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## **Finanzwissenschaftliche Diskussionsbeiträge**

### **Integration, Decentralization, Taxation, and Revenue Sharing:**

Good Governance, Sustainable Fiscal Policy and  
Poverty Reduction as Peace-keeping Strategies

Hans-Georg Petersen

Diskussionsbeitrag 57  
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# **Integration, Decentralization, Taxation, and Revenue Sharing:**

## **Good Governance, Sustainable Fiscal Policy and Poverty Reduction as Peace-keeping Strategies**

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### **Abstract:**

The paper tries to shed some light on the problems of centralization and decentralization within an economic union and the federal member states. Integration and decentralization are not opposite policy strategies but both meaningful if the single public goods and services supplies are analyzed in more detail. Both strategies doubtlessly have advantages, which can be realized if the manifold possibilities are combined in an efficient approach of good governance. Best practice approaches in inter- or supra-national integration, fiscal federalism and taxation do exist and have to be successfully implemented. Obviously such a modern fiscal policy has to be accompanied by an appropriate monetary policy, which in an economic union has to be carried out by an independent central bank as one of the necessary counter-vailing powers in a democratic setting. A modern fiscal policy strategy efficiently controls budget deficits, which naturally have to be limited to finance reliable public investments. Such strategy has to be safeguarded through modern methods of budgeting and fiscal planning. Modern public management with a clear code of conduct for the government officials ensures corruption free administration.

### **Keywords:**

Centralization, decentralization, ethnic differences, fiscal federalism, fiscal planning, good governance, harmonization, integration, nation building, revenue sharing, sustainable fiscal policy, tax reform.

### **JEL Codes:**

H7, F5, F15, H8, N4, O2, H2.

## Preamble

Nation-building was one of the most important political processes in modern Europe beginning in the 19<sup>th</sup> century. Typically the nation state is defined by a more or less homogeneous ethnic population, a common language and prevailing culture. Besides the ethnic roots also religious belief and ideologies have been crucial factors, the latter especially as an integrative power, which for instance explains the rise of the Soviet Union – an empire encompassing people from many different ethnic as well as religious groups.

But the borderlines of the national states were often not consistent with an efficient economic area; hence, single states were suffering from shortcomings in natural resources and real or human capital as well. Colonialist and imperialistic expansion especially to overseas continents strengthened the economical, political and military power. Empires were formed, which then often repressed and exploited the people in the colonies. Military force became an accepted means of power politics, leading to two World wars in between the nationalistic and socialistic super powers, followed by the Cold war ending at the end of the last millennium.

Nationalistic and socialistic ideas have functioned as integrative powers; as far as local people with different ethnic roots or cultural backgrounds were pressed under such regimes this form of integration by violence (or occupation) is not any longer acceptable but has in the past often had economic advantages for regional as well as global development. The socialistic regime in the Soviet Union has industrialized at least some regions in spite of the fact that millions of farm workers were killed. The inability for re-investment, the incompetence to satisfy the people with a sufficient supply of consumption goods and the erosion of the socialistic values and ideas led to a collapse of the Soviet Union as well as many other socialistic regimes. Already some decades before the colonialist regimes crashed in overseas. New borderlines had to be drawn predominantly not in accordance with the ethnic boundaries and even multi-ethnic states like Yugoslavia decayed as consequence of a bloody civil war.

The former period of compulsory integration was followed by a long lasting process of des-integration (or secession), nationalistic and religious ideas replaced the former ideologies, thus leading to new conflicts in the multi-ethnic states or even in between the newly created states. The des-integration processes have destroyed the former extended economic areas, reduced the regional and inter-regional labor division and productivity. Mass poverty and pauperization became crucial problems in developing countries as well as in the transformation states. Therefore, des-integration has become a major obstacle against regional and global economic progress, which is especially true for the Balkan Peninsula, the Middle Caucasus, Central Asia, and Africa. Regional re-integration to form larger economic areas and to improve the regional labor division is the silver bullet regarding foreign policy while internal decentralization is a major prerequisite to serve the different interests of the people in multi-ethnic and/or multi-religious states.

## I. Introduction

Economic integration is closely connected with the liberal ideas of free trade as well as mobility of people and capital. The formation of an extended economic area is often connected with decreasing per-capita cost of public goods and services (including a single currency) or increasing economies of scale. If citizens of such a region do face the advantages of economic cooperation, voluntary integration by democratic decisions seems to be a feasible option. But already in “pre-democratic” periods economic integration took place, e.g. in the case of the numerous German states of the 19<sup>th</sup> century, which in 1834 formed the German customs union (Deutscher Zollverein), being the fore-runner of the 2<sup>nd</sup> German Empire formed in 1871.

The process of European integration is another democratic example, started with the Treaty of Rome 1957 and the preliminary ending in 2007 with the Treaty of Lisbon. In spite of the fact that an European constitution has been refused by some member states the European Union (EU) has more or less got the character of a federal state, at least having an own budget and revenue from common customs as well as contributions from the member states. Hence, former sovereignties of the European member states have been transferred to the Brussels Commission or the European Parliament. With other words decentralized autonomies of the member states have been centralized on a new jurisdictional level. Therefore, integrative processes are usually accompanied by centralization, contrary to the fact that at least some of the members are organized as federal states in which decentralization plays an important role.

Obviously integration and fiscal federalism are sometimes in conflict so that a careful analysis of both, integration and decentralization, is of utmost relevance evaluating the advantages and disadvantages of regional cooperation. A clear and conflict-reducing distribution of public tasks in between the jurisdictional levels is the major prerequisite for a rational and successful integration process, in spite of the fact that in the example of the EU the distribution of tasks in between the member states and Brussels was more the outcome of historical compromises than of rational planning. However, the following paper has the purpose to describe briefly the role of voluntary international integration and efficient national decentralization in an approach of a democratic constitutional setting in which human rights and individual self-determination play a decisive role. Therefore in part II the basics of the economic theory of economic integration are summarized before in part III the main elements of fiscal federalism are discussed, while in part IV the urgency of a democratic setting connected with modern public choice arguments is described in more details.

Efficient integration and decentralization then generate a distribution of public tasks over the different jurisdictional levels thus defining the different goods and services to be supplied on the supra-national, national, regional, and local sphere. The rules of good governance are then expressed within the institutional settings (institution building) as well as the efficient organization of the supply of public goods and services (yard-stick competition, benchmarking, and best practice analysis). The supply of public goods and services of the individual jurisdictional levels then creates the fiscal need of the jurisdictions under consideration. The public expenditures on the different levels have to be financed by the citizen, depending on the per-capita income within the single jurisdictions. Therefore, the jurisdictional levels have to be supplied with adequate taxes, contributions, and fees, which yield a proper revenue. The revenue potential of a jurisdictional level depends on the citizens' per-capita income, which

determines its fiscal capacity. Because of a predominantly more or less unequal distribution of national, regional, and local per-capita income the fiscal (or revenue) capacities of the jurisdictional levels are heterogeneously distributed so that single jurisdictional levels have a fiscal capacity, which is more or less below their fiscal needs. Then problems of revenue sharing, intergovernmental grants (transfers) or fiscal equalization in vertical as well as horizontal direction arise, which will be discussed in part V. Part VI describes the consequences for tax reform processes and the tax administration while part VII briefly summarizes the results.

## II. Integration in Theory and Practice

Economies and diseconomies of scale are determining the advantages and disadvantages of integration. The character of the public goods supply often influences the optimal size of a jurisdictional level. The classical example is national defense. A nation alone might not be strong enough to protect itself against a foreign threat or the specific form of defense techniques do yield in so-called spill-over effects (positive external effects for the neighbor nations). Therefore a set of nations can link together, sign a defense treaty and organize inter- or supra-national defense forces. In a democratic setting such nations often share common values, for instance expressed in their single constitutions. So human rights and the individual liberties often form the value base for such an international cooperation. Therefore, the first question to be raised regarding integration is connected with the reasons and the targets of the integration process: Which value base do the states (or nations) share, which common policies should be jointly executed, and which legal framework should be chosen?

### II.1. Reasons, Targets and Framework for Integration

As mentioned in the preamble nation states have been historically formed by ethnic homogeneity as well as cultural and religious consensus. National ideas and values are often the base for the creation of states in spite of the fact that within the state boundaries also people from different ethnic minorities do live. Conflicts with such more or less large minorities have often ended in secession and the formation of new independent states, which have reduced the space for an efficient economic area. Therefore, with the movement to modern democratic structures and constitutions, ideas of a constitutional state have been formulated, which refer its attraction more to the quality of the constitutional settings than to national sentiments. At least partly national patriotism has been substituted by constitutional patriotism (see Habermas, (1992)), which allows for a much higher degree of ethnic heterogeneity as long as the vast majority of citizen still share the basic values of the constitution.<sup>1</sup> The constitu-

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<sup>1</sup> These values are usually expressed in the basic rights section of the constitution. The Basic Law for the Federal Republic enumerates them in the first 19 articles of the constitution: Human dignity; personal freedom; equality before the law; freedom of faith, conscience and greed; freedom of expression; marriage and the family, children born outside the family; school education; freedom of assembly; freedom of association; privacy of correspondence, posts and telecommunications; freedom of movement; occupational freedom, prohibition of forced labor; compulsory military or alternative service; inviolability of home; property, inheritance, expropriation; socialization; citizenship, extradition; right of asylum; right of petition; restriction of certain basic rights by laws respecting defense and alternative service; forfeiture of basic rights; restriction of basic rights. For more details see Bundestag (2000) under [http://www.bundestag.de/htdocs\\_e/parliament/function/legal/germanbasiclaw.pdf](http://www.bundestag.de/htdocs_e/parliament/function/legal/germanbasiclaw.pdf).

tional state in the European tradition, however, clearly separates in between societal norms and religious values, the latter only belonging to the secured private sphere of the individuals.

In case of rationally planned international integration the legal form of the new governmental entity has to be chosen. Usually one would start with an *international organization*. In international law such an organization is defined as a union of at least two independent states, which is acting on a continuing basis beyond the national boundaries and fulfills supranational functions, based on an international treaty. The typical functions of such organizations are conflict reducing and peace keeping strategies (e.g., the United Nations (UN), the Organization for Security and Cooperation in Europe (OSCE) or the African Union (AU)) or economic cooperation (like in case of the EU or the East African Community (EAC)). As long as the role of such organizations is rather limited in relation to the numerous public tasks fulfilled on the level of the member states, such organizations are only politically controlled by the governments of its member states. Hence, neither within the member states nor in the international organization democratically steered control mechanisms do exist.

Without doubt a common normative basis is one important prerequisite for an efficient functioning of an international organization because this alone has conflict reducing impacts. Therefore, the EU has set clear conditions for EU membership candidates, which have to have a stable democratic setting under the rule of law, realizing human rights and protecting the minorities. Additionally a functioning market economy and competitive enterprises able to survive in the process of European competition are prerequisites and the adoption of the European law to fulfill the membership obligations and to realize the targets of the EU are also indispensable responsibilities. Under such framework conditions not only a common (or at least coordinated) foreign policy and defense policy seems to be desirable but also all joint policy strategies, which are connected with the supply of global, international or regional public goods.

Stressing the problem of economic integration, historical developments (especially in the EU) have proven that the advantages of integration in form of increasing real per capita income within the member states due to induced economic growth creates more demand for further integrative movements. This stepwise also rises the influence of such an international organization on the national governments as well as their constituents. Increasing public tasks are also expressed in rising budgets, which have to be financed by the taxpayers within the member states. Incrementally the international organization is overtaking more and more tasks, additional institutions (instead of a pure general secretariat a commission with executive powers, a parliament etc.) are implemented, which raises the question if this entity does get the character of a new, more centralized jurisdictional level – being for instance a confederation or even a federation. Then the necessity of an own constitution has to be discussed.

Having the history of the EU in mind, the process of stepwise integration was not rationally planned and connected with numerous throwbacks, often leading to intense political frustration and temporarily delays. Therefore, a better and more realistic planning can avoid such setbacks and the often interlinked growth retardations. In a first step the fields of common policy have to be clearly defined. Possible fields are foreign policy, defense and security policy, environmental policy (for global, international or regional public bads and goods), regional and development policy, labor



market and social policy, energy policy, transport policy etc. Within the single policies well defined targets have to be formulated, which can be easily controlled. The scope of the policies defines the basket of public goods and services to be supplied on the community's level, which also determines the volume of public expenditure to be financed on this jurisdictional level. Then the sources of financing have to be identified, principally in form of contributions of the member states (grants or transfers to the community level) or in form of own taxes. If the latter is chosen an independent parliament has to be established following the rule of John Locke: No taxation without representation. Obviously such institutional setting has already elements of a jurisdictional character, which at least in the long run necessitates constitutional regulation.

## II.2. Economic Integration: Forms and Merits

Economic Integration has often been the main reason for a voluntary association of independent nations. In case of a fair and open competition the competitive pressures themselves create impacts to harmonize production processes, norms and regulations as well as institutional settings. This form of integration is called *functional integration*, which means harmonization by market forces. But usually the market forces are distorted by different forms of national regulation so that an active interference of the political institutions is often necessary; therefore, this form is named *institutional integration*. Because of the persistence of national regulation, institutional integration is often the only means to overcome market obstructions. Then the decision has to be made on which hierarchical level of the institutional setting harmonizing activities seem to be reasonable. In responding this question the *subsidiarity principle* is usually applied, which also plays a decisive role in fiscal federalism (see below III.2) and acts as rule for good governance: In case of an equally efficient execution of public tasks the lower jurisdictional level has the priority to fulfill such task. If the fulfillment creates impacts on other jurisdictional units (spill-over effects) then it has to be checked if the next higher jurisdictional level has to overtake such public task. In case of international integration, therefore, possible *cross border effects* are of utmost relevance.

### II.2.1. Real and Monetary Integration

In the following one has to differentiate in between real (or trade) integration and monetary integration. Regarding *real integration* there are to extreme forms: complete self-sufficiency (autarchy) or global free trade. In between those two extremes more or less tight forms of integration are placed, which are represented in the overview of table 1. The main target of real integration is to induce economic growth in the member countries for an increase of national as well as community welfare. The reasons are to be seen in the more intensified international labor division and specialization, connected with trade creation, and trade diversion into the direction of the partner countries (often at the expense of third part countries).<sup>2</sup> Additionally the larger scope of the community creates positive impacts on the terms of trade. In practice the reduction of trade barriers, liberalizing the factor markets (for labor and capital), harmonization of institutional settings, coordination of trade policies and internal policies do play a dominating role.

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<sup>2</sup> For more details see Viner (1950).

**Table 1: Forms of Real and Monetary Integration**

	Preference zone	Free trade zone	Customs union	Common market	Single market	Economic union	Currency union
Trade liberalization on single markets	X						
Trade liberalization on all markets		X	X	X	X	X	X
Common external customs policy			X	X	X	X	X
Free factor mobility					X	X	X
Harmonizing economic policies						X	X
Single currency area							X

Source: Beckmann et al. (2000: 4), Basseler et al. (2006: 663 f.).

In the horizontal direction table 1 shows the intensity of economic integration starting with the preference zone and ending with a currency union. In the vertical direction the single economic policy decisions are grouped. The X mark the single policies implemented in the process of intensified integration. The currency union is the highest form of monetary integration. Pre-stages are the exchange rate regimes (in the EU from 1972 to 1978/79), the currency system (1979 to 1998) and the currency union as well as the single currency (since 1999 or 2002, respectively).

The European economic and currency union is a far reaching integration regarding economic policy but far from a political integration. The basic political sovereignties do still exist on the level of the national jurisdictions determined by the single constitutions of the member states or their special law, respectively. The single European market demands four basic liberties: free movement of goods, free movement of persons, free movement of services, and free movement of capital. Therefore, border controls have to be abolished (Europe without barriers), industrial norms harmonized, public purchases liberalized, labor mobility implemented, capital movements and transactions facilitated, and tax barriers removed. The following remarks are closely related to the latter problem.

### *II.2.2. Tax Competition and Harmonization*

The basic idea of an economic union is growth enhancement within the union's area, which can be only realized by fair competition within the enterprise sector. Differences within direct and indirect taxation have influence on the after-tax profits of the firms within the different member countries thus influencing their competitiveness within the union and beyond. Therefore, economic integration has cross border im-

pacts, which have feed back effects on national tax law.<sup>3</sup> In addition an economic and currency union needs institutional settings creating transaction costs, which often can be only partly financed by the external customs revenue so that additional grants (transfers or contributions) of the member states or even own taxes are necessary. In case of grants and transfers the assessment base is usually related to a unique national tax base. Hence, at least the harmonization of the definition of this tax base becomes inevitable.

The member states of an economic union still do have the legal monopoly regarding constitutional and specific law. Within the union a monopolistic competition is emerging, which in a certain way limits the national sovereignties. Especially the tax and transfer systems are elements of regional and global competition, having serious impacts first and foremost on the mobile production factors. But the mobility of factors within an economic union and beyond is quite different: Capital itself has the highest mobility because of free movement of capital; then people with predominantly capital income have a high mobility, while the mobility of employees (only dependent on their wage income) is lower and heavily dependent on their occupational qualifications. Realities and buildings are immobile by definition so that tax burdens imposed on them do automatically reduce their market prices (tax amortization).

Mobility of persons and of capital are basic components of human rights; consequently the tax basis of wage and capital income taxation (both bases linked to traditional income and corporation taxes) are mobile as well, if highly qualified employees and capital owners are voting by feet, moving to regions with the most attractive combination regarding the supply of public goods and services and the connected tax financing. While high tax burdens push potential taxpayers away, high transfer payments attract potential transfer recipients. Due to the residence principle (unlimited tax liability) and the world income principle as cornerstones of direct taxation and (at least partly) for social protection, tax burdens and transfer generosity at residence determine the behavioral adaptations of citizen. In a world of almost legally unlimited mobility – or in other words in a globalized world – the outcome is local, regional and international competition of tax and transfer systems, setting pressures on efficient regulation and limiting the always threatening Leviathan.<sup>4</sup>

Obviously the mobility is dependant on the individual endowment with human, monetary, and real capital. Because of free movement of capital, monetary capital has doubtlessly the highest mobility, even if physical persons are not mobile.<sup>5</sup> Regarding physical persons, people with overwhelming capital income are highly mobile, whilst employees with lower qualifications and mainly dependant on their wages have a comparatively low mobility. Realities and buildings are immobile by definition. In case of tax increases or transfer reductions the mobile owners naturally can sell real es-

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<sup>3</sup> Regarding location advantages and disadvantages tax differences are only one argument; many other factors do also influence the location decisions of firms, among them energy costs, labor costs, ancillary labor costs, social security contributions, endowment with human capital and infrastructure (public goods and services), geographic and climate conditions, etc.

<sup>4</sup> See Petersen (1993).

<sup>5</sup> The shift of monetary capital and connected interest payments into foreign countries implies a breach of the world income principle and is to classify as tax evasion. The very limited control possibilities for the fiscal administrations as well as the lack in awareness and illusions on side of the taxpayers limit the factual and moral costs of such illegal behavior; for the uninformed electorate with regard to taxation see Lafay (2003: 10).

tate, but the additional burden is then shifted by lower prices as consequence of tax (and transfer) amortization to the former owners.<sup>6</sup> Therefore, the actual behavioral adaptations of the citizen are determined by tax and transfer policy patterns of the past and their expectations for the future burden developments. If their individual projections will make them to believe in further burden increases, then even immobile citizen will reconsider the location advantages (in form of personal and public infrastructure) and disadvantages (in form of factual or at least presumed future burden increases).

Regarding tax policy the mobile factors are moving to those locations where the after-tax returns seem to be most profitable.<sup>7</sup> Such tax competition presses the high tax states to reform their inefficient national tax law so that as result the selection process might yield into more efficiency within the whole union. But often fears are expressed that such a competition is unfair and the selection principle does not lead to more efficiency but into a footrace of permanent underbidding the tax rates. Significant revenue losses might be the consequence, which necessitates at least a certain degree of harmonization within the union and beyond. It has to be mentioned that the latter argumentation can always be heard from tax politicians in the high tax countries, which in the past often have been unable to reform their system of direct taxation and social security thus still being confronted with enormous inefficiencies. Increased voting by feet is an expression of inefficiencies within the tax and transfer systems especially of high tax countries leading at least in short and mid term to expatriation of capital and in the long run even to migration of persons (especially the well-to-do). In spite of the above mentioned necessary adaptations in the national tax and transfer policy patterns, usually tax and social politicians in the respective countries are blaming the countries with immigration of capital and high skilled persons as tax havens or shelters, which they often denote as immoral political strategies.

Therefore, the ongoing national tax policies should have in mind the negative consequences of a ruinous tax competition, which alone definitely will not yield the often assumed negative impacts because besides tax burden differences there are many other factors mentioned above, which determine the location decisions of firms and qualified persons. If such policy strategies are spreading over the member countries, only limited harmonization will become necessary. Because of the cultural differences and historical experiences in between the member states different traditions will yield into different tax systems and tax burdens so that a certain degree of tax competition will always remain thus further pressing member states to reform their inefficient tax and transfer systems. Only under such competition innovation is encouraged, which also limits the threat of political cartels within the member countries.

Possible solutions, however, are to formulate rules for a fair tax competition, at least partly harmonizing direct and especially indirect taxation, and to agree upon a code of good conduct. Tax harmonization regarding indirect taxation is of specific relevance because member state contributions are often bound to an indirect tax base. One of the first steps of *indirect tax harmonization* is the implementation of a value added tax system (VAT or goods and service tax GST) with a common tax base. The

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<sup>6</sup> For details see Petersen (2004).

<sup>7</sup> Such fears of inevitable downgrading in the social security systems due to the globalization process are expressed by Sinn (2001). This argumentation becomes invalid if differences in between risk sharing (insurance) and redistribution are taken into consideration, which are totally neglected by Sinn; see Petersen (2003: 212).

VAT usually follows the country of origin principle so that at the national borders the exporter is released from the own VAT burden and the importer is paying the Import VAT in the respective country. If border controls are abolished, the country of destination principle can be applied if all VAT rates are totally harmonized. An alternative is currently implemented in the EU, where since 1993 the Import VAT has been substituted by the VAT on internal common market turn-over. Here the trick is implemented that the borderlines are shifted into the firms, which has created an enormously complex administration and high transaction costs including a high susceptibility to fraud. The full transition to the land of origin principle is delayed since years.

In spite of numerous trials to harmonize the VAT tax rates in the EU still considerable differences do exist as it is the case within the other indirect taxes on gasoline, energy, alcoholic beverages, tobacco etc. However, the progress of indirect tax harmonization has been comparatively limited. This holds also true for direct taxation. Still differences in the direct tax bases do exist (income and corporation tax). Differences in the allowed depreciations, loss provisions, capital gains definitions etc. exist, having quite different impacts on the tax bases. Additionally different (partly more or less progressive) tax schedules together with a different institutional design of enterprise taxation produce efficient tax rates, which can only be determined if clear assumptions are set. The differences of the effective tax rates for the enterprises within the EU member countries are still remarkable.<sup>8</sup> Naturally such differences do have consequences for cross border transactions; due to the currency union exchange rate fluctuations and interest differences within the union have been abolished. Therefore the tax parameters might gain in influence but are still influenced by the other location factors.

### *II.2.3. Institutional Settings*

With regard to the institutional settings the depth and the extent of the planned organizational level is of utmost relevance. If just a unique target or a set of very narrowly limited public tasks have to be executed by an international organization, an *international treaty* would be appropriate. As more potential member states should be covered, as smaller the normative base and the entry preconditions should be formulated. As more tasks have to be completed as more important becomes a clearly formulated normative base, which usually rests on the human rights and the derived societal values and have to be shared with the people in all member states.<sup>9</sup> Therefore, such values have to be expressed in the constitutions of the member states. In case of a further deepening moving into the direction of an economic and currency union, the question of an own constitutional setting for the union arise, as the discussions in the EU have demonstrated.

Dependent on the scale and scope of the union the institutional form of governance has to be designed. For international organizations usually a general secretariat is sufficient. If more different kinds of public tasks are transferred to the association, community or union, a more complex commission (with different departments) might become necessary. As long as the budgets of the general secretariat or the commis-

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<sup>8</sup> An approach to standardize and compare effective tax rates for different enterprise tax regimes has been developed by Devereux/Griffith (1998). An empirically based comparison is shown in Rose/Petersen/Schmidt/Kambeck (2006).

<sup>9</sup> Societal values are, e.g., peace (internal and external), freedom, welfare and justice (of needs and ability); for more details see Petersen (1993) and Petersen/Müller (1999).

sion are purely financed by contributions of the member states, a control by the governments of the member states seems to be sufficient. With growing budgets the need for an independent audit (or control) court comes into being, which should be headed by a directorate with judicial autonomies. The staff of the general secretariat or the commission has to follow a standard code of conduct, which has to exclude any form of corruption.<sup>10</sup>

In case that the union level gets the form of a governmental entity then a direct control becomes necessary, especially if the own budget is financed by taxes raised on the unions level. In a democratic setting a directly elected parliament by the member states electorate is inevitable following Locke's rule mentioned above. In such a setting but also in case of a solely currency union, an independent central bank is another must. The board of governors also has to have judicial autonomies as well as a legislative period being independent from the respective parliament. While the general secretary, head of the commission or prime minister has the responsibility for fiscal policy (annual budgeting as well as mid-term fiscal planning), the central bank's governor has to steer monetary policy to safeguard monetary stability. Other necessary control institutions are a commission for competition control regulated by competition laws and a regulation office for banking and insurance control.

Independent audit chambers, central bank, competition as well as banking and insurance control are necessary institutions to supervise the political system and the private sector in their specific behavior. Under the assumption of perfectly informed and totally altruistic politicians such institution would be unnecessary: but in view of personal as well as institutional shortcomings, in vigorous democracies a system of checks and balances is needed to avoid a too far reaching accumulation of power, which can easily be turned into a totalitarian regime. Therefore, the independent monetary and control institutions with judicial autonomies act to secure the democratic setting and to limit the influence of the executive and legislative bodies. A network of countervailing powers is the best provision against a misuse of political influence. Usually their legislative period is longer than of the parliament so that these institutions can act more independently and with a longer termed political perspective.

### **III. Fiscal Federalism**

There is not a unique theoretical approach, which can be subsumed as fiscal federalism but there are quite a group of topics being discussed under this headline. Whereas economic integration usually has the introduction of a new jurisdictional level beyond the national states as consequence, this theoretical approach predominantly leads to a more centralized form of political decision making. Fiscal federalism in contrast sets the focus on federally structured states with more than one jurisdictional level and tries to explain the advantages (and disadvantages) of *decentralization*. Often federalism and decentralization are used as synonyms, in spite of the fact that many different aspects are involved. A general and broad definition of fiscal federalism was developed by Rondinelli and Nellis (1986: 5): "... transfer of responsibility for planning, management, and the raising and allocation of resources from the central government and its agencies to field units of government agencies, subordi-

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<sup>10</sup> For details see Lambsdorff (2007).

nate units or levels of government, semi-autonomous public authorities or corporations area-wide, regional or functional authorities, or nongovernmental private or voluntary organizations.”

Prud'homme (1994: 2) has proposed the following differentiation: De-concentration (spaciously decentralized fulfillment of public tasks by different entities under unitary rules and norms), delegation (transfer of single tasks on partly autonomous entities, e.g. public enterprises), and devolution (distribution of political decision-making and the connected management on different jurisdictional levels). However, fiscal federalism is closely connected with the question in a multi-jurisdictional state, namely which jurisdictional level has to fulfill which public task. The public tasks can be executed by the supply of public goods and services, which necessitates on the one hand public expenditures and on the other hand the connected financing, done by taxes, contributions or fees. On each jurisdictional level the citizen should be able to compare the benefits (of the public goods and services) and the costs (in form of the financial burdens) thus evaluating the efficiency of the jurisdictional levels. The capacities of public goods and services determine the “optimal” size of a jurisdictional level. Therefore the theory of public goods is of utmost relevance for fiscal federalism.

De-concentration is then the shift of public tasks to lower jurisdictional levels (regional or local), which also might be connected with full or partly legal autonomies (*legislative sovereignty*) and is often called decentralization. Delegation is connected with the fulfillment of public tasks legally determined by higher jurisdictional levels and to be managed and completed at the lower jurisdictional levels. Often the *legislative sovereignty* is at the central jurisdiction while the administrative sovereignty is shifted to the lower levels. Devolution does mean that legislative as well as administrative sovereignties are shifted to lower jurisdictional levels. Similar questions do arise regarding the financing. Here the question is if the single jurisdictional levels do have fully or partly the legislative sovereignties on taxation (defining the tax base and/or the tax schedules/tax rates) and which jurisdictional levels do have the *revenue sovereignty*. These three sovereignties are discussed in more detail in the chapters below while the question of tax revenue sovereignty is closer described in chapter V.

### III.1. Theory of Public Goods

Some aspects of fiscal federalism are closely connected with the theory of public goods. Due to the technical capacity effects of public goods the literature differentiates in between local, regional, national, international<sup>11</sup> and global public goods.<sup>12</sup> Public goods are only connected with external effects, while private goods do have only internal effects; in case of public goods the market mechanism fails because the non-rivalry in the consumption (an additional consumer does not reduce the benefit of all other consumers) and the failure in the exclusion principles (consumers cannot be excluded from consumption). However, the majority of goods being defined as public goods often cannot be very easily distinguished from private goods because of partly rivalry in consumption.

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<sup>11</sup> International and especially supra-national public goods reopen the question for international integration.

<sup>12</sup> Public bads are defined as negative external effects connected with the production and consumption of public goods. Usually environmental problems can be treated as public bads, which do have a similar special relevance. For details see Petersen (1993a).

The latter often occurs in case of so-called congestion effects, which are often connected with a not sufficient capacity of public goods supply. Then at least transaction costs in form of temporal delays arise, which are also named marginal user costs. In decentralized systems the local public goods are supplied and financed by the local jurisdictions. Because the public goods are anchored within the preference schemes of the local citizen and the preferences are different due to ethnic, religious or ideological reasons, therefore, even the supply of the quantity, quality and kind of public goods might differ. Consequently the costs and financing of public goods also differ depending on the amount of the necessary public expenditures.

In different jurisdictions of the same level then the mix of public goods supply and financing is more or less varying, thus attracting or pushing off potential citizen. Autonomous supply of public goods and financing on the different jurisdictional levels then create local, regional, national, and international competition, which enables the citizen of one jurisdiction to compare the benefits and costs of the public goods supply in similar entities. Consequently competition creates the possibility for efficiency comparisons, which from a theoretical viewpoint can be done in using the instruments of yardstick competition, best practice analysis or benchmarking.<sup>13</sup> Efficiency comparisons do have behavioral consequences on side of the citizen. In case of a bad performing entity the citizen do get incentives to migrate to the better performing entity – competition in between entities of the same level induce voting by feet so that the jurisdictional tax base becomes mobile thus setting incentives for the responsible politicians and bureaucrats to increase efficiency and to limit the ever growing Leviathan.

In theory the optimal size of a jurisdiction can be determined by the capacity of the public goods.<sup>14</sup> Due to technical reasons the capacity is usually not arbitrarily divisible and often different for different kinds of public goods. Therefore, an optimal size is just connected with one public good and for others with larger (smaller) capacities the optimal size would be larger (smaller) thus getting overlapping responsibilities on the different jurisdictional levels. Taking for instance a public good with a capacity being to large for one jurisdiction, member of other jurisdiction can also profit from the benefits of this public good's supply – the above mentioned spill-over effects emerge. In practice it is impossible to have just one jurisdictional level for one public good because of the overlapping political responsibilities connected with such an approach. Hence, spill-overs are inevitable and can only be reduced if jurisdictions of the same level do form local authorities associations for the joint supply of such public goods, which in economic unions can also be founded in form of cross-border organizations.

## III.2. Competitive Federalism

In case of competitive federalism the public tasks are clearly separated in between the different jurisdictional levels (union, federal state, member states, counties and communities). For instance the communities supply the local public goods and have to bear the financial burdens, which are distributed by local taxes (contributions or fees) on the local citizen and enterprises. In such a setting the three sovereignties – legislative sovereignty, revenue sovereignty, and administrative sovereignty – are with the lower jurisdictional levels. They can autonomously define the quality and

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<sup>13</sup> For details see Bodenstein/Ursprung (2001).

<sup>14</sup> For details see Petersen (1988).



quantity of their public goods and services supply, which principally have to be financed by their own citizen or electorate, respectively. Due to capacity problems usually spill-overs occur, which also might favor the citizen of neighbor communities so that their citizen can also consume the benefits without any cost sharing.

Decentralization in this form has the advantage that the public goods and services supply can be strictly bound to the preferences of the citizen or electorate, which in direct and representative democracies are usually determined by the median voter.<sup>15</sup> If as in direct democracies the voters decide on the supply of a specific public good and have also to decide how to finance that good, they can individually evaluate the benefits and the connected costs. In representative democracies the parliamentarians and the political parties are additionally involved in the political decision process. Consequently the so-called principle-agent-problem appears because the preferences of the voters are then also influenced by the preferences of the parliamentarians as well as of the political parties.<sup>16</sup>

Due to local and regional preference differences caused by ethnic, religious, ideological, social etc. distinctions, the public supply will also be different thus leaving the free decision to the citizen or voters to choose their residence in those jurisdictions, which most perfectly fit into their own interests (voting by feet).<sup>17</sup> Therefore competitive federalism in one or other form with strong autonomies for the local and/or regional level is one instrument to channel ethnic conflicts into a peaceful direction and to integrate multi-ethnic states.

But problems arise if the spatial distribution of income is unequal. The local or regional average per-capita income and – in case of progressive tax schedules – also the income distribution on the households determine the local or regional fiscal capacity (revenue or contribution/fee potential) because per-capita income and fiscal capacity are positively related. Then jurisdictions can be identified as “rich” (high per-capita income) and “poor” (low per-capita income). In rich jurisdictions the fiscal capacity is equal to or even larger than the fiscal needs, whereas in poor jurisdictions the opposite is the case. Rich jurisdictions, however, are able to supply better and more public goods than poor can. But the supply of public infrastructure – e.g. for education, research and development – is one of the basic preconditions for economic growth and improved conditions of living so that in poor jurisdictions at least certain minimum standards of public goods supply have to be secured.

If enormous differences in the supply of public goods do not seem to be tolerable the more central jurisdictional level has the task to support poor or weak jurisdictions on the lower level in paying grants (intergovernmental transfers) to them to finance the generally accepted public goods supply (so-called vertical fiscal equalization). These grants are usually financed by the general taxes raised from all citizens being residence in the higher jurisdiction so that indirectly tax revenue from the rich lower jurisdiction is redistributed in favor of the poor lower jurisdictions. The extent of interre-

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<sup>15</sup> For the assumptions of the media voter model see Downs (1957), Buchanan/Tullock (1962) and Congleton (2002).

<sup>16</sup> Representative democracies are confronted with multi-stage principle agent problems because of the hierarchical structures of political parties and the involved other groups of agents (e.g. interest groups, bureaucracies). For details see Petersen/Müller (1999).

<sup>17</sup> In the economic textbooks as example for such an approach often the Tiebout-Model is presented; see for more details Petersen (1988).

gional redistribution is as large as more solidarity exists within the nation or the union.

### III.3. Consensus Federalism

Solidarity can be defined as sentiments of togetherness in between individuals or within groups. In case of the competitive federalism these sentiments are only rudimentary developed on the lower jurisdictional levels but at least taken into consideration by the higher (regional or central) jurisdictions. Within consensus federalism solidarity does play a more important role. The stronger jurisdictions take responsibilities for the weaker jurisdictions so that a direct redistributive relation in between jurisdictions of the same level comes into play (horizontal fiscal equalization). Precisely formulated the tax payers of the strong jurisdictions partly pay for the public goods supplied in the weak jurisdictions.

The extent of redistribution and equalization is dependent on the definition of the fiscal needs. Many constitutions refer to the living conditions and claim similarity or even equality.<sup>18</sup> But this term is an indefinite legal expression, which has to be concretized by the special law. Within the German fiscal equalization system on the member states level (“Länderfinanzausgleich”) the average fiscal capacity is used as reference measure. The Australian member state equalization system is based on standardized needs, which are developed and controlled by peer group evaluation using benchmarking or best practice procedures. The recently reformed communal equalization scheme for Liechtenstein is expenditure oriented, based on the expenditure patterns of the past and guaranteeing the communities a certain minimum standard, which is increased by a formula bound transfer for the smaller communities with a lower number of inhabitants.<sup>19</sup>

Just the claim for equal living standards would mean the largest volume of redistribution, which might lead to overburden the richer jurisdictions and their citizen. It also has to be taken into consideration that solidarity is not an unlimited sentiment and should not impair the self-responsibility of the single jurisdictions. Here the above mentioned subsidiarity principle should return to mind. Intergovernmental transfers do have similar impacts on the behavior of politicians and citizen within the supported jurisdictions like social transfers to private households and individual transfer recipients have.<sup>20</sup> If transfers are paid, it can empirically be observed that the recipients reduce their own efforts for improving their living conditions in personal responsibility. As higher the guaranteed standards are as more the efforts are impaired dependent on the marginal transfer rate like the labor supply is also dependent on the marginal income tax rate. If a local jurisdiction gets very generous funds to finance a high standard of public goods supply the incentives are strongly reduced to improve the fiscal capacity or the tax revenue bases by own activities. In other words high disincentives are involved in such equalization systems, which often do have the effect that weak jurisdictions supported by the strong do not take the support as incentive to

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<sup>18</sup> In article 72 of the German constitution formerly „equal (gleiche) living conditions“ have been mentioned, which was changed after the unification into “similar (gleichwertige) living conditions”. In art. 106 “uniformity (Einheitlichkeit) of living conditions” is mentioned.

<sup>19</sup> The per-capita expenditure per community shows a U-form shape for increasing numbers of inhabitants. For details see Kirn/Petersen (2008).

<sup>20</sup> For details see Petersen (1989).

come sooner or later to self-sufficiency but even to fall back in the general growth trend. Too much consensus and solidarity, however, can produce fiscal needs of the poor which are indefinitely perpetuated.<sup>21</sup>

### III.4. Federalism and Ethnic Differences

The discussion of competitive and consensus federalism has demonstrated that both are connected with advantages and disadvantages. In the process of nation-building or international integration in early stages solidarity and redistribution will be usually very limited. As larger the ethnic, cultural or ideological differences are as less equalization can be implemented. A clear separation of sovereignties and autonomy of the single jurisdictions seems to be an appropriate approach to overcome such situations. Often the situation is further incriminated by former violent conflicts so that negative sentiments like hatred, envy and distrust are dominating.<sup>22</sup> Therefore the readiness to pay for the citizen of other (formerly hostile) jurisdictions is limited or even non existing. In such situations rather secession and self-determination is demanded thus further reducing the returns of scale and scope or larger jurisdictional units.

At least a longer period of time is needed to overcome bad experience and negative sentiments. In this period people will stepwise observe that the process of disintegration connected with the collapse of the formerly ruling systems has also created new problems, which in view of the new independence and personal liberties have been ignored. But uprising nationalism, ethnic conflicts, newly established borderlines and border controls, the re-implementation of protective duties etc. produce costs in form of obsolete productive capacities and mass unemployment. Many regions have lost their key markets abroad and have been thrown back almost to a subsistence economy. Such contraction processes can only be overcome by regional and international re-integration.

Therefore fiscal federalism is the silver bullet for internal re-integration of regions, which have been separated as consequence of the collapse of the former governance system or by the decisions of the local or regional population (secession). Only an attractive design of federal cooperation connected with clearly defined autonomies and financial support by the central jurisdictional level will convince the majority of the electorate in such regions and communities to be unified again within the historical regional boundaries. If these boundaries do not reflect the ethnic, cultural and religious peculiarities, even a new cut of the regions and local jurisdictions should be taken into consideration. Just to accentuate an old legal status is not helpful but leading into new violent conflicts.

As far as ethnic groups are living in different national states, international integration and decentralization of competences can also be of merit because of then possible cross border solutions. In a longer time sequence more redistributive components of fiscal equalization can be implemented, which should be temporarily limited to avoid

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<sup>21</sup> Such developments are often named as „Mezzogiorno Syndrom“ in the literature; the Northern regions of Italy are transferring enormous funds to Rome and the Southern regions since generations without any clear impact of a self-supporting growth in the South. Similar fears are expressed regarding the transfers to the new states in Germany.

<sup>22</sup> For the impact of envy on the social welfare see Petersen (1993).

that single jurisdictions get too much dependent being on the drip of others. The mistakes of the old federal states should not be repeated where indefinite transfers have often seriously impaired the growth potential not only of single states but whole unions. Here the combination of revenue sharing, fiscal equalization and sunset legislation would be a convincing strategy for good governance.

However, having internal integration by federalist structures or external integration in mind, not only clear entry conditions have to be defined.<sup>23</sup> In rule of law states as well as in unions not only a regulated voluntary entry should be possible but also exit options should be taken into consideration.<sup>24</sup> Especially the experiences with the collapse of multi-ethnic states and violent secessions have led to intense discussions that in case of a voluntary entry also a voluntary exit including the exit conditions have to be formulated to avoid armed hostilities.

Usually the entry conditions are fixed in detail. The Maastricht criteria for the EU are a typical example.<sup>25</sup> These criteria have been set as criteria for the EU member states to get convergence regarding the most important economic indicators as prerequisite for the entry into the third stage of the economic and currency union. In the years before the adoption of the Euro in 2002 the criteria have had a strongly disciplining impact on the potential member states factually leading to convergence of the national economic policies and remarkable stability progresses. This educational impact has been lost after the implementation so that since years the basic economic indicators are diverging again. Principally the Euro has been an enormous political progress but it becomes highly visible that the centrifugal powers within the system are increasing. Therefore, at least single members are beginning to reflect upon exit so that clearly defined rules for a controlled exit someday might be badly missing.

Regarding federalism and integration also the mobility of capital and people might create some pressures. As more the societies have been closed before the integration process as more resistance exists against free movement of capital and persons. Often foreign direct investment is taken as a sale of national wealth and immigration of people especially with divergent cultural and religious backgrounds as threat for the local population. Negative reactions have often reached international attention but there are some objective reasons why such reactions happen. Dependent on the occupational qualifications of the immigrants especially on some labor markets competition for scarce jobs is strongly increasing. Shortages in the supply of dwelling as well public goods and services (schools and other educational institutions) are often connected with large scale immigration. Therefore, the local people have to be slowly convinced that the long term effect of migration are positive and the short term problems have to be overcome by careful immigration regulations.

Specific problems arise if ethnic differences correspond to per-capita income differences. If ethnic minorities do have a much lower income than the majority population often the feeling of exploitation is generated; the same holds true for poor regions with a homogenous population within multi-ethnic states where other ethnic groups are prospering and try to get rid of the poor neighbors by secession. Beside other

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<sup>23</sup> The EU conditions are presented under [http://www.bundesregierung.de/nn\\_87720/Content/DE/Artikel/2001\\_\\_2006/2005/11/2005-11-08-kriterien-beitrittskandidaten.html](http://www.bundesregierung.de/nn_87720/Content/DE/Artikel/2001__2006/2005/11/2005-11-08-kriterien-beitrittskandidaten.html)

<sup>24</sup> For the relevance of exit options see Schäfer (2005) and Slapin (2007).

<sup>25</sup> For details see Polasek/Amplatz (2003).

problems this was one important reason for the collapse and the clash on the Balkans. Only a long termed regional policy, which reduces such regional differences can overcome such problems. Therefore, also in the integration process regional development plays an important role at the central state or rather union level to strengthen the centripetal effects and to convince even the secessionists of the advantages of a larger economic area.

### III.5. Pros and Cons

As more the preferences of the citizen are different as better is the decentralization of the public goods supply and financing especially if the regions and communities of a nation state have divergent ethnic roots and cultural as well as religious backgrounds. Autonomies do more or less perfectly work if the regional or local population is homogenous. Problems might arise in ethnic mixed areas when a further spatial division is not any longer reasonable. Then careful measures of minority protection have to be implemented. Tensions regarding ethnical conflicts can be avoided if the constitutional settings concentrate on basic values, which have to be shared by all people. Integration and assimilation processes are difficult and long lasting but the orientation to well defined democratic values often is helpful to overcome traditional and at least partly out-dated habits. A permanent discourse on values and change in values is indispensable for states on the move into the direction of an open society.

Therefore, decentralization is an almost perfect mean to safeguard the imprescriptibly human rights against the overpowering central state or Leviathan, which has already been mentioned by Montesquieu and Tocqueville.<sup>26</sup> Usually the median voter of the central state has other preferences than the median voters in the regions and communities so that decentralized decision making per se is welfare increasing.<sup>27</sup> Beyond that the decentralized supply of certain public goods and services opens possibilities for divergence und experiments. In case of innovative state activities a test in single jurisdictions is possible, which minimizes the risks of a central decision. If such an innovation seems to be not reasonable, failures are made only on a regional or local scale, which is much cheaper than in case that a whole central jurisdiction would have followed wrong development patterns. Therefore, principally divergence in the regional and local supply of public goods and services allow for efficiency comparisons then done by best practice analysis and benchmarking. Beyond that empirical analyses show certain evidence that regional and local liberties are often connected with growth enhancement and improved supply of public goods.<sup>28</sup>

Federalism has also a positive perspective regarding the problem of corruption. Especially in direct democratic settings the control of the local and regional voter is often much tighter and intense than it could be on the central level. Therefore, the decentralized electorate has often better information on the local and regional relations. But often complains are to be heard that decentralized decision making also causes nepotism because of local and regional personal networks. Also for this form of corruption empirical evidence can be found; but as more as the voters are involved in the political mechanism and as tighter the links are in between the public expenditure side and financing as less is the threat of nepotism. In the contrary in centralized

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<sup>26</sup> See Kirchgässner/Feld (1998).

<sup>27</sup> See Blankart (2006).

<sup>28</sup> See Thiessen (2002) and de Mello/Barenstein (2001: 4).

states with limited democratic experience of the electorate and obviously old tribe traditions nepotism is to be found on the highest hierarchical levels where top political positions are inherited within families.

As a con it is often mentioned that in case of federalist structures the jurisdictions might be not large enough to profit from the economies of scale. Obviously this argument is connected with the optimal capacity of public goods supply so that with a new distribution of public tasks such problems can be avoided. In case of too large capacities for single jurisdictions it is – as already mentioned above – also possible to form communal or regional associations for a joint supply of certain public goods so that the average user costs are decreasing, too.

Especially in case of countries in transition local and regional jurisdictions exist with extremely low per-capita income; often these jurisdictions are purely based on agricultural production predominantly being subsistence production. Then it is almost impossible to finance the fiscal needs (even in form of a minimum standard) by the own electorate. Often suitable tax bases are missing so that for intermediate financing only grants from the regional or central level is a practicable solution. The development of suitable local and regional taxes also depends on the cultural traditions and the implemented regime of property rights. Usually a land and real property tax might be an appropriate approach to local financing but such tax can only be implemented if the land ownership is clearly regulated. In a nomadic setting land is often handled as common property resource so that for instance a livestock tax is the only alternative.

Another critical argument against decentralization is seen in the skepticism that the social and technical competence is more concentrated on the higher than on the lower jurisdictional levels. This critic is also bound to the development level, which federalism has reached within a country. As better the remuneration of the staff is organized and as more the local and regional electorate is democratically involved in the local and regional decision making as less such argumentation is convincing. Beyond that it is often mentioned that the precaution for existence (German: Daseinsvorsorge) interferes into the area of private goods supply. Principally this critic is true but also holds for some good supplies on higher jurisdictional levels. Regarding the traditional local and regional production activities a careful revision is necessary. Partly privatization or public private partnerships (PPP) are practicable alternatives.

In total the cons are predominantly connected with problems of a more or less imperfect institutional design. Especially the participation of the local and regional electorate is of utmost relevance, which will be discussed in the following chapter. Improvements in the democratic setting and the institutional conditions are possible as increasing international evidence has demonstrated. At least in the long run federal states and supra-national unions have seriously contributed to the wealth within the member states so that the pros for federalism and integration are clearly dominating.

#### **IV. Public Choice Arguments**

The above mentioned arguments have demonstrated that the influence of the electorate is of utmost relevance. Education, occupational qualifications and the information base (free media) of the electorate determine the efficiency and the quality of a democratic setting. In democracies the voters are the principals whose preferences

have to be aggregated by majority voting mechanisms. Automatically at least one or more large groups of voters do belong to the losers of the voting process falling under the minority protection of the constitutional setting. A federal system with different jurisdictional levels and different median voters allows for elections on each jurisdictional level and avoids simultaneously that a too large portion of the electorate gets into the minority position on all levels due to differences in the local and regional voting behavior. So federalism guarantees by multi-party governance within the different jurisdictions a better representation of the conflicting political positions and often necessitates political compromises, which also broaden the basis for acceptance in the broader electorate.

Decentralization obviously has economic advantages as far as the advantages of scale and scope are carefully taken into consideration. Usually the jurisdictional level with the best information on the supply side (local, regional, central or union authorities) and demand side (the respective electorate) should supply the public good under consideration. As far as possible the *benefit principle* has to be applied (fee financing or benefit pricing) so that the voters can individually evaluate the quality and the costs of the public goods provision. This quasi-pricing corresponds to the market equivalence, which clearly compares the “do ut des” on private goods and services markets. If inefficiencies happen the voters can react with their voting behavior dependent on the institutional settings in direct or indirect (representative) democracies. Then the public good supply will be directly changed or another political representation gets the mandate to change the policy strategies.

This approach is reflected by the principal of *institutional congruency*. It is fully achieved if in case of the supply of a certain public good the group of beneficiaries fully coincides with the group of decision makers, tax payers and voters (see figure 1).<sup>29</sup> The circle determines the local area of the public goods supply. In case of perfect information the voters have all necessary knowledge about the merits and costs of the public good supply and the politicians as well as the bureaucrats are forced for an efficient behavior. Even in case of absence of full information the voters control often functions quite sufficiently. Therefore, it is well known that the supply of public goods and services as well as the public expenditures are in direct democracies like in Swiss substantially lower than in representative democracies because of the direct voters control and the avoidance of multi-stage principal-agent problems. Hence, for an efficient federal setting the voters control is of utmost relevance. Decentralization without democratic setting might also have some merits but without the voters control negative developments like nepotism and corruption become much more likely.

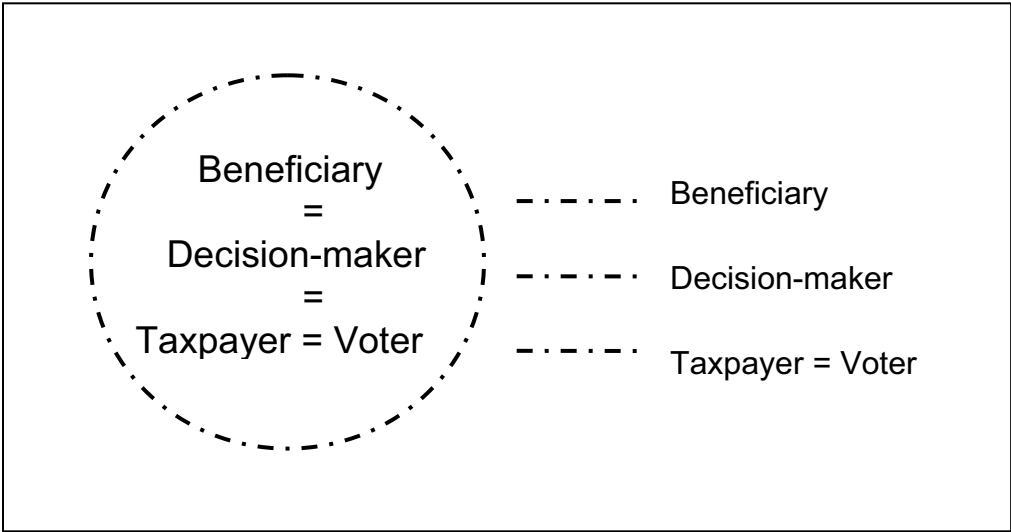
Due to capacity problems mentioned above spill-over effects happen and often especially lower jurisdictional levels cannot afford to pay for some specific public goods as consequence of a limited fiscal capacity. Then taxpayers on the central level or from other jurisdictions have to co-finance at least the necessary public goods so that the principle of institutional congruency is more or less violated. Figure 2 represents such a situation of institutional in-congruency. Additionally in this example the decision for the supply of a specific public good is not made by the local authority but by the central entity. Here another important principle of federalism comes into play: the *principle of connectivity*. Most constitutional settings follow this principle so that one and the same jurisdictional level is responsible for the supply decision (legislative sover-

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<sup>29</sup> For details see Blankart (2006).

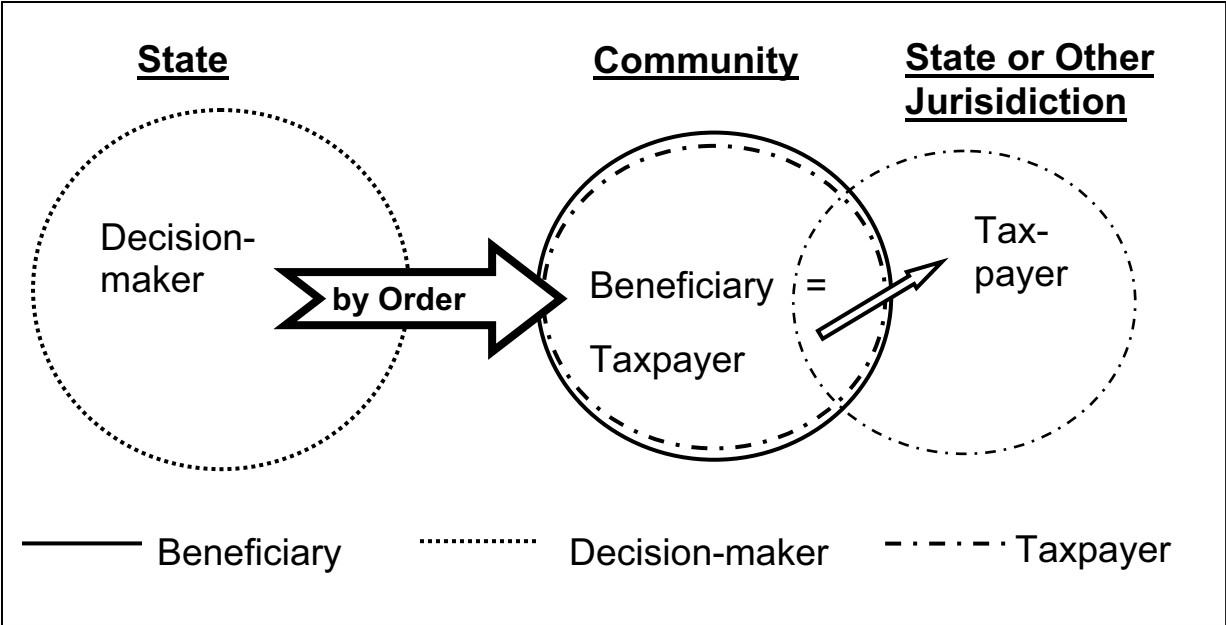
eighty), financing (revenue sovereignty) and the administration (administrative sovereignty). In case of super-ordinate interests of the central state or the union (joint public goods supply to guarantee a certain provision of goods of common interests) some divergence might be allowed while principally connectivity remains the basic norm. In some constitutional realities such divergences have become so often that the federal character is more and more impaired. Then usually verdicts of the constitutional courts claim for reforms where the re-establishment of the basic norm is often demanded.

**Figure 1: Institutional Congruency: Beneficiary, Decision-maker, Taxpayer, and Voter Coincide**



Source: Blankart (2006).

**Figure 2: Institutional In-congruency: and Order Management**



Source: Blankart (2006).



In case of non-connectivity one jurisdictional level (usually the central) determines the fulfillment of tasks while the other levels have to administer and sometimes also to finance those tasks. This management by order influences the fiscal capacity and the behavior of the jurisdictions. If parts of the public expenditures are financed by the taxpayers of other jurisdictions (vertical or horizontal fiscal equalization) the congruency is more or less heavily impaired, too. Grants and intergovernmental transfers do have the character of a present without any local or regional expense loading so that the local and regional responsibilities might be negatively influenced. Often the supply of public goods is then exaggerated with the consequence of wasting public funds.

This threat is always existing and cannot easily be controlled by the taxpayers of the other jurisdictions due to the fact of often complex regulations regarding tax sharing and fiscal equalization as well as lacking information. All this is often leading to discontent with the political system, mistrust in government and reduced acceptance for democratic steered solutions in open societies. Therefore, good governance and modern public management lays the stress more upon the benefit principle and financial means in which the taxes do play more the role of market pricing. Whereas the often named ability-to-pay principle of taxation is more bound to the distributive and redistributive aspects and neglects the relation in between cost and benefits, the benefit principle is much more bound to self-responsibility and the voter's evaluation of the jurisdictional performance in comparison to the tax burdens.<sup>30</sup> Institutional incongruency and non-connectivity harm fiscal responsibility of the different jurisdictional levels; the exploitation of one and more jurisdictional levels by others becomes possible. This fact has seriously to be taken into consideration if an efficient federal system has to be designed.

## **V. Revenue Sharing, Grants and Fiscal Equalization**

Usually the public tasks are distributed over the jurisdictional levels by constitutional rule or tradition. A change in the allocation of public tasks is often badly needed but difficult to be implemented in the political practice because of serious resistances from politicians, bureaucrats and interest groups. Therefore, in transition and development processes the existing distribution is often accepted so that the expenditure side of the jurisdictions is more or less defined. The first transformation activities are then directed to the revenue side of the budgets. As mentioned above the revenue capacity is heavily dependent on the local, regional or national per-capita income and remarkable differences within the fiscal capacities usually exist.<sup>31</sup> Such differences call for a well balanced design of the revenue sharing and fiscal equalization system.

With regard to revenue sharing principally four different forms do exist.

- separate taxation of the single jurisdictions,
- surcharge on tax yield raised by other jurisdictional levels,
- common tax pool with defined shares for the participating jurisdictional levels (quota system), and
- grants system.

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<sup>30</sup> See Petersen (2003a).

<sup>31</sup> For such regional differences see the example of Georgia in Petersen/Gelashvili (2008).

Dependent on the influence pursued by the central jurisdiction the systems are characterized by more central or de-central features.

But before tax laws are implemented at best a constitutional decision is needed on the legislative sovereignty regarding tax legislation. For a unitary economic and currency area it is considered to be reasonable to define the tax bases in a homogenous way, which especially holds true if the ability-to-pay of the member states within an economic union is the base of their contributions to the union's budgets. Often the per-capita income, the turnover or VAT tax base are used as contribution base. Therefore it is necessary to harmonize at least the indirect tax bases especially if an economic union with free mobility of goods and services is striven for. In federal states mobility is comparatively high and similar or equal living conditions are an often important target. Then the tax bases for direct taxation should also be equally defined for the whole federation's area.

All these arguments support the argumentation for a centralized legislation regarding the national tax law. Depending of the degree of decentralization the regions or member states might participate in the legislative process. The German constitution for instance distinguishes in between *exclusive legislation* (art. 73 GG) with majority approval in the federal parliament and *concurrent legislation* (art. 74 GG) where the federal parliament and the member states (Bundesrat, 2<sup>nd</sup> chamber) have to pass the draft laws in majority approval. Principally indirect taxes are due to exclusive legislation of the federation while direct taxes are under concurrent legislation so that the "Länder" do have substantial influence.

Apart from the legislative sovereignty tax sharing distributes the tax revenue on the different jurisdictional levels. As mentioned above fully separate taxation would in practice lead to double taxation and overburden the connecting tax bases. Therefore, in practice **separate taxation with free competition** for the tax bases does usually not exist. *Separate taxation without legislative sovereignty* at the regional or local level is dominating but in some federal states also partial legislative sovereignty is shifted to the regional and local level by allowing these jurisdictions to fix the effective tax rate autonomously.<sup>32</sup> In the example of the Federal Republic of Germany the separate taxation is partially implemented. Table 2 shows the common taxes shared by all jurisdictional levels, then the federal, member states and local taxes (of the communities within the member states). The federal taxes are under the exclusive legislation and administration of the federation while the common taxes and state taxes are under concurrent legislation of the federation (federal parliament: Bundestag) and the member states (2<sup>nd</sup> chamber: Bundesrat). The local taxes, especially the firms and land tax, are under separate taxation with partial legal sovereignty of the communities on the tax rates.

In a **surcharge system** usually all sovereignties (legislative, administrative and revenue) are at the central level so that the tax bases as well as the tax schedules and rates are determined by the federation. The lower jurisdictional levels have the autonomy to determine a surcharge rate in self-responsibility, which determines the effective tax rate. This surcharge is typically defined as a certain percentage of the tax rate fixed by the central level. In Liechtenstein, for instance, the central state determines by earnings tax law the tax schedule and the individual tax yield of the sin-

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<sup>32</sup> For instance the German communities are allowed to determine the effective tax rate of the land and local firm tax.

gle household. The communities then apply their different surcharge rates, which differ in between 170 % and 250 % of the central state's yield. Therefore, this system is quite similar to separate taxation with partial legislative sovereignty. Hence, this system has a comparatively high degree of decentralization.

**Table 2: German Tax System – Classification by Jurisdictional Level**

Common taxes	Federal taxes	State taxes	Local taxes
Wage tax	Tax on gasoline	Automobile tax	Firms tax
Asses income tax	Tobacco tax	Inheritance and gift tax	Land tax
Firms tax revenue share	Tax on alcoholical beverages	Beer tax	Other local taxes
Corporation tax	Insurance tax	Other state taxes	
Capital income tax	Tariffs (imposed for the EU)		
Value added Tax (VAT)	Solidarity surcharge		
Source tax on interest payments	Other federal taxes		

In case of a **common tax pool**, the pool might be defined for single taxes, a group of taxes or the whole tax system. The degree of decentralization heavily depends on the legislative sovereignties and the regulations how the tax revenue is distributed on the participating jurisdictional levels. A fully centralized system has the legislative sovereignty and the administrative sovereignty at the central level. If concurrent legislation is implemented in the constitution, lower jurisdictional levels are allowed to participate in the legislative decisions so that such system is more decentralized. In a quota system at first the included taxes and secondly the quotas for the participating jurisdictional levels in the vertical direction (central state, member states and communities) have to be defined. Thirdly the rules have to be determined how the total tax revenues of all the included taxes have to be distributed on the single jurisdictions of the same jurisdictional level (horizontal direction).

For example table 3 and figure 3 represent the vertical distribution of the tax revenue regarding the taxes in the common tax pool in Germany. The wage tax and the assessed income tax revenues (as part of the income tax) are shared by 42.5 % for the federation and the member states and 15 % for the communities within the member states. The corporation tax on corporate entities and the capital income tax revenues are distributed by 50 % on the federation and the member states, the VAT by 50.5 % for the federation and 49.5 % for the member states after a prior deduction of 2.2 % for the communities and an amount of 2,3 billion Euro for the federation.<sup>33</sup> The source tax on interest payments (also part of the income tax) is shared by 44 % for

<sup>33</sup> For more details see Gesetz über den Finanzausgleich zwischen Bund und Ländern (Finanzausgleichsgesetz – FinAusglG) under <http://www.buzer.de/gesetz/1608/b4560.htm>.

the federation and the member states and 12.0 % by the communities. The firm tax is to 90 % with the communities and to 5 % with the federation and the member states, respectively. Whereas the shares of the VAT are negotiated in between the federal government and the member states (Bundesrat), the shares for the other taxes are regulated within the constitution.

**Table 3: Revenue Sharing in the German Common Tax Pool**

Type of Tax	Share of the Federal State	Share of the States	Share of the Communities
Wage tax	42.5 %	42.5 %	15.0 %
Assessed income tax	42.5 %	42.5 %	15.0 %
Corporation tax	50.0 %	50.0 %	
Capital Income tax	50.0 %	50.0 %	
Value added tax (VAT)*	50.5 %	49.5 %	
Source tax on interest payment	44.0 %	44.0 %	12.0 %
Firms tax	5.0 %	5.0 %	90.0 %

**Figure 3: Revenue Sovereignty and Revenue Sharing in Germany and the EU**

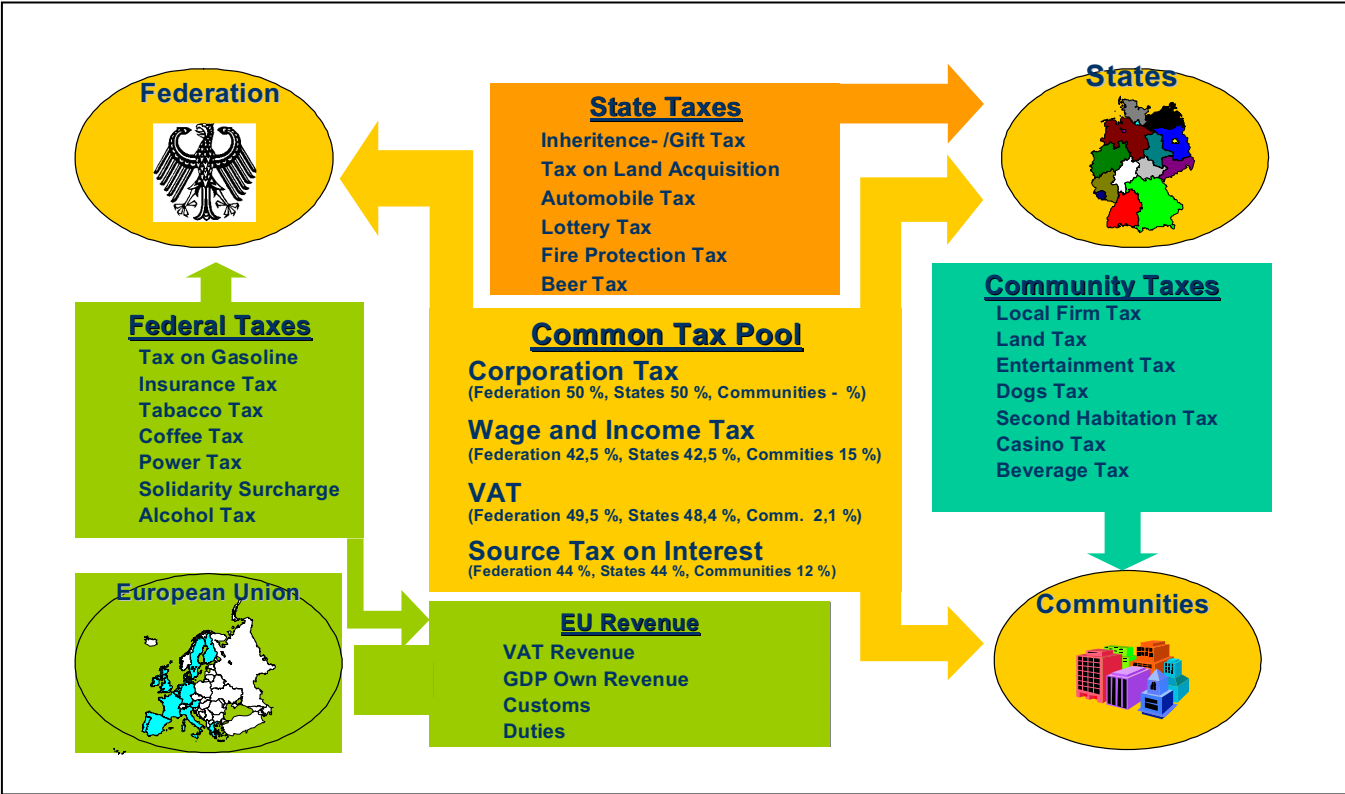
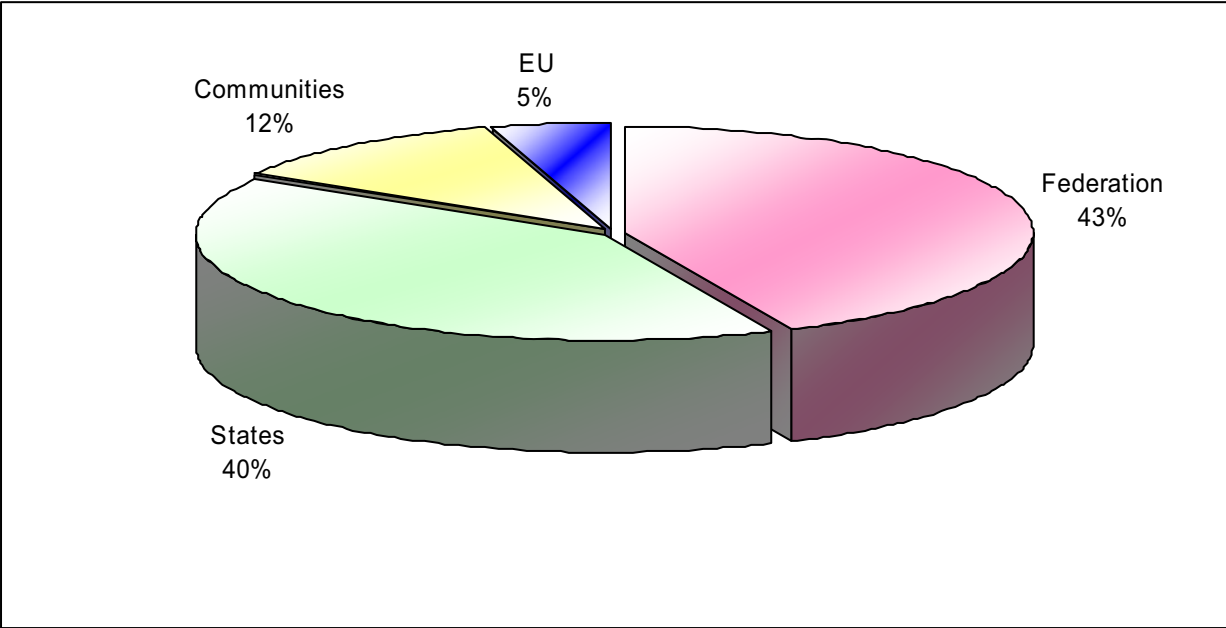
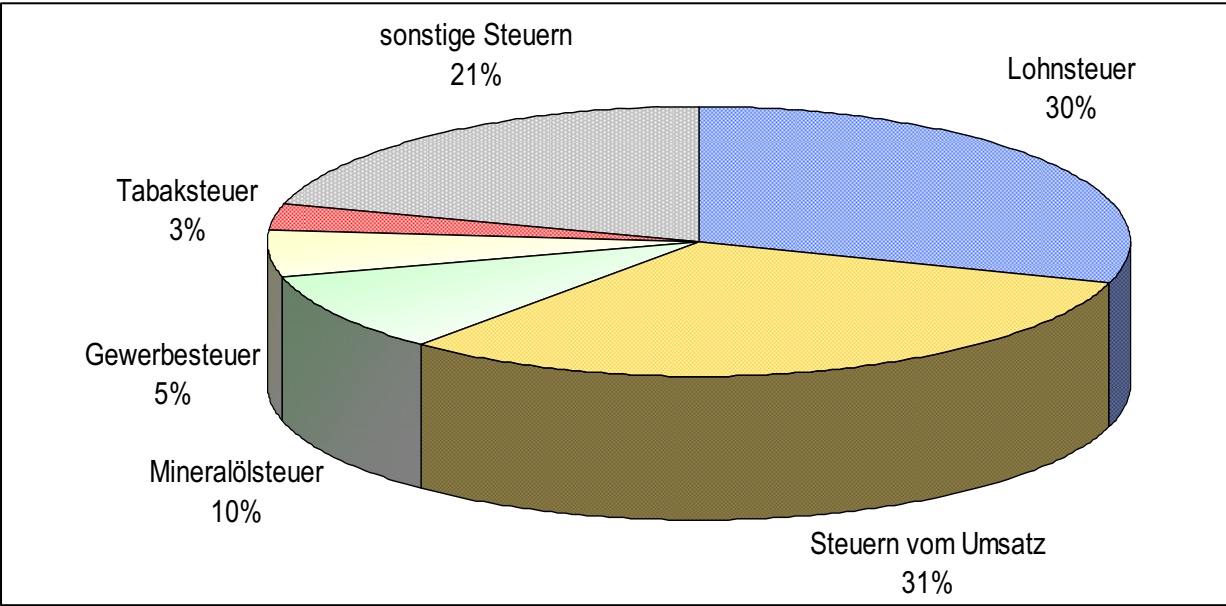


Figure 4 represents the revenue sharing in between the four jurisdictional levels. In 2007 the federation has got 43 % of the whole revenue, the states 40 %, the communities 12 % and the EU 5 % of the total German tax revenue.

**Figure 4: Distribution of German Tax Revenue on the Jurisdictional Levels in 2007**



**Figure 5: Composition of Total Tax Revenue by Tax Types**



The composition of total tax revenue regarding the single taxes is shown in figure 5. In 2007 the VAT was the tax with the highest revenue followed by the wage tax, the

gasoline, firms and tobacco tax. Only three taxes of in total 29 different taxes yield more than 70 % of the total tax revenue. Regarding the revenue distribution on the jurisdictional levels the common tax pool encompasses 67 %, the federal taxes 20 %, the state taxes 4 % and the communities taxes 8 % auf the total tax revenue.

Whereas the communities do have a higher bracket in total tax revenue than the states, additionally the communities do have tax rate sovereignties, which the states do not have. Therefore, already for a long time discussion to introduce at least one state tax with tax rate autonomy on the state's level are ongoing.

The German example demonstrates that regarding the vertical distribution separate taxation as well as a common tax pool is implemented within the revenue sharing system, which on the one hand avoids the shortcomings of the appliance of only one basic system but on the other hand increases the complexity of the fiscal constitutional setting. With regard to the vertical distribution of the tax revenue on the single member states additional more or less complex regulations have to be implemented. Principally two possibilities of horizontal revenue distribution exist: (1) the distribution according to the local tax revenue (based on the tax yield of local residents - individuals or households as well as the local business premises) or (2) the distribution per capita or per resident. The local tax revenue is seriously influenced by the per-capita incomes in a region or community. In case of high per capita income the tax revenue is high and vice versa. The decision in favor of a per capita or per residents distribution thus means that the tax revenue is more equally distributed in favor of regions or communities with lower per-capita income so that a redistribution from the rich jurisdictions to the poor jurisdictions is implemented within the horizontal tax sharing system.

The last form of revenue sharing is the **grants system**. The highest degree of centralism is given in case of fully centralized sovereignties and a central fiscal administration, which raises the tax revenue for all taxes on the central level. Then grants or intergovernmental transfers are paid from the central budget to the budgets of the lower jurisdictional levels, which have no influence on legislation, administration, and the local as well as regional tax revenue. Fully decentralized is a system in which the subordinated jurisdictions have all sovereignties and the central state, federation or union is financed by the member entities. This holds partly true for the budget of the EU being partly financed from revenue of the member states (see figure 5).

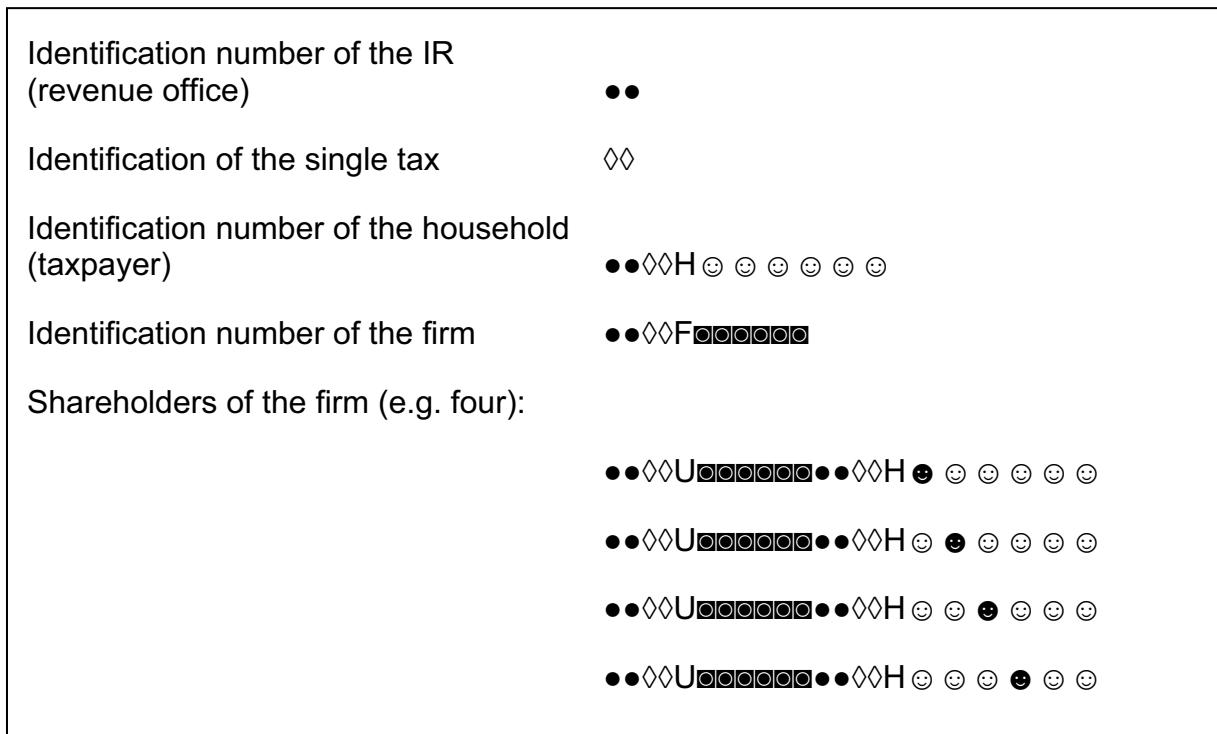
Figure 6 intuitively groups the different revenue sharing systems due to the extent of centralization and decentralization. Without doubt separate taxation with free competition and a grants system from the lower to the higher jurisdictional levels are the most decentralized ones. Separate taxation without legislative sovereignties for the lower levels and the grants system from the central state to the lower level have the highest degree of centralization. But the possibilities to implement decentralized tax systems also have consequences for the organization of the tax administration and the internal revenue service (IR). The tax base must be assignable to the different jurisdictional levels and at best the revenue offices should also be hierarchically structured due to the existing jurisdictional levels. With modern information technology (IT) such information can also be raised by central offices but still local offices are necessary for the jurisdictions to control their own tax base and to supply customer oriented advice for the taxpayers thus improving the transparency of the tax system and compliance of the taxpayers (especially to avoid tax evasion and transfer fraud).

**Figure 6: Revenue Sharing and Centralization/Decentralization**



For a systematic coverage of all necessary tax data a full registration of all liable individuals, households and firms including the place of residence is necessary. Therefore, a tax identification number (TIN) has to be implemented being equal for all jurisdictional levels. The TIN should clearly indicate the local responsible revenue office, the kind of tax raised, the tax number of the respective individual/household or firm, and the shareholder numbers of the firms consisting of the firm tax number and the individual/household tax number. All these TIN numbers have to be used within the different tax forms for direct and indirect taxation so that a clear base for the tax statistics is formulated, which enables the fiscal administration or the Ministries of Finance (MoF) to implement highly sophisticated revenue estimation models (e.g. micro simulation models) for the necessary revenue forecasts.

**Figure 7: System of Tax Identification Numbers (TIN)**



Usually the structure of the IR follows the jurisdictional composition within the federal state. Figure 8 represents the basic structure of the German internal revenue system. It becomes obvious that the federal tax authorities also collect the customs, duties and taxes, which revenue is then transferred to the EU level (see figure 5).

Hence, a fiscal equalization system (FES) is composed of a tax sharing component and/or a component, which distributes public revenue vertically to other jurisdictional levels or horizontally to jurisdictions of the same level. If competitive federalism is aspired, especially vertical equalization takes place, which also might have redistributive impacts in the horizontal direction. If in a vertical FES the revenue is not distributed according to the local revenue but to average per-capita formulas then already a horizontal redistribution from the rich to the poor jurisdiction is implemented. This redistribution is more or less hidden in the central grants system. In consensus federalism separate horizontal FES exist in which the redistribution is openly determined by equalization formulas, which favor the poor member jurisdictions. Therefore, receiver jurisdictions and net payer jurisdictions exist. In Germany, for instance, such systems are implemented on the member states level (Länderfinanzausgleich) and for the communities within the member states (Gemeindefinanzausgleich).



**Figure 8: Structure of the Internal Revenue Service in Germany**

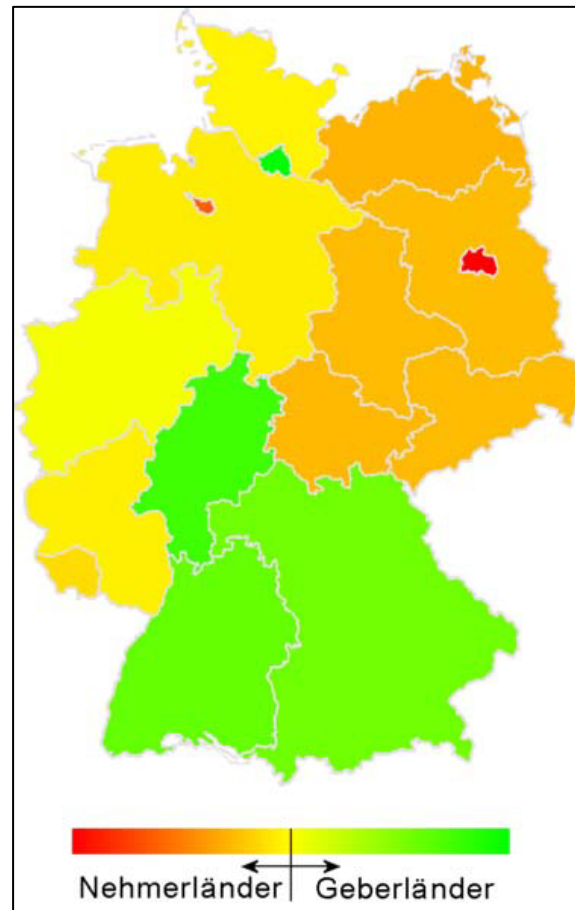
<b>Federal Tax Authorities</b>	<b>State Tax Authorities</b>	<b>Local Tax Authorities</b>
<b>Federal Ministry of Finance</b>	<b>State Ministries of Finance</b>	↓
<b>Revenue Directorates</b>		
Main Customs Offices, Customs Investigation Office, Federal Property Office and Federal Office of Forestry	Revenue Offices	Local Revenue Offices, Town Revenue Offices
administration of special federal taxes: - tariffs - consumption tax determined by federal law including value added tax on imports and beer tax - finance monopolies - duties as effected by the EU	administration of state taxes + administration by order of the federal government: - remaining federal taxes and common taxes - tax assessment	administration of local taxes

A short view on the member states equalization system will demonstrate how such horizontal equalization schemes work. Taking the local tax revenue distribution into consideration the fiscal capacity for the 16 federal states is in between 35 % (in some new states) of the federal average to almost 200 % (in the seaport and city state Hamburg). If the VAT revenue is distributed per capita (inhabitant), the fiscal capacity ranges in between 55 % and about 150 %.<sup>34</sup> Then within the State Fiscal Equalization Scheme parts of the VAT revenue are distributed in favor of the poor member states (up to 25 % of the revenue) until the poor member states have reached 92 % of the average fiscal capacity. The remaining revenue (up to 25 % of the total revenue) is then distributed by the population numbers. This also means a more or less strongly redistribution compared to the original revenue distribution. Then further tax revenue of the rich member states is transferred in favor of the poor until they have reached 95 % of the average fiscal capacity. Finally the federal state pays supplementary federal grants to the poor member states so that all of them reach 99.5 % of the average fiscal capacity. Then the fiscal capacity ranges from 99.5 % to about 105 % of the average fiscal capacity.

<sup>34</sup> For more details see Petersen et al. (2001).

Figure 9 presents a map of the Federal Republic of Germany where the net paying states are drawn in green color and the receiver states in yellow up to red depending on the level of net transfers they receive.

**Figure 9: Net Payer and Net Receiver in the German States FES**



Comparing fiscal capacities before and after the horizontal fiscal equalization it becomes obvious that the interests of the weak member states to improve their own tax revenue are very limited due to the high extent of equalization reached within that system. These negative incentives, which impair the regional responsibilities, have been intensively discussed. Such high redistributive effect can only be justified for a limited time. If in future the receiving states will not be able to improve their own revenue base, the solidarity of the net payers will erode. Then FES have to be developed, which are much more incentive oriented so that the poor member states develop innovative strategies for a self-responsible regional policy, which has made in the post war period at least Bavaria from a net receiver to a net payer state. For setting clear signals, even for the design of FES the sunset legislation would be a reasonable strategy for good governance.

## **VI. Consequences for Tax Reform and Tax Administration**

In transition but also highly developed industrial countries fundamental tax reforms are badly missing. Almost all direct tax systems (income and profit tax systems) do not treat all sources of income equally – in spite of the fact that equal treatment of

persons is one basic component of human rights in nearly all constitutions. Equal treatment of income sources is expressed within the neutrality postulate of direct taxation, which means that income from different sources (labor or capital income) has to be defined in the same way (tax base) and be burdened with the same tax schedule. Especially in case of the taxation of firms this neutrality postulate has been more precisely specified:

(1) Neutrality of the legal form means that equal profits should be burdened equally independent from the fact if they were earned in a sole trader firm, partnership or incorporated company. Otherwise specific legal forms would be discriminated or privileged.

(2) Neutrality of investment means that investment returns independently of the investment objects have to be equally burdened. Principally capital income is connected with financial assets as well as real assets. Therefore, interest payments, rents and leasing returns, capital gains, and profits all are results of entrepreneurial activities and have to be burdened equally. Otherwise single capital income sources are unequally treated.

(3) Neutrality of financing means that equity capital has to be burdened in the same way as borrowed capital, and that self-financing from profits is treated equally as equity financing and external financing. Otherwise the financial structures of the firms are distorted by taxation.

(4) Neutrality of profit means that profits should be treated independently from the form of their usage. If retained profits are favored by certain tax regulations, a lock in effect might occur, which is an obstacle against structurally necessary changes within the economy.

(5) Neutrality of inflation means that equal real profits are taxed equally independently from the inflation process. Therefore the tax system has to be adequately adapted to the inflation process by avoiding cold progression and inventory profits caused by inflation.

As mentioned above the basic principles to define the income of an individual or the profit of a firm are the residence principle<sup>35</sup> and the world income principle, which are dominating in national tax laws and double tax agreements. Therefore, the tax burden at the residence determines the behavioral reactions of individuals and enterprises. In case of free mobility of labor and capital, also consequences for the location decisions have to be taken into consideration: As mentioned above (see II.2.2.) the tax base itself might become mobile. However, increasing voting by feet in favor of low tax countries is an expression of inefficiencies existing in the national tax laws of countries with the expatriation of capital and/or highly qualified as well as wealthy persons. Instead of doing the necessary tax reforms such countries often blame the countries with immigration of capital and persons as tax heavens or shelters, using unfair methods of tax competition. Obviously in countries with expatriation of labor and capital Laffer curve effects might occur, which lead to a further reduction of tax

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<sup>35</sup> This practice is rooted in reports of the League of Nations published in the 1920s. Alternatives are the source principle and the principle of origin. In case that in two or more countries different principles are applied double tax agreements become necessary to avoid double taxation. In an economic and currency union it is reasonable that consistent regulations are applied.

revenue.<sup>36</sup> Such effects can only be avoided in adapting the national tax law to best practice standards.

In case of direct taxation and VAT best practice has the following features: (1) Easy definition of labor and capital income, (2) lifetime orientation instead of an annual income concept to keep in mind the dynamical aspects of capital formation,<sup>37</sup> (3) liquidity orientation of capital income taxation and VAT to avoid bankruptcies just caused by tax payments and (4) the realization of the neutralities mentioned above.

Entrepreneurial activities are leading to self-employment income and capital income (profits, interest income, rents and leasing). Usually those income components are taxed within the personal income tax (for individuals) or the corporation tax (legal entities). But also some other taxes are burdening the capital income components: general taxes like property tax, firm tax, capital gains tax, inheritance tax and specific taxes (partly indirect taxes) like land tax, second habitation tax, motor vehicle tax, stock exchange tax, insurance tax etc. Therefore, single components of capital income are periodically double taxed or in a dynamic perspective double burdened (so-called avalanche effect of taxation).<sup>38</sup>

Most of the existing types of income and profit taxation have serious shortcomings especially with regard to capital income taxation. The synthetic income tax is a tax following the concept of the comprehensive tax base and taxing annual labor income as well as capital. Because this type of tax is concentrated on the annual aspect, the long termed consequences of capital formation are not taken into consideration thus burdening already the saving and the following interest payments and producing the just mentioned avalanche effect so that the effective tax burden is a multifold of the annual tax rate.<sup>39</sup> The expenditure tax of the Fisher/Kaldor-type is a personalized consumption tax, which does not tax profits at all. Therefore a complimentary property tax is hold necessary, which would bring all the negative impacts of the synthetic income tax back into the tax system. The dual income tax separately taxes labor and capital income thus usually discriminating labor income with a progressive tax schedule. Capital income and particularly retained profits are taxed much lower. Such systems especially typical for Scandinavia are often taken as unfair and are not in accordance with the ability-to-pay-principle especially in its dynamic interpretation.

From an international perspective the *best practice model* would be a **consumption oriented income tax**, which burdens annual labor and capital income; but the saving adjustment for pensions (downstream taxation) and the interest adjustment for profits and other interest payments eliminate the avalanche effects of synthetic income taxation so that the annual tax rates as well as the lifetime tax burden on capital income remain the same.<sup>40</sup>

The “Easy Tax Proposal” is such consumption oriented income tax, which integrates personal and profit taxation (income and corporation tax). There are two forms of tax collection: *personal income tax* (on persons and pass through companies or S-

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<sup>36</sup> For more details see Petersen (1981 and 1982).

<sup>37</sup> For more details see Petersen (2003, 2003a and 2006).

<sup>38</sup> See for more details Petersen (2004).

<sup>39</sup> See Petersen/Rose (2004).

<sup>40</sup> For details and a complete draft law see [www.einfachsteuer.de](http://www.einfachsteuer.de).

companies like in the US corporation tax law) and *profit tax* (on large corporations). Three sources of taxable income do exist: Income from *wages*, income from self-employment (*capital*) and *retirement* income (negative: contributions, positive: pensions). *Interest adjustment* with regard to capital income (protective interest rate) is implemented, a modified cash-flow taxation (liquidity oriented) established and *saving adjustment* with regard to contributions to and pensions from old-age security systems applied.

For private households equal treatment of lifetime income from wages and capital is assured and intertemporal neutrality on consumption decisions realized. For enterprises such a system put into practice an equal marginal burden for all enterprises, often decrease the marginal burden for small and medium enterprises (SME) as well as small corporations and also decreases the average burden for SME, which improves capital formation and investment. Because the SME are the backbone of each economic setting this guarantees job creation and less unemployment.

The macroeconomic impacts are:

- Simplification of income and corporation tax law,
- decrease of marginal tax rates (flat-rate 25 % even possible in Germany),<sup>41</sup>
- abolishment of avalanche effects,
- increase in efficiency and positive incentives,
- improved growth dynamics,
- re-integration of unemployed into the official labour markets,
- decrease in tax avoidance and tax evasion,
- cutback of shadow economy.

Therefore such a reform of direct taxation at best integrated with a fundamental transfer reform (to guarantee an efficiently integrated tax and transfer system) is a fitness program for global competition. A nation or union in which such systems are applied has the best chance to attract monetary and real capital (foreign direct investment) as well as high qualified human capital (the able and the well-to-do).

Regarding tax administration the efficiency is directly bound to the existing tax law. As more complex the tax law is as more difficult the assessment and control procedures are. For at least a first overview and a better understanding it is of utmost importance to develop an integrated tax law so that all taxes are regulated within one **tax code**. Within the tax code the general definitions of all tax terms being relevant for the single tax laws as well as the general procedures should be described. Regarding the administrative implementation the equal enforcement in the whole fiscal administration and the internal revenue service is crucial and important for the equal treatment of all individuals and firms. Obviously an easy tax law facilitates an equal implementation where the single taxes should be structured as simple as even possible. Many examples in international comparisons have proven that the taxation of the “average taxpayer” just having labor income can be done in a relatively simple procedure. It is self-evident that such a complex problem like the enterprise taxation requires much more difficult regulations but even in this case much more simple rules can be implemented.

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<sup>41</sup> For more details see Petersen/Anton/Brehe (2002) und Petersen/Fischer/Flach (2005).

For example the liquidity orientation of enterprise taxation regarding the profit tax as well as the VAT can encourage the tax investigation branches. If according rules are implemented often just the control of the bank accounts of the firms would be sufficient. Therefore the criminal investigation service would have a much easier job and the control of tax evasion and the shadow economy could be far more efficient.

The complexity of the tax law is usually also expressed within the tax forms. As already mentioned above a TIN system as steering and control mechanism is of utmost use. Then all relevant variables of the tax law have to be captured in the tax files at best in an electronic form.<sup>42</sup> As example for an easy tax form of the “average taxpayer” the basic easy tax form is presented in figure 10, which shows the main form of the reform proposal.<sup>43</sup> At least for the normal case a simple assessment is possible, which neither burden the individual nor the revenue service.

Besides the tax forms the single tax procedures are of specific relevance; bookkeeping methods, safekeeping conditions for documents, receipts and bank accounts are important for control purposes as the obligations of the taxpayers to support the fiscal administration in its control activities. Also the possible IT access for the internal revenue service might improve the control practice but is often controversially discussed. Always the protective interests of the individuals and firms have to be taken into consideration, which also holds true for the banking confidentiality being often a problem of control in international tax affairs.

Usually all information kept in the tax files of the individual and firms should be documented in an electronic form so that for statistical purposes the best information can be processed and also be published at least in an anonymous form. The fiscal administration itself but especially the MoF can even use the original data for tax estimation purposes. Budgeting and fiscal planning requires tax revenue projections in a short and mid term perspective. A reliable projection seriously depends on the quality of the available tax statistics. And adequate estimation procedures are not only necessary for tax revenue projections but also for the test of tax reform proposals, which have to be simulated before the implementation in group based or micro simulation models.<sup>44</sup>

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<sup>42</sup> From the very beginning of any tax reform and harmonization the electronic documentation is of utmost relevance. It should be started in assuring the possibility for the taxpayers to present the tax forms and the necessary tax declaration in electronic form; see, e.g., the German Elster System under [www.elster.de/index.php](http://www.elster.de/index.php). Regarding the complexity of the German tax forms see for instance [www.steuertipps.de/?menuID=8&navID=14](http://www.steuertipps.de/?menuID=8&navID=14).

<sup>43</sup> All other forms can be found under [www.einfachsteuer.de](http://www.einfachsteuer.de).

<sup>44</sup> For an overview see Brunner/Petersen (1990) and Petersen et al. (1992).

Figure 10: Main Form of the Easy Tax Proposal

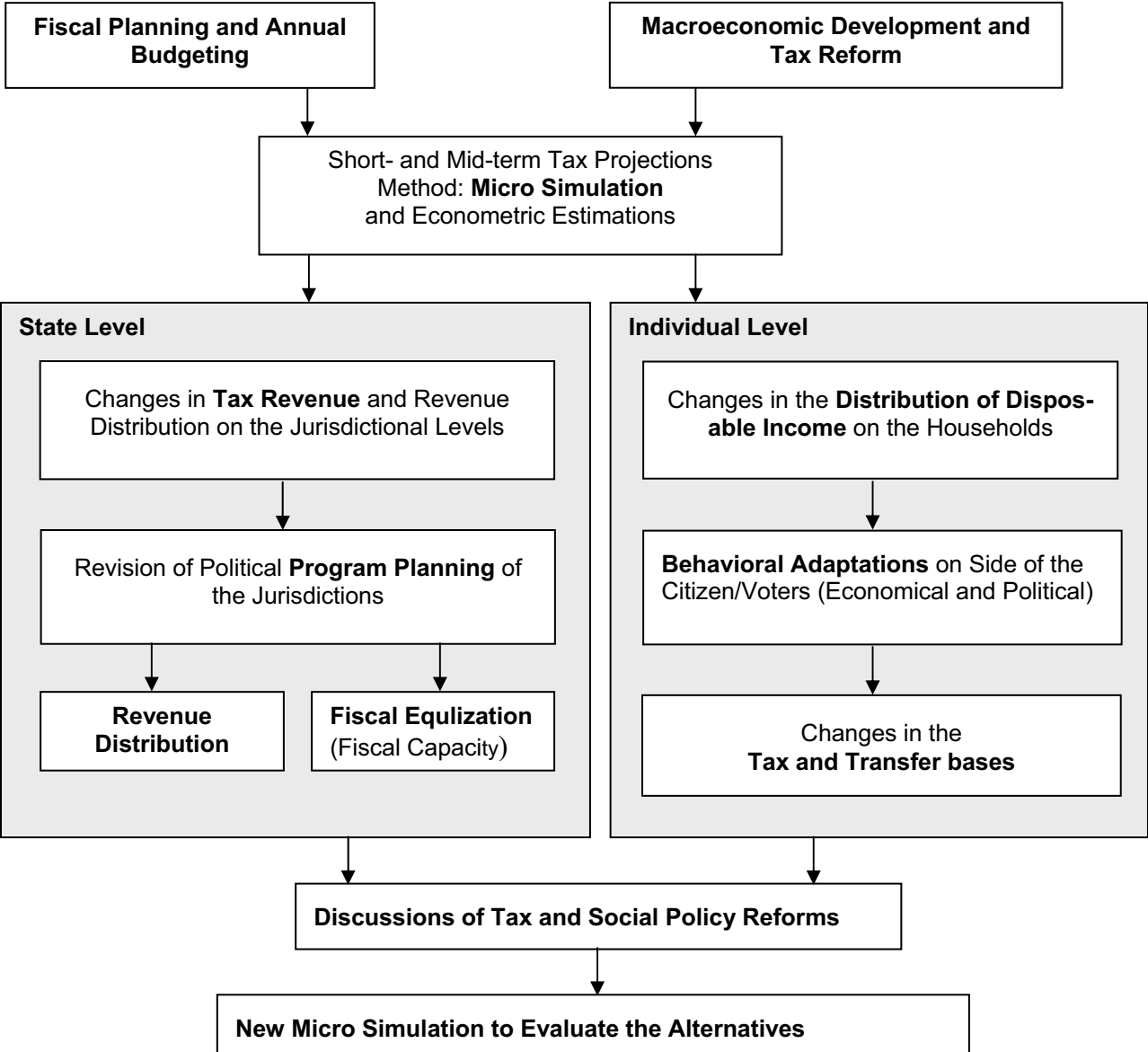
Zeile			Nach amtlichen Unterlagen in €		Nach privaten Unterlagen in €
1	Einkünfte aus nichtselbständiger Erwerbstätigkeit	+	28 800	+	28 800
2	Einkünfte aus selbständiger Erwerbstätigkeit		0	+	200
3	Einkünfte aus Finanzkapitalanlagen		0		0
4	Vorsorgeeinkünfte	-	3 825	-	3 825
5	Ausgaben für berufliche Bildung		0	-	500
6	Erwerbseinkommen [Summe: (1) bis (4)]	+	24 975	+	24 675
7	Verlustvortrag		0		0
8	Schutzzinsen auf Verlustvortrag		0		0

9	Markteinkommen [Summe: (6) bis (8)]	+	24 975	+	24 675
10	Lebensbedarfsbezüge		0		0
11	Lebensbedarfsabzüge	-	12 295	-	12 295
12	Zu versteuerndes Einkommen [Summe: (9) bis (11)]	+	12 680	+	12 380
13	<b>Steuerschuld {+} :</b> Steuersatz × Betrag in (12) <b>Steuervergütung {-} :</b> Steuersatz × Betrag in (5), wenn dieser negativ und ein Steuerguthaben vorhanden ist	+	3 170	+	3 095
14	Anrechenbare Einkommensteuern	-	3 170	-	3 170
15	Zu zahlende Steuer {+} Zu erhaltende Steuer {-} [Summe: (13) und (14)]		0	-	75

<b>Bankkonto</b>	<b>Nr.</b>		<b>Kreditinstitut:</b>	
			<b>Bankleitzahl:</b>	
Ich versichere, dass die Angaben in dieser Erklärung nach meinem besten Wissen und Gewissen der Wahrheit entsprechen.			An der Erklärung hat mitgewirkt :	
Datum und Unterschrift			Name/Firma und Adresse	

An overview for the merits of micro simulation is given in figure 11. The annual budgeting as well as the political program planning (Planning, Programming and Budgeting System – PPBS, Zero-Base-Budgeting, Sunset-Legislation) necessitate revenue estimation methods for short and mid term projections. Whereas in case of indirect taxation traditional econometric regression analysis are often sufficient, for direct taxation (income and profit taxation) tax simulation models are needed, which reproduce the status quo of the tax and transfer system and are usually based on micro data files to be produced by the internal revenue service. Only with such an approach the impacts of economic growth, wage and profit trends, inflation and changes in tax law (tax reforms) can be determined. Micro simulation can be carried out for the whole tax and transfer (social and private insurance schemes) system. With the help of such an model it is possible to describe the revenue and expenditure development in a short and mid term perspective as well as estimating the effects on the distribution of gross incomes, the tax yield, transfer payments and the disposable income of individuals and households (winner/loser analysis). Reforms can be evaluated before they are implemented in practice so that internal political discussions are much more rationally based.

**Figure 11: Micro Simulation as Instrument of Modern Fiscal Planning**





The macroeconomic developments as well as the changes and tax and transfer law have direct consequences for the budgetary situation. In federal states also the revenue distribution on the different jurisdictional levels is often seriously influenced by such phenomenon. This might result in undesirable deficits or surpluses within the budgets of some jurisdictions as long as the revenue sharing, fiscal equalization system or the distribution of tasks on the jurisdictional levels remains unchanged. If micro data files are available, which contains the necessary data even on the regional and local levels such effects can be made obvious using the micro simulation approach. With the help of such model the consequences of the FES reform for the communities in Liechtenstein have been estimated, which has been extremely helpful for the acceptance of the new system by the single majors as well as in the state's parliament.

## **VII. Summary: Good Governance, Budgeting and Fiscal Planning**

The paper has tried to shed some light on the problems of centralization and decentralization within an economic union and federal member states. Integration and decentralization are not opposite policy strategies but both meaningful if the single public goods and services supplies are analyzed in more detail. Both strategies doubtlessly have advantages, which can be realized if the manifold possibilities are combined in an efficient approach of good governance.

Best practice approaches in inter- or supra-national integration, fiscal federalism and taxation do exist and have to be successfully implemented. Obviously such a modern fiscal policy has to be accompanied by an appropriate monetary policy, which in an economic union has to be carried out by an independent central bank as one of the necessary countervailing powers in a democratic setting. A modern fiscal policy strategy efficiently controls budget deficits, which naturally have to be limited to finance reliable public investments. Such strategy has to be safeguarded through modern methods of budgeting and fiscal planning. Modern public management with a clear code of conduct for the government officials ensures corruption free administration. The organization of private-public-partnership (PPP) is often another powerful strategy to use the efficiency advantages of the private sector. A partially efficient privatization of public enterprises has also to be taken into consideration if the public supply can then be organized in a more efficient way. The discussions have shown that the way to good governance is really not an easy one but a way, which is worth to be gone because it will lead to peaceful developments and a reduction of local, regional and individual poverty.

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