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MAINTAINING TAXES AT THE CENTRE DESPITE DECENTRALIZATION: INTERACTIONS WITH NATIONAL REFORMS

Maintaining taxes at the centre despite decentralization: interactions with national reforms

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June 2011

Although fiscal (de)centralization literature explains easily the centralization of taxes on the basis of a superior tax administration capacity, it finds more difficult to argue why in federal and decentralized systems subnational governments are ready to accept the demise of their taxing powers. This paper aims to contribute to the debate by analyzing the conditions under in which sub-national governments are willing to cede their taxing power to a central authority. A simple bargaining model is used to illustrate the choices available to both the central (federal) government and the sub-national governments (regions), where the main contribution lies in the introduction of the expenditure side of the budget and of its relevance for solving the commitment issue. We conclude that tax centralization will take place – transfers will prevail over sub-national taxes – if substantial efficiency gains from the centralized administration of taxes are expected. To support this conclusion, the paper presents evidence from decentralization processes in Argentina, Canada and Italy.

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Paper prepared for insertion in the volume “Is decentralization good for development. Perspectives from Academics and Policy Makers”, edited by Jean-Paul Faguet and Mani Shankar Aiyar. The paper was written during the stay of Juan Pablo Jiménez at International Center of Economic Research (ICER) in Torino between September-November 2010. Both authors express their gratitude to ICER for facilitating their joint work.
**Introduction**

Centralization of taxes is a clear feature of the long term evolution of federal and decentralized systems, if this is taken to mean simply that present day federal governments have taxing powers that are much larger than those reserved to them in the original constitution. Also, transfers from federal to local governments were totally absent in the initial stages of all federations and unitary states, meaning that federal/central governments have now more tax resources than they need for their direct expenditure, while subnational governments have now lesser tax resources compared to their expenditures (the so-called vertical fiscal imbalance). This long term trend is compatible with extensive fluctuations over time of tax revenue and of the assignment of taxes between national and subnational governments.

There are immediate reasons for the appearance of subnational transfers, the most immediate of which is equalization. No present day federal, or decentralized system operates without some system of conditional or non conditional equalization grants. What is less immediate to explain is that highly decentralized systems rely exclusively on transfers for the financing of basic subnational expenditure responsibilities – this is the case of health and social protection in Canada- or that transfers play a predominant role in the financing of subnational governments in a large number of federations, such as most Latin American federations. In general, one would expect that during decentralization processes the importance of local taxes should increase. This is, however, not always the case, as evidence about Italy shows. Decentralization of policies and expenditure responsibilities is frequently non-accompanied by decentralization of tax assignments. This may happen because national tax reforms, which are concomitant with decentralization processes, can preempt the space for local taxes; or because reliance by subnational governments on transfers from the central government looks more attractive to local politicians.

While centralization of taxes can be rather easily explained on the basis of a superior tax administration capacity in the central government, it is more difficult to explain why federal and decentralized system are ready to accept, with tax centralization and the consequent demise of local tax administration capacity, a situation where they are at the mercy of the central government that could renege its commitment to finance subnational expenditure with its own grants.
The paper analyzes this issue and tries to provide an explanation of the readiness of subnational government to give up their power to tax. The paper is divided in four sections plus the conclusions. The first section starts with the meaning of tax centralization and provides a review of the literature. The second presents the options available to the central and the subnational governments, when they are negotiating the ways of financing the expenditure deriving from the devolution of an expenditure responsibility. The third section deals with the commitment issue.

Evidence is provided in the fourth section and it is followed by the conclusions.

1. **Centralization of taxes in the literature**

Despite the fact that one of the main tenets of the literature on fiscal literature prescribes that subnational governments should be financed as much as possible through local taxes and other sources of own revenue, the literature on the actual trends of tax (de)centralization and on their interpretation is not very long. Also the meaning of tax centralization and how to measure it are not always well defined.

The literature on fiscal federalism makes a distinction between own local taxes (and fees) and other taxes. According to it own taxes are those for which local governments have a discretionary power in determining the burden they impose on their citizens. This discretionary power can be exerted with three different instruments (and their combination): a) tax administration; b) setting of tax rates and, c) determination of the tax bases. Hence tax (de) centralization should refer to three instruments. The reference to them should also inform the measurement issue. One cannot infer simply from changes in the distribution of tax revenue between levels of government that tax (de) centralization has changed. For example, if transfers to local governments are replaced with shared tax revenue, no real decentralization of taxes has taken place, if local governments have no discretionary power for determining the size of share revenue.

Centralization of taxes being, neither a necessity, nor a continuous trend, we can observe extensive fluctuations over time in the assignment of tax bases between the national and the subnational governments. Even larger fluctuations can be observed in the apportionment of tax collections between the central and the local governments. This because, among other factors, tax collections do not depend only on assignment, but also on interdependent decisions about
use of tax powers by distinct levels of government. For example, in the last seventy years the allocation of the collection of the personal income tax has widely varied in Canada, following the agreements between the federal government and the Provinces about the use of their tax bases and of the decision of the federal government to cede to the Provinces a number of tax points for the personal income tax [see Chernick and Tennant (2010) and Winer (2000)].

There are various branches in the literature trying to explain, or to make policy prescriptions about tax (de)centralization. The largest body of the literature is the normative, or prescriptive theory of fiscal federalism [Oates, (1972), Inman and Rubinstein (1997), and Ambrosanio and Bordignon (2006) for an excellent updating]. While initially (in the classical federal constitutions) the main criterion for assignment was avoidance of tax exportation, more precisely the minimization of tax impediments to the smooth working of the domestic market (thus tariff duties were assigned to the centre, and sales taxes as well in most cases, such as in Canada), the literature has later focused on the mobility of the tax bases, more specifically on the elasticity of the tax bases with respect to the changes of the tax rates.

Most of the normative literature stresses the efficiency advantages of centralization, particularly for the collection of taxes, but for a small number of them (such as the property tax). The prescriptions of the normative literature bear, however, a pale resemblance with the real world.

Turning to positive theory, Breton (1996) presents a general explanation of the assignment of powers between levels of government. His analysis does not refer specifically to taxes, but rather to all government functions. Breton’s argument is that assignment derives from competition among layers of government. In the case of taxation, economies of scale in administration and in collection would make the federal government a most likely winner, because it can better exploit these economies. At the same time, other factors, such as difficulty of coordination, may constrain the bargaining power of the central government. However, as for the other functions, Breton points out that there is no prevailing trend towards centralization, or back from it. This conclusion is also maintained by the all the positive literature.
This literature is mostly the work of political scientists [Riker (1964); Filipov, Ordeshook and Shvetsova, (2005); and more recently Diaz-Cayeros (2006)] and addresses specific cases and derives conclusions that in some cases do not go much beyond them. The authors stress the importance of the structure of political parties and of their capacity to make commitments for striking of federal bargains concerning the allocation of taxing powers. In addition political parties, more precisely the national structure of them, are essential for ensuring the benefits of tax decentralization (in addition to general decentralization). This is because with national parties, local officials have career incentives to take into account the overspill of their decisions on other jurisdictions and not only the benefits to their local constituency. This was the main argument developed by Riker (1964) for assessing the benefits of decentralization. This view is particular popular with Latin American scientists. O’Neil contributions (2003 and 2005) to the analysis of decentralization are the main reference point of this literature and they establish a link between this process and the electoral incentives of political parties.

The political parties approach to centralization/decentralization has been also developed by Enikolopv and Zhuravskaya (2007). Filippov, Ordeshook and Shvetsova (2005) are amongst the most widely quoted authors on the issue. However, their focus is on the design of stable federalism systems and on overall (de)centralizing trends in federations and not on (de)centralization of taxation per sé. Clearly, proper tax arrangements contribute to stability and derive from proper institutions ensuring agreements among levels of governments. These include: 1) fundamental constitutional principles designing the basic rules, such as the right to secession (their Level 1 constraints); 2) constitutional principles regarding the amendment of the constitution, the structure of the separation of powers, and the principles guiding the legislation process, 3) political institutions that impact on the implementation of the rules and on the agreements reached through bargaining, such as electoral systems, the structure of party systems and of political parties.

The centralizing role of national parties is questioned by Chibber and Kollman (2004), who maintain that while one can surely argue that political parties are actually the instruments of centralization and decentralization “evident trends toward centralization and decentralization are actually the consequences of larger forces that work mostly independently of the party system” (Chapter 1).
There is also a nascent political economy approach to the centralization of taxes. Or better it is possible, as Rodden shows (2004), to develop some contributions to the political economy of decentralization in view of understanding the centralization of taxes. Rodden draws specifically on Bolton and Roland (1997) and sketches very briefly a model where centralization of taxes is promoted by a coalition of relatively underdeveloped jurisdictions that also keeps high the cost of subsequent modifications.

Levi (1988) provides a careful account of the process by which Australian States relinquished their substantial taxing powers and were left almost completely dependent on transfers from the federal government. There is no formal model of this process, but Levi stresses three factors. They are: a) the superior tax administration capacity of the federal government; b) the capacity of the latter to keep commitments with the States due to strong national structure of political parties; and, c) the increasing unpopularity of widely diverging State tax systems. As in other federal systems, such as Canada, wars and demand for social protection policies facilitated the task of the federal government that Levi views essentially as a revenue maximizing (page 150).

Winer (2000) compares the Australian and the Canadian cases. In Australia the States have given up most of their taxing powers accepting a centralization of intergovernmental relations that goes much further the constitutional prescriptions. In Canada the evolution of fiscal assignment between the federal government and the Provinces is far from linear. Epochs of intense centralization have been succeeded by epochs of equally intense decentralization of taxes. In both cases, also, the constitutional discipline bears no resemblance with actual assignments in the various phases (see, especially, indirect taxation).

Diaz-Cayero’s work (2006) is focused primarily on Mexico and Latin America. He provides a stylized model of the bargaining process between the federal and the state governments. Mexico is, possibly, the most tax centralized federation. Centralization in Mexico is explained by Diaz-Cayero by the one party (PRI) regime that prevailed for half a century and that allowed the federal government to make a credible commitment vis à vis the regional politicians concerning the payment of the transfers that replaced the taxes administered by the States. In the experience of the rest of federations of the region (Argentina and Brazil) it is important to include the alternation in power between democratic and military governments,
as an element that helps understanding changes in the tax authority between central and subnational governments.

Blankart (2000) views – in line with Brennan and Buchanan (1980) - tax centralization as the result of cartelization efforts between layers of government. By reaching an agreement on the sharing the same tax base of the personal income tax, for example, and on leaving the definition of the tax base and the administration of the tax to the federal government, the federal and subnational government reduce the intensity of tax competition and can increase collections. Tax centralization is thus the obvious goal of greedy politicians, but it can be attenuated if not eliminated by proper institutions, such as constitutional assignment of taxing powers or instruments of direct democracy, such as referenda.

2. What is at stake with tax (de)centralization: the bargaining framework

Building on the bargaining approach by Diaz-Cayero and introducing also expenditures into the picture, let’s consider the negotiation over tax (de)centralization between a federal government and a Region, or a number of Regions all of equal size and characteristics (which will amounts to the same), when a Region considers taking on a policy responsibility, namely education, that is assigned in the constitution to the central government, but that may be assigned to regions if they request it. In other words, we have an asymmetric arrangement. Introducing the expenditure in the analysis allows us to focus on a typical decentralization processes involving both sides of the budget.\(^1\)

We later relax the equality of Regions by assuming that they differ by income conditions.

To simplify the model, let’s assume that there is only one earmarked tax for funding this function, the education tax. The tax base and the tax rates are determined in the constitution. Variations in the volume of tax collections depend only on the efficiency of administration. Skills and effort capacity can vary between levels of government. Since we focus on the negotiation between the central government and a single Region we do not consider possible scale economies. However, the negotiation could take place also with other Regions, since they have the same characteristics. In this case scale economies in tax administration would be considered by the central government

\(^1\) Diaz-Cayero and other authors introduce a third, more radical, alternative. Regions can choose between tax decentralization, tax centralization and secession. Their models stay, however, on the revenue side of the budget.
and would modify the bargaining process, making the perspective of tax centralization more attractive to it.

We do not consider variations in tax rates or in the tax bases that are the essential ingredients, along with tax administration, of subnational own taxes. The main reason is to maintain simplicity: inserting variation of tax rates would require consideration of strategic choice if the tax base has some mobility. Moreover, getting or keeping tax administration is possibly more important in terms of subnational autonomy than setting of tax rates, since administration gives subnational government direct access to revenues without any intermediation and can also lead to different amounts of collections.

The assignment of education and the assignment of the administration of the tax to either level of government are the objects of the negotiation.

Let’s start with the choice of the Region. The choice is split into a two-stage process. Namely, the Region has to decide if it wants to take on the new responsibility and how the new responsibility will be funded. There is no obvious hierarchical relation between the two stages of the decision process. The terms of the negotiation are the following:

1. Centralization of administration of the tax with produce expected collections of $C$, accompanied by an expected transfer to subnational governments of $T$, leaving revenue equal to $C - T$ to the federal government.

2. Administration of the tax by the Region will originated expected revenue of $L$ for the Region.

The Region will receive $T$ with tax centralization and $L$ with tax decentralization. *Coeteris paribus*, that is, if no other than revenue considerations enter into the decision-making process, the Region will prefer tax centralization when $T > L$. It will prefer decentralization, at the contrary, when $T < L$, that is when the transfer it expects from the central government is lower than its own expected tax collections.

Let’s turn to the devolution of the expenditure. The Region has to check whether its preferred choice for revenue - $R = \max (T,L)$ - is enough to cover the expected new expenditure, $E$. 
Summing up, in financial terms the Region will ask for the assignment of the new function and will choose the transfer if:

\[ T > L \quad (1) \]

and

\[ T \geq E \quad (2) \]

Let’s turn now to the federal government. Again, it is faced with a double choice process. It has to decide whether to accept the devolution of education to the Region and, second, the way it will be financed: tax centralization meaning that either it will keep for itself the administration of the tax, or it will accept its devolution to the Region.

The federal government will prefer tax centralization if the expected transfer it has to pay to the Region is lower than the expected collections of the tax. Secondly, it will accept the devolution of the function if the grant is lower than, or at most equal to, the expenditure it is presently making for education. Otherwise, there will be no financial gain for it from the change.

That is the federal government will accept the whole package provided that

\[ C > T \quad (3) \]

and

\[ T \leq E \quad (4) \]

When we combine the four constraints we get that an agreement can be reached if

\[ C > L \quad (5) \]

and

\[ T = E \quad (6) \]

The agreement will be reached if tax centralization of tax brings in higher revenue than decentralization, implying better administration with centralization, and if the size of the transfer is equal to size of expenditure. The agreement means that there will be devolution of expenditure responsibilities only, with no devolution of tax administration responsibilities.
Under the existing conditions, no level of government is going to gain in terms of revenue from the bargain. This is because the Region will get exactly what is needed to fund the new expenditure and the central government will have to pay a transfer that is equal to the foregone expenditure.

There are, however, other possible financial reasons for the bargain and they derive from future actions by both levels of government. For example, the Region could believe that it will be able to spend with greater efficiency on education than the federal government, saving part of the grant for other purposes. The central government, on the other hand, could believe that it will be able to achieve larger efficiency gains in the administration of the tax in the future. The gains could also accrue from centralizing deals reached with other Regions. With the increase of the number of deals national tax reforms also become more likely, because the central government will reap larger benefits deriving from reform. This can explain the concomitance, frequently observed, between decentralization and tax reform.

The arguments developed in this section presume that governments are revenue, or power maximizers. In a democratic setting governments are constrained by voters, or more precisely by the extent and quality of political competition. This implies that governments have to maximize the difference between revenue, R, and expenditure, E, for the public services requested by citizens. The difference can be termed, as in the bureaucratic and managerial literature, as slack and it can be spent for uses that give utility to governments, without implying necessarily corruption. What is more important to consider is that the amount of the slack is reduced by the intensity of competition that forces governments, if they want to stay in power, to use the expenditure according to the preference of citizens. In a truly competitive system – for example in the “consensual democracy” as defined by Mc Guire and Olson (1996) slack would disappear - \( R - E = 0 \) – and all tax proceeds will be spent on the public goods desired and the politicians’ choices are completely constrained by voters.

*Tax centralization with differences in income and fiscal capacity between Regions*

Clearly, this is a more realistic case, but with less straight conclusions, because redistribution comes to the fore and it is quite difficult to model. With tax decentralization the revenue available to each Region is related to its income and wealth conditions. Rich Regions will have a
larger tax base and larger potential revenue than poor Regions: \( L_r > L_n > L_p \), where the subscript distinguishes between rich and poor Regions.

The choice between the tax and the transfer will thus depend, \textit{prima facie}, on the existing level of central government expenditure for education (centralization does not imply \textit{de jure}, or \textit{de facto}, homogeneity of levels of service provision across the country). If education expenditure is the same (per capita) across all the country,

\[ L_r > T \text{ for the rich Regions,} \]

and

\[ L_p < T \text{ for the poor ones,} \]

making the former less inclined to accept the grant and to ask for the devolution of the expenditure responsibility, unless they fear they will have a weaker capacity in their tax administration, or big expectations on their capacity of shrinking the expenditure.

If present levels of expenditure are higher in the rich Regions than in the poor ones – this situation is actually observable for a range of services in many countries- the propensity of rich Regions to choose the transfer will increase, since its size will vary according to the income conditions, making \( T_r > T_p \).

Propensity for tax centralization can become stronger when we look at commitment issues, to which we come now.

\textbf{3. Dependence on transfers and commitment problems}

Intended future actions - savings on expenditure and higher tax administration effort – introduce naturally into the discussion the commitment issue$^2$.

Intergovernmental long-term contracts are subject, as any other contract, to this problem. Once the Region has accepted the centralization of the education tax and the compensating transfer, it is potentially at the mercy of the central government. This government could in subsequent years renege the agreement and reduce the size of grant. One does not have to

$^2$ Faguet (2004) in his bargaining model of decentralization also stresses the strategic importance of commitment in decentralization processes. Furthermore, when institutional conditions are insufficient for commitment, subnational governments should not relinquish strategic powers, such as tax administration.
think to extreme situations, where future transfers are set to zero, to stress the importance of the commitment problem. Once the Region has given up its taxing powers, resuming them will take time – especially when they consist of tax administration – and even a modest reduction in real terms, or and worse in the money value, of the grant will do a lot of harm to its finances.

Clearly, both the literature and the observable experience provide more or less effective solutions to the commitment problem, depending on the context where they apply. There are basically three of them. The first solution is to increase the initial size of the transfer, to take care of the fact that the Region applies a discount factor to transfers in future years. In other words, the central government posts a bond. This is an elegant analytical solution in a typical two-period time frame. The federal government will pay in the first period $T_1 = T (1 + d)$, where $d$ is the discount rate, to assuage the fear of the Region that the transfer will be reduced in the second period. This solution becomes more problematic in a more realistic multi-year time frame.

The second solution is to act with legal provisions. The commitment problem can be eased/solved through the insertion in the constitution, or in a law with higher hierarchy than ordinary laws when this kind of law exists, of a protection clause about the size of the transfer.

The third solution refers to the structure of political parties. This is the major argument advanced in the political science literature on tax centralization. In essence, commitment is firmer when parties have a national structure at both levels of government and, especially, when the same party governs at both the federal and the subnational level. It is still firmer when the same party stays unchallenged at power for a lengthy period, as it happened in Mexico with the PRI for 70 years (Diaz-Cayero, 2006).

**Political interactions between levels of government as a major source of commitment**

Political/electoral interactions may be a main player in ensuring commitment. The argument starts with considering that in (or almost) every present day intergovernmental system the various spheres of government are never completely separated, in even in extremely decentralized systems. One implication of this missing separation is that the policies and services provided by subnational governments impact also on the popularity, and thus the probability of re-election of the central government. On the basis of this consideration we use an index of centralization/decentralization (Brosio, 2007) with meaningful properties that adds
to the literature that measures the meaning and the intensity of decentralized systems [see Treisman (2000) for a review].

Obviously, the index relies on the view that voters’ preferences have a real impact on the political legitimacy of various levels of government and on the assignment of policy responsibilities to them. This view has ancient, illustrious antecedents. For example Madison in the Federalist 46 (quoted by Kincaid and Cole, 2010) said that “If, therefore, as has been elsewhere remarked, the people should in future become more partial to the federal than to the State governments, the change can only result from such manifest and irresistible proofs of a better administration, as will overcome all their antecedent propensities. And in that case, the people ought not surely to be precluded from giving most of their confidence where they may discover it to be most due; but even in that case the State governments could have little to apprehend, because it is only within a certain sphere that the federal power can, in the nature of things, be advantageously administered.”.

Essentially, this index maintains that (de)centralization of a service, or of a policy, does not refer to the institutional assignment of it to the central government, but to the probability of re-election for the central government deriving from the level of provision of this service. For example, education can be constitutionally decentralized and thus provided by subnational governments, but it will still be to a varying extent centralized if the probability of re-election for the central government also depends from the level of provision of education.

Suppose a country with a central government, $G$, and another sphere of, local, government. There are only two publicly provided goods, namely, defense, $D$, a national good, and education, $E$, a local one. Both goods can be provided under different institutional arrangements.

The probability of re-election depends on the level of service provision for the publicly provided goods, that is,

$$P_g(D, E)$$

where $P_g$ is the probability of re-election of the central government and $D$ and $E$ are the discount factors, assigned to the arguments, with $0 \leq D, E \leq 1$. This probability is related to the probability that each voter will grant his/her consent to the incumbent politician. In turn, this probability is a
function of the utility of each voter. [Muller (1989) provides a good summary of, and references
to, the literature on voting under conditions of uncertainty]. For simplicity, we assume that voters’
utility function has only two arguments, namely defense and education provision.

The degree of decentralization can be inferred – according to this approach – from the value of
$\alpha$ and $\beta$. When $\alpha = 0$ the system is completely centralized, since voters consider that the central
government only is responsible for both goods. In fact, in a purely centralized system the two
arguments are discounted equally by the central government. This is because, independently from
constitutional and/or other legal regulations, voters consider that the central government has the
full and exclusive responsibility for their provision. When $\beta = 0$ the system is decentralized.
When $\beta = 0$, the system is completely decentralized and the central government bears no
responsibility whatsoever for the provision of the local good. A completely decentralized system
with two levels of government assigned with the provision of one good each implies that the
probability of re-election depends for each level/unit of government from the single good for
which the voters hold them responsible.

The interest of this approach lies also in the fact that it accounts for different degrees of
decentralization for different sectors. A country may, for example, be quite decentralized for
health, but very centralized for education.

With the devolution of a function comes inevitably also the commitment on the transfers for
that function if voters consider that this is also a central responsibility and hold the national
government accountable for it. Coming back to our example, the Region can clearly bet on this
commitment, when it accepts to be funded with a central government transfer. Furthermore,
the national government dependence on regionally provided education could enhance the role
of federal government as an insurer against asymmetric shocks. This role is increasingly
discussed and tested in the literature, although with no unanimous results [Hepp and Von
4. Evidence

*Italy: the tax reform of 1970*

In that year a large-scale reform of the Italian tax system took place. It was based on the creation of comprehensive personal income tax, of a new corporate income tax aligned to the model prevailing in industrial countries, and on the elimination of a number of nuisance taxes. Also the VAT was introduced to comply with European regulation and to modernize the taxation of consumption. This comprehensive national tax reform of 1970 was enacted on the eve of the regionalization of the country and it centralized all the taxes. All the existing municipal taxes (among them a simplified personal income tax and a octroi type sales tax) were abolished, while the Regional governments were born without any taxing power and were financed (and the municipalities as well) until the 1990’s entirely out of transfers from the central government (and both levels of government did not complain). Hence, a major step towards the creation of a more decentralized system of government took place alongside the most complete centralization of taxes one could conceive

The tax reform was conceived in the 1960’s when the country found itself in a political mood very favorable to the government intervention in the economy. Tax centralization rested primarily on the presumption of greater central government efficiency in the administration of taxes that is difficult to test.

*Argentina: creation of the Regime of Federal Co-participation taxes in 1935*

In principle, or better de jure, Argentina is a quite decentralized federation. The present (1994) Constitution states that the Provinces retain all powers not delegated to the federal government. With regard to the financing side, the National Constitution (article 75, paragraph 2) delimits the tax powers of the central government and the Provinces by establishing that indirect taxes are concurrent between both levels, except in the case of import and export duties, which are the exclusive prerogative of the federal government (article 4). In principle, direct taxes are exclusively provincial, but the federal government has the right to use them for a limited time if defense, common security and the general welfare required it. Hence in
principle, Provinces have a large access to taxing powers, but they make only partial use of them preferring relying on shared revenues collected by the central government.\textsuperscript{3}

The system of co-participation (revenue sharing) began in 1935, through laws 12139, 12143 and 12147, and was designed to increase the amount of resources collected by the federal government in order to face the financial difficulties caused by the fall in revenue from foreign trade during the 1930s crisis. New taxes were introduced (on sales and profits), and the internal taxes at federal government level (excise taxes) were reordered and unified, eliminating those taxes that had the same characteristics of those collected at the sub-national level.

In order to achieve the approval of these new taxes, two different mechanisms of distribution were established: on the one hand, considering the concurrent character that the National Constitution had introduced for the new taxes (sales and profits), a revenue sharing mechanism of compensatory nature was stipulated for these taxes (a primary co-participation of 82.5% for the Nation and 17.5% for the 14 existing provinces and the Municipality of the City of Buenos Aires). In the case of internal taxes, their distribution was established in response to the derogation of similar taxes collected by the Provinces. Therefore, in lieu of the taxes abolished, each Province was guaranteed the same amount collected the previous year, plus a percentage increase. The commitment problem was solved in Argentina mainly by three elements: the coexistence of authoritarian government with fragmented parliamentary power; the introduction and implementation of an automatic and daily system for disbursing the co-participation transfers by the Central Bank; the granting of debt bailout (law 12139) to several Provinces.

Also in this case tax centralization rested primarily on the presumption of a greater central government efficiency in the administration of taxes.

\textit{Argentina: the decentralization of education in 1991}

Still in Argentina the experience in the decentralization of education in 1991 and the subsequent shaping of the National Fund for Teacher’s Incentive (\textit{Fondo de Incentivo Docente}) in 1998

\textsuperscript{3} In fact provincial taxes (there are four main off them, namely on real estate, motor vehicles, stamp duties and gross income) plus revenue from royalties represent some 40% of total provincial revenues, the rest being supplement by the federal government through its transfer systems (Cetrángolo and Jiménez, 2004).
constitutes an interesting case that supports our argument. In late 1991 the administration and financing of educational services until then in the hands of the Central government (mainly high schools) was decentralized to the Provinces. At the time where the decentralization of the system was decided, high school teachers depending on the Central government had lower salaries than those depending on provincial governments. Therefore, the problem was to decide who would be in charge of leveling out the salary difference. This situation generated long negotiations and intense labor union conflicts. Finally, at the end of 1998, the federal government approved the National Fund for Teacher’s Incentive, which would be financed with a provisional and federal tax on cars, reassuming, in part, the salary financing that was decentralized seven years before. According with the decentralization index (Brosio, 2007), this means that this sector had a higher level of centralization that could be showed by a conventional indicator.

In 1999, facing a fiscal crisis, the authorities implemented a tax reform to improve public sector revenue. To get the additional revenues from this reform, the Central Government proposed to the provinces to replace the revenue sharing mechanism by a fix amount transfer. The commitment problem was solved with the implementation of the Program of Fiscal Adjustment and Financial Restructuring (Devoto and Jiménez, 2000), that included a restructuration of the subnational debt, that have increased significantly in the former decade, vis a vis a fiscal deficit reduction program.

**Italy: the quasi-federalization of the system of intergovernmental relations of 2001**

The bargaining model presented above is to some extent tailored to explain the recent decentralization process of Italy. The new constitution extends to education and social protection and to a number of other areas the range of basic responsibilities assigned to regional governments. At the same time there is no mention of subnational tax instruments, neither in the constitution, nor in the recent law (law 42 of 2009) that authorizes the government to issue the decrees that will define the new revenue system of regional (and local) governments.

Law 42 pays only lip service to the regional tax autonomy, making a vague reference to the future introduction of regional and local taxes, whereas it details the new system of equalization grants. The law explicitly mandates that IRAP, which is the most productive of regional own taxes (ensuring approximately 30 % of total regional current revenue and 70% of
the collections of own taxes) will be eliminated as a soon as the general conditions of the public finances will allow. The law also does not reverse the recent trend towards the shrinking of the base of the property tax, which is the main tax handle of Municipalities.

This is somewhat surprising. Despite initial vociferations in favor of tax autonomy, the richest Regions and Municipalities of the North seem to be happy to live with a system that will give them presumably very modest tax handles. There are, however, reasons for the acceptance on behalf of all levels of government. The central government can believe that there are substantial possibilities of improving the tax administration process, or to reform the taxes. The present government has announced recently – again on the eve of a likely intense devolution of policy responsibilities to Regions and Local Governments - which it will proceed from next year to a new comprehensive tax reform. The likely strategy is that through tax reform it will be able to satisfy the claims for resources coming from subnational governments and to expand at the same time its reins on the whole tax system.

On the other hand, subnational governments - including those of the rich areas that have huge own revenue potentialities - may be happy with a financing system that makes them largely dependent on central government transfers. This is because the new system will be based on a generous transfer system for a set of basic local function that accounts for 70/80 per cent of total subnational expenditure. These transfers will be based on the standard cost of provision referred to nationally defined standards of level of service delivery. There are thus basically two guarantees for subnational governments concerning their (future) revenue. First, the central government has taken the engagement to cover the whole cost of service provision that corresponds to the standards. Secondly, the central government appears to be fully committed to the payment of adequate transfers in the future. This is because the introduction of nationally defined standard means that the policy responsibilities, to which these standards refer are still, at least partially, centralized in Italy according to our previous definition of (de)centralization. That is, the introduction of standards implies that voters still consider the central government still (partially) responsible for these services. This solves the commitment problem.

Obviously, these recent events are also compatible with a political economy approach to decentralization that stresses the costs for the rich regions to reverse a long time established trend in tax centralization that is supported by a large front of less rich regions.
Canada: moving up and down the personal and corporate income tax

Our model that stresses the importance of efficiency in tax administration is supported by the Canadian experience with the personal and the corporate income tax. In 1941 the Provinces gave up their right to use the personal and the corporation income tax to help the federal government to finance the war effort. In 1947 the tax rental agreements were signed between the federal government and the Provinces (with the exception of Ontario and Quebec) by which latter gave up their right again to administer the two taxes getting in exchange a transfer equivalent to the lost revenue. They thus agreed to tax centralization. The tax rental agreements were replaced with the tax collection agreements, whereby the Provinces resumed their right to use both taxes by choosing their tax rates that would have then been applied to a federally defined tax base. Both taxes remained under federal government administration. Hence, according to the prevailing index Canada reduced its degree of tax centralization. Of course, centralization of the determination of the tax base and of tax administration can be viewed as clear evidence of government cartelization. It shows at the same time the importance of efficiency considerations referred to tax administration.

Our stress on the expenditure side of the budget and our idea that decentralization cannot be simply measured in terms of formal assignments, but it is also determined by the electoral responsibility of governments, can also help to understand why Canada, which is considered as a highly fiscally decentralized federation, finances the provision by the Provinces of health, education and social assistance with a system of block grants, whose allocation is based on population. According to our index of decentralization, health, education and social assistance are in that country to some extent centralized functions.
Conclusions

This paper aims at being a contribution to the literature on tax (de)centralization. It presents a very simple bargaining model between the federal/central government and the Regions that illustrates the main choices open to both levels of government, in terms of revenue and expenditure assignments.

The main results are that transfers will prevail on subnational taxes – that is, centralization of taxes will take place - when substantial efficiency gains in centralization of tax administration are expected.

The main contribution of our paper lies, we believe, in the introduction of the expenditure side of the budget and of its relevance for solving the commitment issue. When voters hold the central government politically, or better electorally, accountable for a devolved function, the latter has, after centralization of taxes, to keep its commitment referring to the size of the transfer.

Our findings may be applied to a number of countries and of systems, as the evidence provided in the last section shows.
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