

AN INTERNATIONAL EQUALIZATION PROGRAM (IEP): RATIONALES, ISSUES, AND OPTIONS

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ABSTRACT

The paper raises and discusses issues related to the potential benefits, institutional arrangements, and design of an international equalization program in support of existing forms of international aid to developing nations. The structure and nature of existing equalization and equalization programs are discussed and their rationales are extended from a domestic to an international context. Some options for an IEP, including, scope, conditionality, funding among recipient nations and financing among donor nations are discussed. The paper concludes that much additional political and

how equalization programs are designed and administered around the world.

The key principles selected are generally:

- Equity, as the key rationale and objective
- Economic efficiency in the allocation of resources

Other desirable characteristics may include:

- Sensitivity/responsiveness to differences among jurisdictions and changing circumstances over time

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Ahorizontal@ imbalances among the states and territories. This is because most of the revenues accrue to the Commonwealth government while many of the expenditure programs are delivered by the state governments.

Germany also operates an equalization program to support the fiscally weaker Länder or states. The program began in 1951 and was initially given a constitutional basis in 1955. The program is designed and administered by the federal government but the Bundesrat, the second house that represents the Länder in the national legislature, plays a very important role in maintaining a balance between the federal and state governments- fiscal interests. The measures of expenditure requirements are basically equal per capita, with some minor adjustments, mainly based on the degree of urbanization and population density. The minimum standard is 95% of the post-equalization average per capita.

While the formula is less elaborate than in Australia, the financing of the transfers are more complex, with funding from three sources: (i) a portion of the VAT shared with the states, (ii) a unique scheme of interstate equalization, which is progressive in structure, and (iii) a variety of vertical grants from the federal government that favour certain Länder.

In Canada, there were elements of equalization in the Tax Rental agreements between the federal government and the provinces introduced during the Second World War, but a formal equalization program to address inter-provincial fiscal disparities was only introduced in 1957, based on only three revenue sources. In 1967, the so-called

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by cash transfers from the federal government. Payments are unconditional.

Because expenditure needs and cost differences are not taken into account in the program, as in Australia, the equalization program for the provinces would not provide adequate fiscal support to the northern territorial governments if applied to them. Beginning in 1985, Territorial Formula Financing (TFF) was introduced to provide formula-based unconditional equalization-type transfers from the federal government to the Yukon and the Northwest Territories (which was subsequently divided into two territories in 1999, Nunavut to the east and the Northwest Territories to the west).

Expenditure need is not taken into account in an explicit way, but the AGross Expenditure Bases@ (GEBs) per capita are several times the level of the equalization per capita revenue standard for the provinces, reflecting the higher costs and higher needs of the population, including many aboriginal peoples, in the territories. Revenue capacity is based on the RTS of the equalization program applied in a modified way.

Since its introduction in 1985-86, TFF has been based on written agreements between federal and territorial ministers of finance. The agreements have generally had five-year livetimes and TFF has also been subject to review leading up to renewal. In 1995, administration of the program was transferred from the Department of Indian Affairs and Northern Development to the Department of Finance.

While discussed from time to time, the program does not have a legislative basis, as does the Equalization program. It also does not have a constitutional basis but there appears to be general agreement, in principle at least, that the equalization principle of Section 36(2) should apply to funding under TFF. Nevertheless, after the repeated application of a ceiling and an ad hoc downward adjustment to the GEBs over the last decade or so, there is much dispute by the territorial governments

concerning the adequacy

of the levels of the transfer, in terms of enabling reasonably comparable levels of public services in the north.

Switzerland's equalization program for the cantons was first legislated in 1959. The program has some similarities with the one in Germany, with limited adjustments for expenditure need based on population density and rurality, and a three-part financing structure.

The reformed states of South Africa and the Russian Federation also have instituted equalization programs for their provinces or regions. In South Africa, there is a constitutionally-based Financial and Fiscal Commission that advises on both the allocation and the level of transfers to the provinces. The Russian equalization program is based on fairly extensive measures of expenditure need, although the data used need to be improved in both quality and timeliness. The allocation formula, negotiated by regional representatives, has a rather unique two-tier structure. The annual level of funding for the program, financed by the central government, is determined independently of the funding formula.

India has had Finance Commissions for over 50 years that advise on both the aggregate level and allocation of fiscal grants to the states. While the grants commission in Australia is a permanently operating institution, the commissions in India are reconstituted for each fiscal review.

Unitary states often operate equalization programs for their local governments. For example, the United Kingdom (and now

equalization-type programs for their sub-national government units. For example, in Canada, most

provincial governments fund transfers to local school boards that take into account expenditure need factors and revenue capacity associated with the education portion of the property tax.

2.3 Rationales

The rationales for equalization derive from several perspectives that are somewhat intertwined.

2.3.1 Social

A federal system of governments allows for potentially greater responsiveness in the supply of public services to differences in demands of the population among jurisdictions. In that sense, it enables greater economic efficiency in public program and service delivery. But that benefit may come at a price. In particular, where there are significant differences in the fiscal capacities of sub-national governments to provide reasonably comparable levels of public services, the full extent of the potential benefits may not be realizable. Equalization programs are designed to create that greater equality of access, so that the benefits of decentralization of government can be more fully achieved.

The call for equalization is based on the desire for equity and social cohesion - that all people across the country should be treated reasonably comparably by government, no matter where they live. This general objective is expressed in several different ways as the principle underlying national equalization programs.

In Canada, it is stated, under Section 36(2) of the *Constitution Act, 1982*, as:

A36(2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.®

In Australia, the objective is stated, similarly, as:

AEach State is entitled to receive a level of general revenue funding from the Commonwealth which would enable it to provide, without having to impose taxes and charges at levels appreciably higher than the levels imposed by the other States, government services at standards that are not appreciably different from the standards provided by other States.®

The objective in Germany is stated as AEquality of living standards®, although the program is directed to equalizing only for public services and, even within public services, differences in expenditure need are taken into account in a limited manner.

2.3.2 Economic

The economic argument in support of equalization derives from both equity and efficiency perspectives.

With regard to equity, the argument is based on the principle of horizontal equity - that persons in essentially similar circumstances before interactions with government should remain in comparable circumstances after interactions with government. To the extent that sub-national governments have differences in fiscal capacities to provide public services, the same level of public services to two similarly-

A welfare trap for receiving governments. Lastly, at the broadest level, some would argue against the objective of fiscal equity in principle, that it should not be addressed by government policy—that it should be left to the market to resolve.

In fact, the United States, likely as a result of some combination of the above arguments, is the only developed federation that does not have a formal equalization program. Some have suggested, in jest, that equalization is carried out in the country through defense expenditures. The federal government does offer a wide range of specific-purpose transfers to the state governments, some with equalization elements and some without. Even though they may not be equalizing on the expenditure side, they may be equalizing on the financing side, to the extent that federal government revenues are financed in a progressive manner among the states. (The author is not aware of any analysis on the extent to which the aggregate of these programs is equalizing.) While there are income disparities among the population of the states, they are no greater than those that exist amongst sub-national jurisdictions in developed countries with equalization programs. The high degree of internal mobility in the United States likely contributes to reducing fiscal disparities, somewhat along the lines of the Tiebout model. Additionally, compared to Canada and Australia, for example, natural resource revenues in the United States accrue to the federal government, while they are primarily received by provincial or state governments in the other two countries.

2.5 Summary

In summary, one perspective on many of the arguments for or against an equalization program within a nation is that they are closely related to the question of convergence—whether or not the natural social and economic forces toward regional economic convergence outweigh those toward increasing spatial disparities, what factors and policies contribute to or inhibit convergence, and if convergence is the dominant trend, the likely time frame involved.

3.0 EQUALIZATION IN AN INTERNATIONAL CONTEXT

The paper now moves beyond the traditional framework for equalization, both in theory and practice, into expanded territory.

This section extends, where possible, the traditional arguments for equalization from a national context to an international one. A comparison of equalization to traditional forms of aid is then presented and the potential contributions of the equalization approach are outlined.

There are a numerous arguments that could be made against international equalization and many barriers that would prevent its introduction. Rather than turning away from these realities, they are identified in a forthright manner. The following sections also attempt to address some of these concerns in greater depth.

3.1 Rationales

As in the case of equalization within a nation, the rationales for an IEP can be made from the political, social, and economic perspectives.

3.1.1 Political

At the broadest level, an IEP would signal a recognition of the Global Village, that the well-being and fate of people everywhere are integrally intertwined. It would be a message from people and their governments in the wealthier countries that they are intensely concerned about the political, social, and economic development prospects of the residents of lesser developed nations. The operation of an IEP could also foster greater awareness and understanding, amongst governments and people of developed nations, of conditions within the lesser developed nations.

Within recipients nations, equalization could support greater democratization and improved governance in several ways. First, as will be discussed in Section 4.2, international

In many cases, governments of recipient countries are bystanders to these efforts, the direct benefits to people in need are elusive, and there is much duplication and lack of coordination of effort. Advice, in the form of a stream of reports - though often sound - is not acted upon. Sometimes, as argued from time to time, by well-informed experts - for example,

recently by Stiglitz (2002) - fundamental advice, that has been forced upon or voluntarily acted upon, has been extremely damaging to entire national economies and has impacted significantly negatively on the most desperate and vulnerable groups in society.

It is not the purpose of this paper to assess international development efforts but, as indicated in the introduction, it appears to the author that there is a gaping hole in the matrix of development programs. As argued in Section 2.2, the form of support that most developed nations provide and take for granted internally, namely systematic fiscal support to ensure that basic public services of reasonable quality are widely available to the appropriate population groups throughout the nation - through equalization and equalization-type programs, is missing from the varied package of international aid programs.

As noted above, there is often duplication and lack of coordination amongst development efforts of different donors. An equalization program for basic public services could provide a unifying framework within which relevant aid programs could be encompassed, providing for greater coordination and reduced duplication. Moreover, equalization funding need not all be incremental. It could substitute for many components of aid currently provided to support the provision of public services in one form or another.

Since the funds would flow directly to recipient national governments in the first instance, it would be those government that would be involved in determining the form and allocation of support, subject to any conditions

that would apply. Specific aid measures in the area of public services would be directed to, and delivered within, the overall structure of governmental priorities. Moreover, as is often advocated in the public expenditure management literature (see, for example, The World Bank (1998)), the funds would flow through, and be accounted for within, the unified budgetary and fiscal framework of the governments of recipient nations.

Moreover, as the administration cost component of equalization programs is comparatively low, most of the expenditure would find their way directly to people in need through programs and services. Additionally, as their purposes are generally relatively simple and straight-forward, it is generally more feasible to evaluate these expenditures in terms of outcomes.

In that respect, it is interesting to consider the experience of the European Union with its Structural Funds. In the 1970s, the European Commission had a study undertaken to examine

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As suggested above, another potentially important benefit for developing nations is that an equalization program could provide greater employment opportunities for scarce skilled professionals involved in the provision of public services. Such skilled labour, although scarce, might be under-employed because of lack of public funding, so that the full benefits of their services are not available to the population. As a result of lack of opportunities, such skilled workers are frequently lost to these countries through migration to wealthier nations. Losing such skilled labour is doubly costly to developing nations; first, because the public funds that have been invested in their education will not yield returns to their society, and secondly, because such badly needed skills are generally in short supply and require time and significant costs to replace.

3.4 Arguments Against and Barriers

The arguments against an IEP are likely to be many and varied. For example, they could include the following:

- The cost would be too great.
- The U.S. would be called upon to be a major contributor, yet does not even have an internal equalization program.
- A donor country would not be able to target its support or to exclude countries from benefiting from its financial contribution.
- It is not the responsibility of wealthier countries to ensure the availability of public services in the poorer countries.
- Expanded trading relationships do not provide a political framework to justify or to support that type of redistribution.
- Most developing countries will welcome free trade without that type of support.
- Free trade and existing aid programs will be sufficient to foster economic development in lesser developed countries. Equalization transfers would be redundant and unnecessary.
- There is no international political accountability framework. The funds would be wasted and the potential for corruption would be great. Much of the funds could end up being spent on military equipment, rather

than basic public services for the population. There are no feasible sanctions for misuse, other than non-provision in the future.

- It would lead to fiscal dependence of governments and people that could inhibit economic adjustment.
- It would be most difficult to assess the effectiveness of the use of the funds.

The last point was briefly discussed in the previous section. Some of these other arguments will be addressed in the following sections.

4. SOME OPTIONS

This section examines some options for certain key aspects of an IEP, including scope, conditionality, governance and accountability.

4.1 Scope

The term scope, in this context, refers to the range of sectors of public services covered by an equalization program. There are two general categories, broad and sectoral, and each is discussed in turn.

4.1.1 Broad Coverage

Under broad coverage, equalization would cover a broad range of public services, such as education, health, income support and social services, public housing, transportation, etc. This type of program would be modeled on the types of programs reviewed in Section 2.2, where funding is provided to cover virtually the full range of expenditure responsibility of the sub-national governments that are subject to equalization.

From the perspective of the objective of fiscal equity amongst constituents of sub-national governments, an equalization program should aim to be as broad as possible. Such broad-based transfers are usually referred to as *general-purpose grants*.

4.1.2 Sectoral Coverage

Under sectoral coverage, equalization would be based on expenditure needs in one or more selected sectors. Sectoral coverage could also include sub-sectoral coverage, for example,

primary and secondary education, but not necessarily post-secondary education. Targeted grants are generally referred to as Aspecific-purpose@ grants.

Since most revenues raised are generally not earmarked for specific purposes, it would be necessary to infer or deem a certain portion of revenue capacity to be associated with the financing of public services in these sectors.

4.2 Conditionality

As noted earlier in the national context, the greater the jurisdictional powers of the sub-national governments, the lesser the degree of conditionality is likely to be. Moreover, the greater the range of expenditure responsibilities covered, the more difficult is it likely to be to enforce sector-specific conditions through expenditures. Other powers of the transferring government could be more effective in enforcing conditions.

Recipient nations may protest that any conditions would compromise their sovereignty. However, it is precisely because of their sovereignty and the limited possibilities for sanctions, except withholding future payments, that donor nations would likely want to apply conditionality to funding, in order to be able to provide a greater degree of assurance that the funds are being used for the purposes and in the manner intended.

Recipient nations may also argue that conditions are discriminatory, since they would only apply to recipient nations and not others. While this, too, has some validity, in reality, given funding constraints, it is likely that the conditions and standards required would be lower than those that are met in non-recipient countries.

Conditions can take a number of forms. They may be general in scope - not pertaining specifically to the programs and services for which the funding is provided, or specific in nature, where they are focused on the supported services.

4.2.1 General Conditions

It is likely that the majority of, if not all, donor governments would want certain types of general conditions to apply to recipient nations. General conditions applying to governments receiving equalization, of either the broad-based or sectoral-specific variety, might include some of the following matters:

- Democratic governance
- Equitable allocation
- Laws and penalties related to conflict of interest and misuse of funds by legislators and government officials
- Financial management controls
- Reporting on expenditures and outcomes
- In the case of broad-based equalization, a condition applying to the maximum level of defense expenditures may be sought.

4.2.2 Specific Conditions

Specific conditions would vary depending on the sector or sub-sector in question.

Specific conditions can often be expressed as, and based on, accepted standards. Specific conditions may apply to inputs or outputs. Input conditions, as the name implies, apply to input items, and could, for example, apply to levels of expenditures either, in aggregate, for specific services, or specific input factors, or they could apply to quality characteristics of input factors. Conditions related to client groups, for example, in the form of eligibility, can also be a form of input conditions. Input ratios, such as student/teacher or doctor/patient, are also forms of input conditions that can take the form of standards.

Output conditions can also take a number of forms and be applied in various ways. Output standards could take the simple form of quanta, e.g., absolute numbers of services delivered of a certain type and quality. They may also focus on improving the quality of the services delivered, rather than the quantum.

Output standards can also take the form of, or include, principles. Some of the principles of the *Canada Health Act*, such as universality and accessibility, are an example of the use of principles as conditions.

Output standards may be focused at a broader levels, taking the form of outcomes, rather than output standards for specific services, by looking at broader measures of well-being or success of the population served.

performance.

The difficulty of imposing sanctions in the case of violation of conditions is that it could harm the very people that the program is designed to help. However, reductions or even the elimination of full benefits in very extreme cases, such as use of funds for other purposes or fraud, would have to remain in the arsenal of sanctions.

5. FUNDING AND FINANCING

This section presents a brief discussion of possible models that might be used for an IEP, at least in the early years.

5.1 A General Model

As noted, the general model of equalization is $\text{Expenditure Need} - \text{Revenue Means}$, but as indicated in Section 2.2, there is no limit to the variations in which this basic framework is applied in practice.

5.2 Expenditure Need

As noted in Section 2.2, expenditure need is and can be measured in a wide variety of ways. A general framework for measuring expenditure need that is often adopted is the product of Cost and Demand factors. These can be measured at several levels.

For example, cost could be an aggregate measure of service costs per person or per client. At a more disaggregated level, Demand can be specified as the product of Service or Workload requirements for various services, and Client group, adjusted for relative needs. Workloads, which are a measure of output, can be further expanded by identifying Input requirements to meet the workloads.

The costs or prices used would correspond with the level of detail in the formula. They may be subject to adjustment for relative differences within the nations. Also, it is essential, for comparability, that all prices and costs be converted to a common basis, by adjusting by Purchasing Power Parity indexes, rather than exchange rates.

Standards are often used for establishing the levels for the various components in the measurement of expenditure need. For example, standards could be used with respect to demand factors, such as the eligible client groups, the services to be provided and their levels and quality, the quantity and/or quality of inputs, and cost or price levels.

To illustrate some of the conceptual issues that may arise in establishing standards, consider the question of the choice of the eligible client group for primary and secondary education. Should it be based on age groups or enrolment? The general practice, in theory, is to choose measures for expenditure need that cannot be used by the recipient governments to influence the level of the grant. From that perspective, age groups would be more appropriate. However, the use of enrolment has a number of important benefits. First, age groups would potentially exclude adults seeking to augment their education. Secondly, age groups would result in funding services that may not be provided. Thirdly, and perhaps most important, funding based on age would not provide an incentive to increase enrolment, while funding based on enrolment could. (It is interesting to note, in this regard, that there was a minority view of a commissioner of the Commonwealth Grants Commission (1993) in Australia, in its report on grant relatives, in favour of using age groups, rather than enrolment, for the purpose of measuring expenditure need for primary and secondary education.)

5.3 Revenue Capacity

Revenue capacity is also measured in a variety of ways, ranging from simple aggregates to highly dis-aggregated revenue sources, such as under the Representative Tax System used in the Canadian equalization program. Regardless of the approach employed, as in the case of expenditure need, it is important that the common measures be based on using PPP indices, rather than exchange rates, in converting to a common currency.

5.4 Data

One of the difficulties of applying an

equalization model across nations, as opposed to sub-national governments within nations, is the much greater variation in circumstances and expenditure and revenue policies that are likely to exist. Thus, time and effort would be required to develop common measures and the necessary data, particularly to enable the use of more precise measures of expenditure need and revenue capacity on a common basis.

There tends to be a symbiotic relationship over time between an equalization program and social and economic statistics. The desire for greater equity generally creates the demand for more extensive, reliable and timely statistics. Since funding is based on the availability of these statistics, it is likely to support the development of the necessary improvements. Conversely, the availability of improved statistics enables greater precision and equity to be achieved and often fuels demands for further improvements. Thus, improved equity and improved statistics tend to be mutually reinforcing.

One of the important roles of an independent commission could be to advise, encourage and oversee the development of improved statistics along with other interested intergovernmental organizations, such as the United Nations, The World Bank, and the IMF.

5.5 Funding Among Recipient Nations: A Simple Model

Given these statistical difficulties, one simple model that could be applied, at least initially, for either a broad-based or sectoral equalization program is the following.

Expenditure needs would be set at a certain level per capita or per client, depending on the sector or sub-sector. The level could, for example, be set at some percentage of the level of expenditure per capita or per client in a group of the wealthier countries. Alternatively, the level could be set at that required to deliver a certain objectively set standard of service

Revenue capacity would be set at a

percentage of GDP that it would be reasonable to expect should be allocated towards the covered services. Perhaps, the revenue percentage would not be fixed but rise with the level of GDP per capita. All measures should be based on Purchasing Power Parity, to provide for comparability of purchasing power among the nations. The advantage of this approach is that it is relatively simple and provides some degree of rough justice until improvements in statistics and measures can be gradually implemented.

In this simple model, it is assumed that the aggregate budget would be set in advance, rather than allowed to emerge from the measurement of expenditure need and revenue capacity. The allocation of the budgeted funding level among the recipient nations, based upon their relative fiscal gaps, would then need to be determined. One simple approach would be to reduce the amounts on an equal basis per capita (adjusted both for need and PPP), in order to maintain a common equalization standard.

One controversial aspect of the design of an equalization program relates to the issue of a fiscal incentive. This matter is also referred to as the tax back issue or as risk sharing. As described above, measured revenue capacity would be fully included in determining funding levels. Thus, any improvement in a recipient government



