



The brass tacks on federalism

No Free Lunch by Cielito F. Habito – February 06, 2018

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I'm glad state think tank Philippine Institute for Development Studies (PIDS) has moved into the needed objective and research-based analysis of detailed design elements associated with federalism, with a study tackling what could well be the most critical element of the proposed governmental shift. I refer to the fiscal aspects of federalism—that is, the delineation and nature of taxing, spending and borrowing by the national (federal) and subnational (state) levels of government.

PIDS just released the discussion paper “Designing the Fiscal Features of a Federal Form of Government: Autonomy, Accountability, and Equity Considerations” by Dr. Rosario Manasan, its resident public finance expert who has studied government finances over the last four decades. The study merits the attention of all who would shape the fiscal configuration of the federal form of government now being pursued by our legislators, who have made the move toward amending the Constitution by themselves as a constituent assembly.

The fiscal federalism literature defines four important considerations pertaining to the fiscal configuration under a federal system: One, how must functions and corresponding expenditures be assigned between the national and subnational governments? Two, how should tax and revenue powers be delineated between the two (e.g., what kinds of taxes must be reserved for one or the other)? Three, what should be the nature of financial transfers from the national to the subnational government units? And four, what conditions should govern borrowing by the subnational units? Space constraints allow me only to touch on some of Manasan's key points here; the full paper has to be read to grasp the rationale behind them.

The guiding principle on functional or expenditure assignment is to assign responsibility to the level of jurisdiction with control over the minimum area internalizing the function's benefits and costs. Public services whose benefits are local in scope (like water supply and sanitation, traffic management) are best done and funded by lower-level governments, with the national government only setting standards. The national government takes charge of functions (and corresponding expenditures) of nationwide scope, such as national defense, foreign affairs, macroeconomic (fiscal and monetary) management, and redistribution. Certain key functions will inevitably have to be shared by both, including health, education, roads and agriculture. Based on the budgets of the departments and agencies concerned, Manasan calculates the implied national-subnational budget sharing to be roughly 50-50.

On tax or revenue assignment, “finance follows function” is the guiding principle. With the estimated sharing, subnational units must be able to raise more revenues. Manasan recommends that states collect a residence-based surtax on the personal income tax, and also take over motor vehicle and driver's license fees from the national government.

Intergovernmental transfers are made necessary by vertical and horizontal gaps in revenue capacity—i.e., between the national government and the states, and among the states. Unless a system of equalization

transfers is carefully designed to bridge these gaps, we risk worsening preexisting inequities in the level of economic development across regions under the federal system. As for subnational borrowings, the national government must be firm in not bailing out state governments that default on their loans. Doing so will be highly risky and unsustainable, as it will only abet irresponsible loans by the latter, and less prudence on the part of banks in lending them such.

Yasuhiko Matsuda, in a 2011 study on fiscal decentralization, observed that legislators generally do not want fiscally stronger local or subnational government units. This is because the latter would depend less on national legislators to fund projects, thereby reducing their political leverage. Interestingly, and as Manasan notes, this can be an important argument why federalism must not be shaped by legislators, but done via a constitutional convention, if the full benefits of federalism are to be achieved.

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