verein fUr Socialpolitik, VOL. 3 (4). Pages 377-990 November.
- Olson, M. (1996) "Theory of Regulatory Federalism: The Case of Environmental Management" in the Economics of Environmental Regulation. Pp319-31
- Quan, Y, and Roland, G. (1999) "Federalism and the Soft BudgetConstraint." American Economic Review 86(5); 1143-62.
- Sagay, C. K. (2008) How a True Federal System Should Run". The Nation. Lagos. Village Press Limited. May 19th
- Salami, O. A. (2011) Taxation, Revenue Allocation and Fiscal federalism in Nigeria Issues. Challenges and Policy Options. Economic Annals. Volume LVL. No. 189/ April-June 2011
- Shamaa, Y. (2005) "The Federal Approach to Fiscal Decentralisation: Conceptual Contours for Policy Makers". Loyola Journal of Scial Science, X1X(2): 169=88
- Sharma , Y. (2005) "The Federal Approach to Fiscal Decentralisation: Conceptual Contours for Policy Makers" Layola Journal of Social Science, X1X(2): 169-188
- Sorenson, P. B (2002)International Tax Coordination: Regionalism Versus Globalism. CESfo Working Papers 483
- Tanzi, V. (1996) Fiscal Federalism and Decentralisation: A Review of some Efficiency and Macro Economic Aspects". In World Bank, World Bank Annual Conference.
- Tiebout, C. M. (1956) A Pure of Local Expenditure. Journal of Political Economy, 64; 416-24.

Biographical note: Dr Imuetinyan Press John Ugiagbe was the director of Press way Global Ventures INC, and also a Marketing Director at JECOM Ltd UK. He has a wide array of experience as lecturer in the UK. He is now a lecturer at Igbinedion University Okada, Nigeria. He holds a degree in law, economics, and also in African studies, a master degree in marketing and finance (MBA) and Ph.D. in Development Economics from Leeds Beckett University, Leeds, UK. He also holds a number of vocational and professional qualifications, which include a Higher National Diploma in Business studies (HNDBS), Chartered Institute of Marketing Diploma, Cert Ed (Garnett College UK). His research interests include: Fiscal federalism, poverty and poverty alleviation in sub-Saharan Africa, marketing ethics across the globe and Nigeria's political and social development.