1 Principles of Decentralization

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Studies of fiscal decentralization in many countries, some of size similar to Mexico, have led economists, political scientists, and policymakers to agree on some useful principles for policy design. First, political and cultural considerations take priority in determining the appropriate model, and many models can work. The next section outlines several possibilities. Within the political and cultural constraints, the economic characteristics of the model need to be optimized, and a section on market-preserving federalism provides four economic criteria for performance. While no model is perfect, and “working” means having ways to compensate for weaknesses, there are certain decentralization-design strategies that can improve performance, and other design flaws that need to be avoided. The bulk of this chapter addresses these design issues in four areas: spending, taxation, transfers, and debt management.

Different Federal Models

At least three models or theories of federalism are relevant to Mexico and, indeed, are partially realized. The first model—“classical” federalism—assigns expenditure and taxation among the levels of government, with financial shortfalls accommodated by a set of conditional and unconditional transfers.

The second model relates to the direct federal-municipal relationship that exists not only in practice in Mexico, but in the constitution as well. Brazil’s national constitution also recognizes in detail the municipal level. In some federal systems (such as Canada), municipalities are creatures of the provinces or states and are not even mentioned in the constitution. The United States’ Constitution also makes no mention of the municipal level, but this is taken to mean that, while the states define and govern the
municipal level, the federal government can have all kinds of direct programs for cities and other substate entities.

The third model—administrative federalism—is the German model where most legislation is federal, but most implementation and administration (even in the areas of federal jurisdiction) are conducted at the länder (state) level. As they currently exist in Mexico, expenditures on education would resonate well with this model. The appendix to this chapter elaborates on the cases of Australia, Canada, Germany, and the United States.

These three models could coexist in long-term equilibrium, as they do now in Mexico. For example, expenditures on some set of national (pan-Mexican) public goods could be legislated federally but implemented by the states. In this context, federally imposed conditions would comprise a set of principles, rather than specific and binding conditions. This would provide some degree of state autonomy in determining how best to satisfy these principles. Likewise, in any long-term scenario, municipalities could retain their constitutional status and their financial links with the federal government (via pass-through transfers). Given the apparent ascendance of the states as economic and political actors, however, a more likely scenario might be one in which conditions are placed on state transfers regarding how these transfers are redirected to the municipalities. Aspects of classical federalism will surely play a key role in any federal system in Mexico. There is considerable scope for creative options. For example, conditional transfers can be rationalized, formula-driven, and designed so that states can take into account their own preferences, cultures, and economic requirements in satisfying the conditions. Moreover, the Ramo 28 revenue-sharing unconditional transfers could give way to more subnational taxation, and the mix between conditional and unconditional transfers could shift toward the unconditional as a result of pressures for further decentralization.

The message is twofold. First, Mexico has many avenues along which to pursue decentralization. Second, the transitional status quo embodies a variety of structural components that could, with creative applications, generate a more decentralized federation. Building or rebuilding a federal model has many objectives, including cultural and political ones on which this book does not dwell (Riker 1964; Stepan 1997). The economic objectives are more than fiscal—the focus of this book—and have to do with providing a better context for economic development.

**Market-Preserving Federalism**

What Weingast (1995) and McKinnon (1998) refer to as “market-preserving federalism” provides a useful summary of the immediate economic objectives of decentralization. According to McKinnon, market-preserving federalism comprises four key components:
1. **Monetary separation.** State governments cannot own or control commercial banks.

2. **Fiscal separation.** State governments do not have access to discretionary or additional central government financing to cover state deficits.

3. **Freedom of interstate commerce.** Goods, services, people, firms, and capital are allowed to move freely across state lines.

4. **Unrestricted public choice.** States are allowed to design and deliver alternative bundles of public goods and services and to finance them by alternative means of taxation.

The first two principles ensure that there are no bailouts. States can, of course, still borrow on capital markets, but credit-rating agencies and financial markets generally are more vigilant if they realize that the states face hard budget constraints. Unrestricted public choice is possible only if the first three principles are in place. In this market-preserving context, the exercise of competitive federalism enhances efficiency and welfare.

### The Federal-State Fiscal Accord

To create and sustain the conditions for market-reserving federalism, federal and state governments may sign a federal-state fiscal accord preserving and promoting the socioeconomic union as the federation decentralizes. The specific elements can vary considerably, but the provisions generally include the following:

- Principles to ensure the free flow of goods, services, people, firms, and capital across state borders.
- Provisions to ensure that people who move across state boundaries continue to have uninterrupted access to basic services such as health and education.
- A code of tax conduct to ensure that states do not discriminate against residents of other states.
- A principle similar to the “national treatment” provision under the North American Free Trade Agreement (NAFTA), referred to in the fiscal accord as “state treatment,” meaning that each state agrees to apply its policies equally to all residents of the state, even if they have migrated from other states.
- Commitment of the federal government to these provisions, except where the federal constitution dictates otherwise.

These are the core elements in any fiscal accord. But the fiscal accord could be made more encompassing. For example, it could incorporate principles or conditions associated with the system of intergovernmental
grants. As in NAFTA, there would have to be mechanisms for resolving disputes, replete with sanctions (such as withholding part of the grant). The dispute-resolution process should be timely and transparent.

"Opting in" Provisions

Mexico is a complex federation. The constituent states differ in their cultural heritage, level of economic development, and relationship with the outside world. It would be surprising if all states viewed the prospects of decentralization in the same way. In some policy or program areas, it may be appropriate to provide for "opting in" provisions. If a state does not support the details of tax decentralization, for example, it need not embrace the new system immediately. Instead, it could continue to follow the existing system and to receive revenues from grants rather than from taxes.

Opting in can provide considerable flexibility, and states would have the option of switching to the new system at any time. Although there will be some asymmetry of treatment, the transfer would be designed to ensure that, overall, all states are treated in a comparable manner.

Regardless of the model followed, Mexico will need to improve the allocation of spending, the system of taxation, the system of transfers, and the management of subnational borrowing and debt. The rest of this chapter addresses these four topics.

Spending and Service-Delivery Assignment

Decisions about which level of government has responsibility for a particular public service must be judged by how well the assignment achieves the basic criteria of fiscal performance, namely, efficiency, income redistribution, and macroeconomic stability. These objectives sometimes conflict, and the government has to determine the tradeoffs.

Cost and Producer Efficiency. Efficiency means satisfying the needs and preferences of taxpayers at the lowest possible cost. Services should be provided by the lowest level of government compatible with the size of benefit area associated with them. Local officials are more familiar with the needs and preferences of individuals residing in their jurisdiction. They are also likely to be more politically accountable, and therefore responsive to, these needs and preferences. Because these needs and preferences are not uniform throughout the country, it is unlikely that the central government will be able to deliver more meaningful services for a given budget. Lower-level governments, especially if they are democratically accountable, are better able than central government to match expenditures with preferences and needs, making decentralization a means of increasing consumer efficiency within government budgets. Moreover, efficiency is enhanced if con-
sumption benefits are linked to the costs of provision via fees, service charges, or local taxes.

A second type of economic efficiency, producer efficiency, also needs to be considered. Because there may be significant economies of scale, it may be more cost-efficient to produce certain public services on a larger scale at a higher level of government. Producer efficiency also reflects the skills and qualifications of government officials, which may be better at the higher levels of government, although not always. Better accountability, competition, and scope for innovation may render the delivery of services by lower-level government more cost-effective than delivery by central government.

The optimal degree of decentralization depends on the nature of the service. For example, the benefit area is clearly the local community for sanitation services, but the national territory for air traffic control. On the other hand, leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient underprovision of services, as when, for example, a tertiary hospital providing regional services is financed by a single municipality. Where there is wide variation in the size and capacity of local government, as in Mexico, it may be optimal to have various options for the extent of local fiscal control, with objective criteria and appropriate financing arrangements corresponding to each.

INCOME REDISTRIBUTION AND MACROECONOMIC STABILITY. Public expenditures for equity or income equalization, such as social welfare or low-income housing, should be primarily the domain of central government. Local or regional governments cannot sustain independent programs of this nature because doing so would attract the needy from other areas, while taxing (potentially mobile) residents more heavily. In addition, the need for redistribution and social welfare assistance may be particularly high within subnational governments that are themselves relatively poor. Although policy formulation and funding should be the responsibility of central government, implementation can be left to local governments that may have better information on the identity and needs of the poor. However, it is not uncommon for subnational governments to legislate and fund their own social welfare policies. This is sustainable as long as these policies fit a national or regional norm or pattern.

Expenditures undertaken to stabilize the economy, such as massive investment or unemployment compensation, are ascribed to the central government. The economies of regional and local governments are too open and dependent on those of the rest of the country for these governments to be able to affect employment or aggregate demand in a meaningful way.
LEGISLATION, FINANCING, AND DELIVERY OF PUBLIC SERVICES. The provision of any public service involves three functions. The first is the legislation of principles and norms. Often, the public function is limited to this activity alone, as is the case with environmental laws and regulations, regulations for the use of airwaves, or traffic laws. The second element is financing. The characteristic of a public good legitimizes the funding of the service out of a general pool of funds raised through taxes. In some cases, funds can be earmarked from some particular service, and these funds may come from cost-recovery fees associated with the service. The last function is the production or delivery of the service. At times, this activity may be undertaken by the private sector.

The design of a clear and efficient system of expenditure assignment should address each of these functions. Different levels of government may handle different functions for any expenditure area. For example, the central government legislates and regulates the content and standards of general basic education (curriculum content, teacher qualifications and training, and so on), the state finances the education system, and the local school district runs the schools. Efficiency means making the best use of available resources, and accountability means ensuring that government officials are responsive to their constituents. Concentrating regulation, financing, and delivery of a public service in a single level of government usually enhances accountability, but this is not always possible or desirable. National interests and goals may dictate that national standards be stated and controlled by the central government. The lack of adequate resources or considerations of equity may dictate that funding be provided by the central government and that services be delivered or produced at the local level. This may be the case for many social welfare programs.

NO SINGLE-BEST ASSIGNMENT. These principles should guide the assignment of expenditure responsibilities, but they are not definitive for all times and all places. Some public services, such as primary education and primary health services, may be local in nature because of the size of their benefit area; but, because of their relevance to welfare and income redistribution, they may also be considered a concurrent responsibility of the regional or central governments. Economic efficiency calls for greater autonomy of subnational governments in expenditure and taxing decisions, but this may lead to fiscal disparities among subnational governments that are unacceptable in a given country. There are other important trade-offs in the implementation of intergovernmental fiscal relations. Achieving a more equal distribution of resources among subnational governments is a worthy objective. But to redistribute resources to poorer regions, central authorities need to tax better-off regions more heavily. Placing higher tax burdens on better-off regions limits their ability to grow. Different coun-
tries and governments make different choices in the tradeoff between redistribution and growth. Even in a single country, the “best” expenditure assignments will change over time, responding to changes in costs and technology or in citizens’ preferences.

It is often argued that an explicit assignment of expenditure responsibilities is not possible because some responsibilities will always be concurrent among different levels of government. This argument is fallacious. Although many types of expenditure responsibilities should be shared among different levels of government, failure to have a concrete and explicit assignment leads to instability and friction, if not open conflict, in intergovernmental relations. Worse, it leads to the inefficient provision of public services.

Common Problems with Expenditure Assignments: Lessons from International Experience

Lack of Clear Delineation between the Public and Private Sectors. Often subnational governments and, of course, central governments get involved in the financing and provision of private market activities. This hinders economic development because subnational governments tend to compete unfairly with private entities. Involvement in the private sector by local authorities creates conflicts of interest and opportunities for corruption and fraud, and this undermines the appropriate regulatory functions of both central and subnational governments. Ultimately, public funds in private activities decreases the amount of funds available for the provision of public services. The best that subnational governments can do to promote economic development in their jurisdictions is to provide the best possible level of public services, capital infrastructure and, where appropriate, other regulation.

Lack of Formal Assignment. The country’s constitution often assigns expenditure responsibilities among different levels of government, but the assignment is usually not specific. Expenditure responsibilities should be specified mostly in the law, not the constitution, providing specificity as well as flexibility. The lack of clear, formal assignment of responsibilities tends to destabilize intergovernmental relations. This was the case early on during the transitions in Kazakhstan, Russia, and Ukraine. What confuses expenditure assignments in practice is that even though responsibility for implementation or delivery may be assigned explicitly, responsibility is not assigned for designing policy, imposing norms over expenditure functions, or financing those expenditure responsibilities.
Lack of an Institutional Mechanism for Coordination and Conflict Resolution. No assignment of expenditure responsibilities can cover all the possibilities and contingencies in a legal document. It is important to introduce well-developed institutions of cooperation and coordination among different levels of government that can discuss and resolve disagreements.

Conflicts involving expenditure assignment and inefficiencies in service delivery are more likely where the different levels of government are involved in the same sector, but there is little communication and exchange between them. When multiple levels of government are involved in most sectors, governments need broad and formal coordination institutions, as with “cooperative federalism” in Germany. In the United States, the pattern of assigning responsibilities varies widely from sector to sector and from state to state, so the only sector coordination is done by technocrats in some areas where there is a clear need, such as highways and law enforcement. Somewhere in between, Australia, Canada, and New Zealand use formal gatherings of politicians and bureaucrats to discuss mutually important fiscal issues.

Misalignment of Capital and Recurrent Expenditure Assignments. In general, capital expenditure responsibilities should be assigned among the different levels of government in the same manner as recurrent expenditures. Decentralization in both capital investment decisions and recurrent expenditures increases the efficiency associated with being closer to the needs and preferences of taxpayers and improves government accountability and responsiveness. Furthermore, maintaining infrastructure at efficient levels in general requires local ownership. Responsibility for capital infrastructure should be placed at the level of government in charge of delivering specific services, including the operation and maintenance of facilities. In this way, only capital infrastructure facilities that are desired by subnational governments will be built, encouraging their maintenance and repair. To assign capital expenditure responsibilities properly, it is necessary to address the issue of long-term financing. Subnational governments need to be allowed to borrow from banks or in capital markets, and that borrowing needs to be regulated either directly or through the market. Borrowing for justified, long-lived infrastructure is both efficient and equitable. Most countries only allow borrowing for capital investment purposes.

Mismatch of Financing Capacity and Minimum Levels of Service. Do subnational governments have enough resources to provide some minimum level of service in the functions assigned to them in areas of national interest (education, health, social welfare, and so forth)? The concept of a minimal level of service, in contrast to what people of a subnational area
can or choose to afford, has operational meaning only when the wider society has an interest in assuring such a minimum. In substance, the issue is whether it is desirable to introduce mechanisms that force or encourage subnational governments to spend (some of) their funds in a particular way in order to provide some minimum standard of service (provided the funds or the sources of funds are present).

One approach, commonly followed, is for the central government to rely on conditional grants or matching grants to induce subnational governments to provide the minimum level of service. This is another example of how expenditure assignment directly relates to the design of other elements of fiscal decentralization, in this case, the transfer system. To protect the principle of subnational autonomy—the core operational concept of fiscal decentralization—minimum standards and similar restrictions on subnational governments should be used sparingly.

One Size of Mandate Does Not Fit All. Achieving the optimal scale in local service provision is an issue in many transition and developing countries, especially when the constitution or the law treats all municipalities the same. Municipalities with small populations cannot take advantage of minimum economies of scale. To improve efficiency, small municipalities could be consolidated into larger ones; associations of municipalities or special jurisdictions could be created; local governments could deliver services through private contractors; or the state or national government could provide the service in small municipalities, with appropriate finance. Asymmetric decentralization is often a practical solution, providing options and incentives by giving more responsibility and resources to entities that demonstrate satisfactory administrative and fiscal capacity. It is important to recognize, however, that regional and municipal governments may be underdeveloped precisely because they have never been given responsibilities or the resources with which to carry them out. Small and poor municipalities often need technical assistance to help achieve adequate capacity.

Unfunded Expenditure Mandates. Unfunded mandates—the imposition of expenditure requirements on subnational governments without adequate funding by central or federal authorities—are a common problem in countries with decentralized fiscal systems. Unfunded mandates take different forms, including the setting of wages at the central level, mandatory increases in pension payments, and the setting of standards of provision for services. As expected, subnational and central governments tend to have quite different views of what is and is not an unfunded mandate. Central governments often argue that subnational governments receive funds through general funding sources (for example, revenue sharing or general
transfers). Of course, subnational governments argue that general revenues should remain at the discretion of subnational governments.

Prohibiting unfunded mandates by law is not always respected in practice, and some may be desirable and acceptable to subnational governments (such as equal opportunity for citizens or environmental standards with cross-regional effects). Universal or blanket reimbursement policies, international experience shows, can easily create an administrative nightmare. An important step is to clarify expenditure assignments as much as possible. Other solutions include requiring supermajority votes in Congress to impose central mandates without funding, introducing mechanisms of self-restraint in Congress, establishing closer working partnerships among the various levels of government, and introducing categorical grants to fund large mandates.

**TIMING.** The assignment of responsibility for expenditures needs to precede or at least coincide with the design of other pieces of a decentralized system. Failing to do this is a common mistake. Many countries of Latin America assigned revenues to subnational governments and put transfers in place before transferring functional competencies from the central government to subnational governments. This approach produced weak subnational governments and fiscally overburdened central governments, which in many cases continued to take on most expenditure responsibilities with fewer resources.

### Tax Assignments

**Definition and Purpose**

Other things being equal, the jurisdiction responsible for spending should also be responsible for raising the requisite revenues. Although this is a favorite principle of federalism scholars, in reality it seldom occurs. Most federations have significant vertical imbalances where a level with more revenue sources than spending responsibility makes vertical transfers to a level with revenues less than responsive. The challenge is to design intergovernmental transfers with an eye toward ensuring that, at the margin, states view transfers as they do their own revenue. For example, transfers should not be open-ended.

Tax assignment considers which level of government should tax what (the tax base) and how. Possible techniques of tax assignment include independent legislation and administration by subnational governments, surcharges on the tax base of a higher level of government, and tax sharing. (Revenue sharing is also considered, even though it is not a form of tax assignment.) The purpose of tax assignment is to provide subnational gov-
ernments with revenues that they control and thus to decentralize the control of public spending.

It is important to distinguish between two concepts. *Own revenues* belong to subnational governments by law. They may include revenue-sharing funds as well as shared taxes and taxes levied by or for the subnational government. (Whether borrowing is considered a source of revenue depends on the context. For the present discussion it is not.) For decentralization to be viable, subnational governments must have their own revenues that are adequate to cover their current expenditures, including debt service. *Marginal (incremental) own revenues* are revenues that subnational governments can affect by their own actions, especially by changing tax rates, but also by imposing new taxes or repealing old ones, by changing the tax base, and by varying administrative effort. Access to marginal revenues is key to fiscal decentralization because it gives subnational governments control over the size of public spending within their jurisdictions.

### Objectives and Constraints

Although the overriding objective of tax assignment is to increase the access of subnational governments to marginal own revenues, not all ways of increasing access are equally satisfactory. Subsidiary objectives and constraints inevitably influence the means used to increase access.

### Desirable Attributes of Subnational Taxation

Decentralization works best when taxes and the benefits of public spending (or costs incurred by governments) are closely related. In the extreme case of user charges and fees, payments act almost like prices for private goods, in that citizens get what they pay for and pay for what they get. The implication for tax assignment is that revenues from taxes closely related to identifiable benefits or public expenditures should be levied by the level of government that provides the benefits or incurs the costs. For example, revenues from taxes on motor fuels are intended to reflect the benefits of using roads and highways, and therefore should go to the governments that finance their construction and maintenance; revenues from taxes on alcoholic beverages and tobacco products should go to the governments that incur the health-related public costs occasioned by consumption of those products.

This raises a subsidiary question: should revenues from benefit-related charges and taxes be assigned (earmarked) to finance the corresponding activity, or should they be part of the general revenue of the level of government that provides the services in question? Optimal resource allocation requires that prices (or taxes intended to serve as quasi-prices) equal the marginal cost of providing services. Marginal cost pricing may provide more or less revenue than is needed to finance activities (depending on
whether average cost is rising or falling), and funds that are earmarked may be trapped in suboptimal places, as when gasoline taxes are used to fund freeways, instead of mass transit in the United States.

User charges, fees, and taxes related closely to benefits are most likely to be feasible for financing services that, although provided publicly, exhibit an important characteristic of private goods: the feasibility and likelihood of excluding those who do not pay. Toll roads cannot be used without paying for access. Those who do not pay motor fuel taxes cannot use roads and highways, even if access is not restricted. In theory it would be possible to deny access to education and health care, but this is rarely done for social reasons, especially in the case of primary education and basic health care. Inherent in the nature of public goods is the inability to charge those who benefit from them. Thus much of public spending provides generalized benefits that must be financed by taxes that are only loosely related to the benefits of public services: general sales taxes, income taxes, and property taxes.

When production and consumption do not occur in the same jurisdiction (because goods are traded between jurisdictions or individuals do not earn income where they live (because they commute between jurisdictions or have investments in other jurisdictions), an important two-stage question arises in the attempt to identify beneficiaries of generalized public services. First, are the benefits of public services provided primarily to businesses or to individuals? And, second, when such benefits are provided to individuals, are they more closely related to (a) consumption or the residence of taxpayers, or to (b) production or the source of income? If generalized benefits are provided primarily to business (and are thus more closely related to production than to consumption), an origin-based sales tax or a commercial property tax might be appropriate. If such benefits are provided to individuals and are more closely related to consumption or residence of the taxpayer, a destination-based sales tax, a residence-based individual income tax, or a residential property tax might closely reflect the benefits of public services. But if such benefits are related more closely to the earning of income, a source-based individual income tax would be more appropriate.

Tax assignment must recognize administrative reality. Some taxes that are attractive in theory may not be administratively feasible or may require inordinate amounts of administrative resources, something Mexico cannot afford.

Subnational governments ordinarily should employ debt financing only for capital projects; they should not borrow for current expenditures. If this rule is to be respected, subnational governments need stable sources of own revenue (expenditures of subnational governments are assumed to be relatively stable.) Therefore, relatively volatile sources of revenues, such as the corporate income tax and taxes on natural resources, should not be assigned to subnational governments.
UNDESIRABLE ATTRIBUTES OF SUBNATIONAL TAXATION. If the benefits of free markets are to be realized, subnational governments should not impose taxes that distort the location of economic activity. Taxes levied at the origin of production or the source of income are more likely to distort locational decisions than are taxes levied at the point of consumption or residence, unless they reflect benefits of services provided to businesses or to employees at their place of employment.

Governments often wish to levy taxes on business that exceed the value of benefits provided to (or costs incurred on behalf of) business. This may be done because taxing business is more popular than taxing people (or the products they buy) or because it is thought that taxes on business can be exported to nonresidents of the taxing jurisdiction. Taxes on business that exceed the value of benefits provided are likely to distort the location of economic activity, unless they are levied at uniform rates throughout the country. But taxes that must be levied at uniform rates do not provide a marginal source of revenue for any one subnational government, and thus do not further fiscal autonomy. Moreover, agreements between jurisdictions to fix tax rates (or the imposition of uniform rates by a higher level of government) represent a form of cartelization that encourages overexpansion of the public sector and inefficiency. Competition among subnational governments both prevents excess taxation of business and impedes inefficiency in government.

Some taxes can be exported to nonresidents if they are imposed by (or for) subnational governments. The best examples of exported taxes are taxes on business that cannot be shifted to consumers or to labor and thus are borne by owners of business, many of whom may be nonresidents. (The view that taxes on business will automatically be shifted to consumers, many of whom are nonresidents, is generally incorrect. Exporting to nonresident consumers is likely to occur only when the taxing jurisdiction dominates the national market for the product taxed.) In the absence of untaxed competition (for example, from imports), excises imposed on products by the producing jurisdiction could be exported to consumers throughout the nation.

Tax exporting is generally undesirable. Not only does it impose unfair burdens on nonresidents, but it also cheapens the provision of public services in the taxing jurisdiction, encouraging overconsumption. An important exception involves taxation that is closely related to the benefits of a public service (such as taxes on motor fuels that finance roads used by nonresidents); in this case, failure to export taxes to users is undesirable. Again, this points to the superiority of destination-based sales taxes and residence-based income taxes over production-based sales taxes and source-based income taxes. The former are much less likely to be exported than the latter.

Except in rare cases, subnational governments within a nation differ substantially in their inherent fiscal capacity. Fiscal capacity may be measured
by applying a representative tax system—that is, by calculating how much revenue each state would receive, per capita, if it levied the taxes typical of all states. Although such measurement depends on the structure of the typical state tax system, it is unlikely to be misleading. Some states are simply richer or poorer than others, as measured, for example, by per capita income or per capita GDP. But there may be other explanations. For example, some activities (for example, tourism) are easier to tax than others. Particularly important is the presence of geographically concentrated, high-value natural resources that can be taxed by subnational governments. Where horizontal fiscal disparities are important, equalization grants may be appropriate to allow all states to provide comparable levels of services with comparable levels of tax effort. (Tax effort can be measured by comparing actual tax collections with collections under the representative tax system. Subnational governments that collect substantially more than under the representative tax system are exerting high tax effort; those that collect substantially less are exerting low tax effort.)

**OTHER CONSIDERATIONS.** Responsibility for income redistribution via taxes should be lodged primarily with the central government. Attempts by subnational governments to redistribute income are likely to be futile, for example, because taxes intended to be borne by capital are likely to be shifted to labor and to owners of land. Moreover, they are likely to distort the location of economic activity or to result in tax exporting.

Public spending should be lodged at the lowest possible level of government to avoid spillovers of benefits between jurisdictions, realize economies of scale, and maximize the fiscal autonomy of those affected by public spending. This principle has a counterpart in the field of tax assignment, because of the seemingly inevitable existence of vertical fiscal imbalance. Higher levels of government can effectively administer virtually any tax that lower levels can administer, but the converse is not true; some forms of taxation do not lend themselves to implementation by or for lower levels of government. Moreover, some taxes are not appropriate for local governments, even if they are administratively feasible; customs duties are perhaps the best example. To minimize vertical fiscal imbalance, it is desirable to assign to subnational governments all taxes that are administratively feasible and appropriate for them. In judging administrative feasibility and appropriateness, one should consider the use of subnational surcharges on the tax base of a higher level of government and independent legislation and administration by the subnational government.

It is often suggested that subnational governments should be rewarded for exerting high tax effort, for example, by providing matching grants that reflect tax effort. In general there is little analytical support for this proposition. Unless there are good reasons to believe that tax effort would oth-
erwise be artificially low, it is generally better to assume a neutral stance toward subnational tax effort. To overcome inertia, however, it may be desirable to encourage tax effort during the transition to a decentralized system.

**Assignment of Taxes to Cover Generalized Benefits**

Subnational governments should, to the extent possible, rely on taxes, fees, and charges that are related to benefits received. Using taxes to cover the generalized benefits of public spending has the following implications for tax assignment. First, if, as suggested, most of the public services provided by subnational governments are provided to individuals, not businesses, taxation that is likely to be borne directly by individuals or shifted to them by businesses in a predictable manner is preferable to taxation of business, including taxes that may be shifted to individuals, but in an unpredictable manner. This implies that a state individual income tax or a state value added tax is preferable to a state corporate income tax. If benefits are provided where people live, not where they work, destination-based indirect taxes and residence-based income taxes are likely to be preferable to origin-based indirect taxes and source-based income taxes. Finally, if subnational taxes are seen as payment for services providing generalized benefits, coverage should be as broad as possible, given concerns for equity; subnational taxes should be “mass taxes,” not taxes paid by a select few.

Because the progressive individual income tax is the tax mechanism of choice for both income redistribution and endogenous macroeconomic stabilization, it should be reserved primarily for use by the central government. This does not mean, however, that subnational governments should not also rely on the individual income tax. A flat-rate individual income tax may provide a satisfactory surrogate for benefit-related taxation. Under certain circumstances, a flat-rate subnational tax can be imposed on the same base as a graduated-rate national tax.

The assignment of taxes on natural resources raises difficult philosophical and political questions as well as economic issues (see McLure 1994). For the most part, economic arguments favor assigning taxes on economically important natural resources to the national government, especially if the resources are geographically concentrated in only some taxing jurisdictions. (Taxes on common low-value and ubiquitous resources such as sand and gravel can be assigned to subnational governments.) Because revenues tend to be unstable, taxes on natural resources are ill-suited for use by subnational governments, which generally need stable sources of revenue. Moreover, subnational governments may not be in as good a position as national governments to impose taxes on economic rents, generally agreed to be the most satisfactory form of tax on natural resources. In
theory, taxes on economic rent, being a tax on surplus, do not affect pro-
duction decisions; the pattern of production that maximizes before-tax
income also maximizes after-tax income. Taxes on production encourage
inefficient exploitation (high-grading) by discouraging production that
would cover marginal costs, but not the tax. Property taxes on deposits of
natural resources are even worse, because they encourage uneconomical-
ly rapid exploitation in order to avoid future taxes.

If effective ownership of natural resources is in private hands, subna-
tional taxes may be exported to nonresident owners. Effective ownership
may be in private hands even if the state owns the natural resources. This
may occur, for example, when resources are exploited under concessions,
subject to terms that are not adjusted for changes in taxation. Finally, if
important natural resources are distributed unequally across a nation, sub-
national taxation may produce or aggravate horizontal fiscal disparities.
Besides raising questions of equity—probably the most important reason
to assign taxation of natural resources to the federal government—such dis-
parities may induce economically inefficient allocation of private resources
to jurisdictions with low tax rates or high levels of public services. These
inefficiencies are likely to be relatively small, except in extreme cases, as in
Alaska, where the combination of vast natural resources and a small pop-
ulation allows the financing of generous public services (including annu-
al per capita grants) with low tax rates (see Mieszkowski and Toder 1983).
Table 1.1 summarizes the current wisdom on tax assignment.

Philosophical arguments are more ambiguous. Advocates of taxation by
subnational governments commonly argue that natural resources and the
right to tax them are part of the “heritage” of such jurisdictions. But it can
equally be argued that the resources and tax revenues are the heritage of
the entire nation. The resolution of this issue calls into question the concept
of nationhood as it is understood in particular countries. All things con-
sidered, it seems appropriate to assign most taxes on important natural
resources to the federal government. Since the Mexican constitution makes
this assignment, taxes on natural resources are not discussed further here.

Methods of Revenue Assignment
This section evaluates four methods of revenue assignment, including tax
assignment: independent legislation and administration, tax and revenue
sharing, state surcharges, and dual administration of surcharges.

INDEPENDENT LEGISLATION AND ADMINISTRATION. A system of tax assignment
based on independent legislation and administration provides maximum
state sovereignty, but this sovereignty is bought at a high price—a price that
Mexico can ill-afford and need not pay. State taxes in the United States illus-
trate these problems. Inconsistent state laws and administrative practices
Table 1.1. Attributes, Strengths, and Weaknesses of Various Techniques of Tax Assignment

<table>
<thead>
<tr>
<th>Assignment of taxing powers—best practice:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defining Tax Base</td>
</tr>
<tr>
<td>Subnational</td>
</tr>
<tr>
<td>National</td>
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<tr>
<td>National</td>
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<tr>
<td>National</td>
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<td>National</td>
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<table>
<thead>
<tr>
<th>Setting Tax Rate(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subnational</td>
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<tr>
<td>Subnational</td>
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<tr>
<td>Subnational</td>
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<tr>
<td>National</td>
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<td>National</td>
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<table>
<thead>
<tr>
<th>Administration</th>
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<tbody>
<tr>
<td>Subnational</td>
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<td>Subnational</td>
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<td>National</td>
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<td>National</td>
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<td>National</td>
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<table>
<thead>
<tr>
<th>Criteria of choice:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Autonomy</td>
</tr>
<tr>
<td>Best</td>
</tr>
<tr>
<td>High: choice of tax rate</td>
</tr>
<tr>
<td>High: choice of tax rate</td>
</tr>
<tr>
<td>None</td>
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<tr>
<td>None</td>
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<table>
<thead>
<tr>
<th>Complexity</th>
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<tbody>
<tr>
<td>High</td>
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<tr>
<td>Low: tax on local activity</td>
</tr>
<tr>
<td>Low</td>
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<td>Low</td>
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<td>Low</td>
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<table>
<thead>
<tr>
<th>Horizontal Disparities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potentially high</td>
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<td>Potentially high</td>
</tr>
<tr>
<td>Potentially high</td>
</tr>
<tr>
<td>Potentially high</td>
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<tr>
<td>Can offset horizontal disparities</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generally not appropriate for Mexico</td>
</tr>
<tr>
<td>Generally best approach</td>
</tr>
<tr>
<td>Poor</td>
</tr>
<tr>
<td>Current best practice</td>
</tr>
</tbody>
</table>

<table>
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<tr>
<th>Most appropriate method of assigning revenues from major taxes to subnational governments:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excises</td>
</tr>
<tr>
<td>Best</td>
</tr>
<tr>
<td>Transition</td>
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</tbody>
</table>

| VAT                                        |
| Best                                       |
| Transition                                 |

| Individual Income                         |
| Best                                       |

| Payroll Tax                                |
| Best                                       |

| Corporate Income                           |
| Best                                       |

| Property                                   |
| Good (greater state control)               |
| Good (most efficient solution)             |

| Natural Resources                          |
| Best                                       |
raise the costs of compliance and administration and create inequity. Use of source-based taxes such as the corporate income tax distorts the geographic allocation of resources and may result in tax exporting. Even the retail sales tax, which is imposed by 45 states and the District of Columbia, contains an origin-based component that distorts locational decisions, since a substantial amount of revenue (an estimated 40 percent) is derived from taxes levied on sales to businesses instead of sales to households.4 Taxes on natural resources generally take the form of state severance (production) taxes, income taxes, and local property taxes, all of which are distortionary. (Distortion is mitigated by the fact that the corporate income tax and sales taxes on business inputs are deductible in calculating liabilities under the federal tax.) There is substantial tax exporting, especially by resource-rich states.5 In short, this system is not appropriate for Mexico.

**Tax and Revenue Sharing.** In tax sharing the central government directs given fractions of revenues from selected taxes to the various states where the revenue originates. In this approach, widely used in the former Soviet Union, states have essentially no control over the choice of taxes, tax base, tax rates, or tax administration; they are thus fiscally weak.6 Although different in appearance, tax sharing closely resembles revenue sharing and grants. Unlike tax sharing, revenue sharing returns funds to subnational governments on the basis of formulas, instead of to the jurisdictions of origin. Like tax sharing, it provides no subnational autonomy over the choice of taxes, the definition of the tax base, the setting of tax rates, and tax administration. The use of formulas does, however, offer the possibility of reducing horizontal disparities among jurisdictions.

**State Surcharges.** An ideal system for many countries (including Mexico) consists of subnational surcharges levied on a tax base (or tax bases) defined and administered by the central government, perhaps with input from the states. In this scheme, subnational governments would exercise the all-important choice of tax rates, but most of the complexity, inequities, tax exporting, and locational distortions inherent in subnational choice of tax bases and administration of taxes would be avoided. That is, state surcharges combine simplicity with subnational sovereignty over tax rates. Canada makes substantial use of this type of system.

Ideally, surcharges could be imposed on some combination of excise tax, residence-based income tax, and value added tax (levied at the destination of sales). States might impose payroll taxes, but on a uniform base. State surcharges on the corporate income tax may be required in order to raise adequate revenues.

Of the three methods of tax assignment, subnational surcharges provide the optimal combination of subnational autonomy and simplicity.
Subnational governments have autonomy over rates—the most important issue for determining the level of subnational spending—while the central government defines tax bases and administers taxes, minimizing the costs of administration and compliance. By comparison, independent legislation and administration are too complicated, and tax sharing eliminates all subnational autonomy. Since tax surcharges may produce horizontal fiscal disparities and vertical fiscal imbalance, they can be combined with revenue sharing from the federal taxes.

Despite the manifest advantages of tax surcharges as a system toward which Mexico should move, the movement could be a gradual one consisting of three stages. In the first stage, the present system of tax sharing/revenue sharing would be replaced with a system in which revenues from certain taxes are shared with the states on a derivation basis. For this purpose, the determination of derivation for each shared tax should approximate as closely as possible the technique that would be used to impose a state surcharge on the federal tax in question. In the second stage, tax sharing would be replaced with a system of subnational surcharges in which state tax rates are constrained to be equal. In the third stage, states would be given greater—perhaps complete—control over state surcharge rates.

**Dual Administration of Surcharges.** It is common for surcharges of subnational governments to be administered by national governments. This arrangement seems preferable to the alternatives of dual administration, in which the federal government administers federal taxes and state governments administer surcharges. In some countries, subnational governments administer national taxes, but this is less common. Administration of the value added tax by the German länder and the Canadian province of Quebec are notable examples. This option deserves little discussion in the Mexican context, where it has an unsuccessful history. On the one hand, federal administration of state surcharges raises several concerns: Will the federal government efficiently transfer the revenue collected on behalf of the state? And will the federal and state governments have different priorities in the assignment of scarce administrative resources? On the other hand, dual administration raises the specter of costly duplication of administrative efforts, overly burdensome compliance, and the possibility that administration will not be consistent between states or between states and the federal government.

The risk that the federal government will not pay to state governments the revenue collected on their behalf can easily be addressed by having taxpayers deposit taxes directly in the bank accounts of each government. A greater risk is that taxpayers might meet their obligations to the federal government, but not to state governments, and that the federal government would condone this behavior. It is desirable to find ways to prevent this.
Federal and state tax administrations may have quite different priorities. First, the federal government may prefer to concentrate its resources on administering the taxes that yield the greatest marginal revenue for the federal government; these may not be the taxes that yield the greatest marginal revenue for the state. Second, in the administration of a particular tax, the federal government will presumably prefer to concentrate its activities on taxpayers whose expected marginal yield of revenue for the federal government is highest. Since economic activity is not homogeneous throughout the country, the federal tax administration might pay less attention than state tax administrations to taxpayers in some states. (What might be a “big fish” for the state might be a “small fry” for the federal government.) To the extent that the federal administration ignores taxpayers in poorer states, horizontal fiscal disparities are accentuated. Third, the assumption that the federal tax administration allocates its resources rationally may not be valid; the administration’s coverage of taxpayers in various parts of the country may vary widely for reasons that have no basis in sound policy. (It may be difficult to hire trained auditors to work in the hinterland; alternatively, coverage in some rural areas may be “denser” than in the major cities.)

One risk of dual administration is obvious: instead of filing a single tax return with the federal government, the taxpayer would file a return with each state where there is an actual or potential tax liability. Similarly, the return would be potentially liable to audit by the tax authorities of all these governments. Under a system of dual administration, tax administrators in all states must apply the law consistently. Although a single law might, in principle, apply throughout the country, it might not be interpreted uniformly by state tax administrations.

The treatment of interstate transactions is especially important. In a system with federal tax administration, the flow of information on interstate sales would stay with the federal government. By comparison, in a dual system, the information on interstate transactions would have to flow between state administrations.

The states could be given a role in the supervision of the federal tax administration, essentially making it a national agency that is accountable to both the federal and state governments, instead of a federal agency that is accountable only to the federal government. This would bring the benefits of uniformity, avoid duplicate effort, and respect state priorities.

**Transfers and System Integration**

Federal systems are characterized by a formal (constitutional) division of powers between central and subnational levels of government. These powers can be assigned to one or the other order of government (self-rule) or they can be concurrent (shared rule). Theoretically, there could be a
serendipitous matching of revenue and expenditure responsibilities among the two orders of government such that there would be no need for intergovernmental transfers. However, in virtually all federations, the central government has de facto, if not de jure, capacity to raise revenue in excess of its expenditure responsibilities. This is certainly the case for the Mexican federation, even more so now that state taxation responsibilities have been transferred to the center and significant expenditure responsibilities devolved to the states.

As mentioned earlier, in general, two sorts of fiscal balance (or transfer) issues arise in federal systems—vertical fiscal imbalance and horizontal fiscal imbalance. Vertical fiscal imbalance relates to the allocation (or, rather, misallocation) of revenue-raising capacity relative to expenditure responsibilities. The Mexican federal government has revenue-raising capacities well in excess of its expenditure responsibilities. Although a high degree of vertical fiscal imbalance in favor of the federal government can be rationalized on a variety of grounds (such as economies of scale in tax collection) and does exist in some mature federations (such as Australia), a corresponding set of intergovernmental grants (federal-state and perhaps federal-municipal) is required to address the revenue shortfall of subnational governments.

Horizontal fiscal imbalance has to do with fiscal capacity across the states. Fiscal capacity has a precise meaning: it relates to standardized per capita revenues, where these are calculated as the product of the all-state average tax rates and commonly defined per capita state tax bases. The intergovernmental transfers associated with alleviating these horizontal fiscal imbalances are typically referred to as equalization transfers and programs.

**Analytical Underpinnings of Intergovernmental Transfers**

Expenditure responsibilities at the state (subnational government) level usually exceed the states’ revenue-raising capacity, lending to both vertical and horizontal fiscal imbalances. These imbalances occur for various reasons. The most obvious is that they arise from the allocation of taxing and expenditure responsibilities under the constitution. Or they could result from “first-mover” advantage. That is, according to the constitution, the states may have adequate capacity to raise revenue but may have to share the major sources of revenue with the federal government, which has preemptively occupied these tax areas. Unless the federal government is willing to transfer tax room to the states, there is no way, short of excessively high tax rates, that the states can exercise their taxing authority. Third, it may be more efficient for the federal or central government to collect taxes on behalf of the states. This can also occur for a variety of reasons—inadequate state-level collection capacity, economies of scale, and the presence
of spillovers. This last reason is becoming more important: with increasing economic integration the optimal jurisdiction for collecting taxes is expanding (that is, the tax bases are becoming more “mobile”) relative to the optimal jurisdiction for spending. In order to “internalize” these potential spillovers or externalities, taxes are collected at the national level with an understanding that some or all of the revenues will be returned to the states under a set of transfer arrangements. Whatever the reason, both horizontal and vertical fiscal imbalances exist at the subnational level. What is the role of intergovernmental transfers in ameliorating horizontal fiscal imbalances across the states?

ACCOMMODATING HORIZONTAL IMBALANCES. The literature focuses on two criteria for assessing horizontal imbalances: fiscal efficiency and fiscal equity. Drawing on Boadway and Hobson (1993), the underlying theoretical model postulates that an individual’s “comprehensive income” is the sum of his or her market income, \( W \), and net fiscal benefits (NFBs), defined as the difference between the value of government expenditures and taxes paid. This leads to the following basic equation of labor-market equilibrium:

\[
W_i + NFB_i = W_j + NFB_j
\]

where subscript \( i \) refers to state \( i \) and subscript \( j \) refers to state \( j \). Thus an individual will be indifferent between living in state \( i \) and state \( j \) when comprehensive incomes are the same in both states. But now assume that \( NFB_j > NFB_i \). Net fiscal benefits in state \( j \) can exceed those in state \( i \) for a variety of reasons. For example, states with high source-based tax revenues (from, say, resources or corporate income taxes) or with high residence-based revenues (because they are higher-income states) could finance a given level of public goods and services with lower tax rates, which, in turn (and in the absence of capitalization) implies higher net fiscal benefits. Moreover, NFBs could also arise on the expenditure side: it may be more costly to provide a representative bundle of goods and services in some states than in others. These differences in NFBs provide the backdrop for what the theoretical literature refers to as the fiscal efficiency and fiscal equity rationales for equalization, that is, for ameliorating horizontal differences in fiscal capacity.

FISCAL EFFICIENCY. Consider fiscal efficiency first. Output maximization requires that \( W_i = W_j \), namely that individuals distribute themselves across states so that their market-based marginal products are everywhere identical (that is, in state \( i \) and state \( j \) ). However, if, as assumed, \( NFB_j > NFB_i \), then individuals will be willing to move to state \( j \) even if this means that \( W_j < W_i \), in order to ensure that their comprehensive income (\( W + NFB \) ) is
in equilibrium. The result is inefficient or fiscally induced migration. The solution proposed in the literature is to provide a set of intergovernmental transfers (they could be federal-state transfers as in Canada or interstate transfers as in the German federation) in order to ensure that $NFB_i = NFB_j$, which, in turn, implies that, in equilibrium, $W_i = W_j$. Hence, migration will be efficiency-driven, not NFB-driven.

Several caveats are in order. First, since the underlying model focuses on individuals, equalization payments to provinces are a second-best solution. The first-best solution is a set of payments to individuals. But this is typically ruled out on constitutional or practical grounds. Hence, the literature argues that the presence of equalizing grants allows states, in principle, to equalize NFBs. In practice, this is highly unlikely to occur since it implies that similarly situated individuals in both states are treated similarly by taxes and expenditures. Second, the model implicitly assumes zero migration costs. If there are costs to migration, then NFBs can differ up to this cost differential with no deleterious impact on migration efficiency. The third caveat is more important. Although the model is general in the sense that it can accommodate any degree of capitalization of NFBs in terms of rents and wages, its typical application tends to argue for full equalization of revenues up and down, as in Australia. This application effectively assumes zero capitalization. Phrased differently, it assumes that an increase in revenues in state $i$, for example, is equivalent to an increase in NFBs in state $i$. But this does not hold if the revenue increases become capitalized in wages, rents, and so forth. This is not a defect in the theory, only in the way the theory tends to be applied. Finally, in Canada at least, the emphasis is shifting away from the fiscal efficiency case for equalization to the fiscal equity case, because the efficiency gains may not be very significant in any event (Watson 1986).

**Fiscal Equity.** The traditional case for equalizing federal-state transfers in a federation is premised on fiscal equity, which in turn is based on the public finance concept of horizontal equity—equal treatment of equals. The argument is straightforward: individuals with similar employment incomes ($W_i = W_j$) should, on horizontal equity grounds, also have similar NFBs. Thus “fiscal equity requires that all differences in NFBs be equalized regardless of their source” (Boadway and Hobson 1993, p. 89). Under what has come to be viewed as “broad-based horizontal equity,” the underlying assumption is that people who are equally well off in the absence of government should also be equally well off in the presence of both levels of government. Hence the role for the federal government, under broad-based horizontal equity, is to design discriminatory transfers (essentially via equalization) to provincial governments so as to “undo” any differential NFBs that arise because of government policies (both federal and state). This
approach turns the federation into something comparable to a unitary state (Boadway 1998; Hobson 1998). One can mount a convincing case, however, that the goal of broad-based horizontal equity is the very antithesis of federalism.

Nonetheless, the theoretical conception of fiscal equity underpins the comprehensive equalization system in place in Australia, where state revenues are leveled upward and downward to an all-state per capita level and then further adjusted to take into account differential state needs and costs of providing the average all-state expenditure bundle. Not all federations accept this approach to fiscal equity. The Canadian equalization system focuses only on revenues and then brings only low-revenue-capacity provinces up to some acceptable standard (it does not bring above-average provinces down to this standard). And the United States does not even have an equalization program, presumably on the grounds that differential NFBs will be fully capitalized so that there is “nothing to equalize.” The degree to which federations seek to ameliorate horizontal imbalances across their subnational governments appears to be derived from the deeper political values and logic of the federal contract rather than from a simple application of fiscal theory.

**Vertical Balance and Conditionality**

This section reviews the theory and practice of vertical fiscal transfers, beginning with a focus on conditionality.

Conditional grants come in a variety of forms and rationales. The traditional public finance literature has devoted substantial attention to the “interjurisdictional spillover” rationale for conditionality. An interjurisdictional spillover (or externality) is said to exist when the activities of the public sector in jurisdiction A provide benefits to the residents of another jurisdiction (Boadway and Hobson 1993, p. 96). In the presence of such externalities, jurisdiction A has an incentive to underspend on the provision of public goods in the presence of such externalities. The greater the proportion of external to “own” benefits, the greater the underprovision will likely be. The obvious way to correct for this is to provide a matching conditional (expenditure-specific) grant where the degree of matching (degree of cost sharing) relates to the degree of interjurisdictional spillover. Although this argument is well grounded in theory, it is rare in practice to find open-ended, shared-cost conditional grants where the degree of cost sharing is predicated on the differences in intergovernmental spillovers. But this externality can be addressed in other ways. For example, the per capita value of conditional grants could vary across subnational jurisdictions in accordance with the degree of spillover. And the various equalization programs in federal systems imply that these moneys are designed to ensure that all states can provide national, average public services to their
citizens. This can only be an implicit condition, since equalization grants are generally unconditional.

The most typical forms of conditional grants link the transfers to spending in specific areas or for specific purposes. These specific-purpose grants are intended to ensure that all individuals, as a right of citizenship, receive minimum levels of certain public goods and services. Presumably, this explains the degree of conditionality embedded in Mexico’s Ramo 33 transfers, especially for health and education.

Although some forms of conditionality may embody problematic incentives (such as open-ended, 50-50 shared-cost grants that distort state expenditure priorities because states are spending “50 percent pesos” in the grant areas and “100 percent pesos” elsewhere), or overly strict conditions that prevent states from achieving the goals of the conditions in more efficient ways, conditional grants can also be employed creatively. Several examples come to mind. First, cost sharing can be combined with subnational spending priorities at the margin. For example, the cost sharing can be close-ended (intramarginal) rather than open-ended. And the amount of this intramarginal sharing can be different for different states (it even could accommodate the spillover rationale alluded to earlier). At the margin, however, states would be spending 100 percent their own pesos on all spending areas.

The United States’ experience with shared-cost grants a few decades ago suggests another degree of flexibility. The federal government provided cost-sharing grants for highway construction, where the degree of sharing incorporated considerations relating to the states’ fiscal capacities and the costs per mile of highway construction (mountain states required more than plains states, for example). In effect, this brought both fiscal capacity and fiscal needs into the design of conditional grants.

Canada’s experience with conditional grants presents another perspective. In the 1950s and 1960s, when the Canadian welfare state was in its embryonic stage, the federal government provided generous shared-cost programs in areas such as welfare, health, and education. As these programs became established, they developed receptive and demanding citizens in their respective provinces and came to be viewed as an integral part of the Canadian social contract. As this occurred, the Canadian federal government could and did gradually abandon the shared-cost and highly conditional nature of these grants and converted them into block-funded unconditional programs, with the important proviso that the provinces agreed to a set of pan-Canadian principles in these expenditure areas. In turn, this suggests that there may be an optimal evolution of conditional transfers. Previously centralized federations that embark on a process of decentralization will probably have to resort, initially, to highly conditional grants. However, as the federation evolves and as citizens come to view
these conditional-grant programs as entitlements, the federation can gradually eliminate the conditional nature of these transfers and use instead a set of mutually agreed operating principles. In either case the result is greater subnational autonomy.

Since Mexico is only beginning the process of meaningful decentralization, some of the federal-state transfers will probably have to be conditional. But even at this early stage of decentralization, the design and implementation of conditional grants can be flexible enough to accommodate both conditionality and an important degree of subnational autonomy.

**Horizontal and Vertical Transfers in Practice**

Different federations combine transfers in quite different ways. Canada is one of the few countries that compartmentalizes these two types of transfers. The federal government first overlays an equalization system on the taxation capacities of the various provinces. This is “pure” horizontal equalization since the equalization payments only go to low-fiscal-capacity provinces. Then, with all provinces thus brought up to the equalization standard, the vertical transfers are designed to be equal in per capita terms, subject to a set of pan-Canadian principles on which Ottawa and the provinces have jointly agreed.

The Australian system is quite different. Because the degree of subnational fiscal imbalance is so large, the unconditional financial adjustment grants overseen by the Commonwealth Grants Commission (CGC) incorporate both horizontal and vertical fiscal-balance concerns. That is, all Australian states receive CGC grants. One could interpret the per capita level of grants going to the “richest” state, Victoria, as embodying the all-state level of vertical transfers and the additional grants going to the other states as embodying the horizontal component of the grants. Beyond this, Australia has a set of specific-purpose payments (conditional grants) that, in the aggregate, exceed the unconditional CGC grants. The continuing importance of conditional grants in Australia reflects the more centralized nature of their federation (or, analytically equivalent, citizen preferences do not differ across states and that the conditions effectively capture these preferences).

The German system is different again. The shared taxes are distributed to the länder according to criteria that embody derivation, equal-per-capita, and equalization principles. The resulting differences in fiscal capacity are then subject to an overarching interländer revenue-sharing pool; rich länder contribute to the pool, and poor länder draw revenues from the pool. This revenue-sharing pool is an exercise in pure horizontal equalization. No magic formula applies to all federations. Moreover, there is ample evidence that the approaches to intergovernmental transfers chosen are far from arbitrary; they find their rationale and underlying logic in the deeper political values of their respective federations.
Debt and Borrowing

Two levels of policy influence borrowing and debt management by state and municipal governments—the policies of subnational governments themselves and the policies of the national government (or the state for municipal government) that set the constraints and incentives for the local governments.

The proper policies for the subnational governments are straightforward—they should only borrow to fund an activity (investment) that will yield a rate of return to society above the interest rate and sufficient to service the debt. A project that generates its own direct revenue is most likely to meet these criteria, but it can also be met in an investment like local roads or school construction that is associated with growth of economic activity and tax revenue adequate to cover the debt service.

Since the principal of a loan typically comes due before the full benefits of the investment arrive, the stock of debt should be kept small enough so that debt service (interest plus amortization that is not scheduled for refinancing) is less than the current balance before debt service. Alternatively, amortization not scheduled for refinancing should be less than the current account balance.

To these minimum criteria for borrowing one must add a safety factor, so that even in the face of adverse shocks the local government will maintain its fiscal independence and thus meet the conditions for market-preserving federalism. Then, even after paying scheduled amortization, there is enough current surplus left to fund part of the investment program, that is, without borrowing for all investment. These rules apply to any level of government.

In a perfect world, decisionmakers would want to do this to maximize social welfare, or voters could discipline them to act this way. In the real world, there are many problems of information, and decisionmakers have short time horizons, so governments at all levels often borrow in excess of these rules. For local governments, there is an extra complication in that if they overborrow, a higher level of government may bail them out, in effect rewarding their imprudence with extra resources. In other cases, the higher level of government may impose spending requirements on them or limit their revenue options, making unsustainable deficits almost unavoidable and giving the local government a reason to expect a bailout from above. To deal with such problems, the higher level of government may establish and enforce rules that prevent the local government from borrowing imprudently. These policies are our central concern here.

Research on Latin America and the rest of the world indicates several conditions that are needed to achieve sound management of debt and borrowing by states and municipalities (see table 1.2).
HARD BUDGET CONSTRAINTS. First and foremost, a firm allocation of expenditure responsibilities is critical for establishing a hard budget constraint for subnational governments. If the central government can effectively delegate functions to subnational governments to go along with the delegation of revenue sources, central spending and deficits are more likely to be contained. If this is not the case—because, for example, the constitution or the law mandates resource transfers without allocating equivalent responsibilities—the central government can find itself with a constitutional obligation and political expectation to continue providing some services, even after revenues or tax bases have been turned over to subnational governments with the understanding that they will do the task. Or it may have to resume spending on functions when subnational governments experience a fiscal failure.

Table 1.2 Institutional Arrangements to Set and Keep Hard Budget Constraints on States

<table>
<thead>
<tr>
<th>Constraint</th>
<th>Institutional arrangement</th>
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| Hard budget constraint from the central government to subnational governments | • Rule-based transfers  
| | • Firm allocation of spending responsibilities |
| Constraints on borrowing | • Ex ante constraints  
| | • Ex post consequences and resulting incentives  
| | • Enforcement of payment by subnational governments  
| | • Enforcement of losses on banks with bad loans to uncreditworthy subnational governments, via bank regulation  
| | • Independence of Central Bank and regulators |
| Autonomy of subnational government to reduce costs and raise own revenue | • Ability to control spending and costs  
| | • Ability to increase tax rates and improve enforcement |
| Transparency: timely disclosure of information to improve accountability of policymakers | • Regular publication of data  
| | • External auditing  
| | • Legislative oversight |

Source: Dillinger, Perry, and Webb 2000.
Basing transfers exclusively on clear rules is the other necessary ingredient for a hard budget constraint. Wherever there is recourse to significant discretionary transfers, including matching grants, subnational governments will have an incentive to overspend in the expectation that they can get a larger transfer.

BORROWING CONSTRAINTS. Although tax and spending policies create fiscal pressures, whether they cause problems for macroeconomic management depends on whether the subnational governments face hard limits on their ability to borrow or to spend more (Ter-Minassian and Craig 1997). Unsustainable deficits are less likely if the central government controls subnational borrowing ex ante. But how to enforce this in practice is not always clear when the subnational governments have considerable political autonomy. Pseudo-strict controls could make matters worse if central government approval creates the impression, and perhaps the self-fulfilling expectation, that the central government has extended a guarantee. The best controls would mimic the requirements of prudent lenders.

To run deficits, subnational government must find a source of financing, which potentially includes contractual borrowing from private foreign or domestic banks (especially banks owned by subnational governments), issuance of domestic or foreign bonds, and the running up of arrears to suppliers and personnel. A creditor and the subnational government would only agree to finance unsustainable deficits if both sides expected to gain, most likely through some sort of federal bailout. The bailout can take many forms, including allowing the financial system (implicitly insured by the government) to count as an asset a subnational government debt that is not being serviced. Unsustainable deficits are also less likely if the central government credibly commits not to have bailouts, prohibiting explicit bailouts and forcing subnational governments to service their debts, and if regulators force creditors to accept the losses implied by any failure of subnational governments to service debt. It is still an open question whether ex ante regulation or ex post enforcement of debt service is more effective in preventing excessive subnational government borrowing. Although conflicts are also possible, both can work together and complement each other. Ex ante controls keep the problem from growing so big that it threatens the entire system, and ex post consequences increase appropriately the concerns of individual borrowers and lenders.

Financing from the central bank often is what loosens the budget constraint for subnational governments, either directly by discounting subnational debt or indirectly by easing the national government’s budget constraint or allowing commercial banks to roll over bad subnational debts. Unsustainable deficits are less likely when the central bank (and the bank supervisory agency) is more autonomous and has a strong anti-inflation mandate.
Subnational governments may also accumulate excessive contingent liabilities. This is more likely to happen wherever subnational governments are allowed to run their own pension regimes, when they own banks, and when they make concessions to the private sector without adequate regulation from above.

**Autonomy to Reduce Costs and Raise Revenue.** The third group of institutions relates to the capacity and autonomy of subnational governments to stay within the budget constraint. The first element is expenditure autonomy. If subnational governments do not have autonomy over their expenditure, there is no fiscal decentralization and no macro fiscal problem likely to come of it. Giving subnational governments autonomy over spending is, of course, the way in which decentralization can improve efficiency in matching the needs and desires of a diverse population. But to live within a sound budget constraint, subnational governments must have authority to control their costs. Too often central governments keep for themselves decisions (such as determining the wages of teachers and doctors) that critically affect the costs of subnational governments, and a liberal decision may throw subnational governments into deficit. In particular, subnational governments must have the authority to spend less, particularly to cut personnel, salaries, and pension benefits, collectively the largest single item of subnational expenditure, in order to be able to adjust to shocks or contribute to needed fiscal retrenchment. If central rules constrain this authority, it is more difficult to reduce deficits, and expectations of a central government bailout are higher. Thus unsustainable deficits should be less likely if subnational governments have authority to cut their costs.

With fiscal decentralization, subnational governments usually obtain certain tax bases, but for reasons of politics, equity, and efficiency, these bases rarely cover all their expenses. Subnational governments always receive significant federal transfers. It is commonly believed that subnational governments will have smaller deficits if they rely more on their own tax bases (and have the power to change tax rates on the margin), because then they have the ability to adjust to shocks by increasing revenue. In addition, relying on one’s own resources may strengthen the incentives to control spending. Unsustainable overall public sector deficits are less likely if subnational governments raise much of their own revenue and have enough flexibility to change rates or impose new taxes.

**Transparency.** Although increases in competitive democracy accelerated the process of decentralization, sometimes to a pace that is problematic, democracy can contribute to responsible macroeconomic management, as well as to other worthy ends. When congress and opposition parties have access to accurate and up-to-date information about public sector finances,
they become effective watchdogs and bring the law and public opinion on the side of good management. It is thus important that subnational governments publish information on fiscal balances, revenues sources, expenditure composition, borrowing, debt structure, and contingent liabilities. A federal government can impose such requirements on subnational governments. This works well administratively because the federal government is giving the states transfers, which can be made conditional on transparency and reporting requirements. Politically it works, as well, when there is some balance of parties at the federal level, and each side wants to be sure that the other side cannot profit from lack of transparency in the subnational governments. In this context, transparency not only creates pressures for good fiscal management but also acts in a virtuous circle with political competition.

**Interlinkages**

While this chapter has dealt separately with the areas of spending, taxes, transfers and borrowing, in practice they are all closely linked. For example, states can only control their debt if they can control spending and/or borrowing. Further, a federation can maintain a tough budget constraint in its transfers to states only if state fiscal problems do not threaten the nation’s financial system or do not result in politically unacceptable shortfalls in payments to service providers, like teachers. Or the dissatisfaction of a state with the tax transfers plan can lead it to threaten to withdraw from the fiscal pact if the government does not agree to increase transfers or pay for some expenditures that are normally the state’s responsibility. Reforms to any part of the system must thus take account of the rest of the system and often must be accompanied by other reforms.
Appendix

Intergovernmental Transfers in Developed Federations

All federations have a constitution that allocates powers on a self-rule, shared-rule basis. Beyond this, some federations are highly decentralized (Canada), while others are highly centralized (Germany, Australia). Some are legislative federalisms, where subnational governments have substantial legislative powers especially with respect to expenditures (Canada, Australia, the United States). Germany, however, is a model of an administrative federalism because virtually all legislative power rests with the center and almost all implementation and administration is the responsibility of the länder.

All federal systems have to address both vertical and horizontal fiscal balance, although the United States, alone among federal systems, has no program of equalization directed toward ameliorating horizontal balances across subnational governments. Accommodating these fiscal imbalances falls to the system of intergovernmental transfers. In this sense, intergovernmental grants are the residual component of the expenditure, tax, and transfer assignment nexus, and the nature of these transfers varies markedly from federation to federation. Nonetheless, the nature and magnitude of, and incentives within, the system of intergovernmental transfers in each of these federal systems resonate closely with the underlying nature of the federation itself. Far from being merely a residual component of fiscal federalism, the transfer system tends to embody the values and norms of the citizen-government and intergovernmental relationship consistent with the federation’s social and political contract. To be sure, causation may run both ways. If grants are unconditional, the balance of power tilts toward subnational governments, and vice versa. Decentralized federations may dictate that most grants be unconditional.

Phrased differently, the design of intergovernmental grants is not incidental to the underlying social and economic nature of the federation itself. This appendix examines intergovernmental transfers in a comparative fed-
eralism context, beginning with the Commonwealth of Australia and then turning to Germany, Canada, and the United States.

**Australia**

Australia is not only a highly centralized federation but also a highly egalitarian nation. For example, welfare payments are designed and delivered from Canberra and, as a result, are identical across the country, in sharp contrast to, say, Canada, where responsibility for welfare is provincial. Wage grids are also essentially uniform across Australia—university professors are on the same wage grid whether they teach in Perth, Sydney, or Launceston.

More relevant for our purposes, the Australian states do not have effective access to broad-based taxes (income taxes, sales taxes), and the taxes that they do levy are being eroded by a combination of global forces and high-court decisions (Courchene 1999). The Australian states are highly dependent on transfers: “Australia has by far the highest degree of vertical fiscal imbalance among the major federations in the world” (Walsh 1996, p. 115). However, the system of intergovernmental grants complements Australia’s centralization and uniformity nicely. First, more than half of the cash transfers to the states are in the form of conditional grants (specific-purpose transfers, in the Australian context), which, in turn, enhances both centralization and uniformity. Second, Australia’s approach to removing horizontal fiscal balances—the financial adjustment grants monitored by the Commonwealth Grants Commission—is the most comprehensive among federal nations. The fiscal equalization principle that guides the Commonwealth Grants Commission is as follows: “Each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenues from its own sources” (Commonwealth Grants Commission 1995, p. 1).

Operationally, the equalization system works as follows. First, the 19 state revenues (at assumed common tax rates) are equalized both upward and downward to the all-state average. With revenues fully equalized, the 40 or so expenditure categories are then subject to upward and downward equalization to ensure that each state can deliver the average expenditure bundle at an “average level of operational efficiency.” The end result of these calculations is a series of per capita “relativities”—that is, revenue- or needs-adjusted ratios relative to the national average. Hence, during 1994–95, for example, Victoria’s relativity was 0.85 and Tasmania’s was 1.54—that is, Victoria would receive 85 percent of its population share of overall Commonwealth Grants Commission grants, and Tasmania would receive 154 percent. This is full revenue and expenditure (needs) equalization.
The Commonwealth Grants Commission is the key institution in Australian fiscal federalism. Its operations are open and increasingly transparent, which ensures that the resulting “relativities” are accepted by all Australians. Beyond this, Australia has an effective process of state-commonwealth coordination to ensure overall macroeconomic cooperation and to preserve and promote the internal socioeconomic union (Courchene 1999).

Thus Australia has latched onto a highly egalitarian equalization program and, more generally, a system of intergovernmental transfers that meshes well with the underlying homogeneity and egalitarian nature of its federation.

Germany

The German federation is also highly centralized, but in a way quite different from Australia. Designated as an administrative federalism, all major tax rates are set centrally, with no variations allowed at the länder level (although the länder administer or collect these revenues). Apart from a relatively minor range of länder and municipal taxes (taxes on property, cars, and beer as well as fees of various sorts), most länder revenue comes from revenue-sharing arrangements with the center. The major shared or joint taxes include corporate and personal income taxes, capital taxes, and the value added tax. Some of this revenue sharing follows the principle of derivation, some of it is equal per capita, and some (especially for the new länder) is based on equalizing principles.

Beyond revenue sharing, there is a second and overarching tier—an interländer revenue-sharing pool. The rich länder contribute a share of their per capita revenues in excess of 102 percent of the national average (70 percent of per capita revenues between 102 and 110 percent of the national average and 100 percent of any revenues beyond this). The poorer länder then draw from this pool to bring them up to at least 95 percent of the all-länder average. The guiding principle underlying intergovernmental transfers in Germany is the constitutional provision assuring “the uniformity of living conditions.” Needs are also taken into account in operations of the interländer revenue-sharing pool, meaning that the “standardized” revenues for purposes of the pool incorporate expenditure needs to a degree. Other things being equal, länder with large cities or dense populations are deemed to require more revenue and vice versa. (This is in sharp contrast to the Australian approach in which population scarcity is deemed to require greater expenditures, which, in turn, suggests that the approach to needs equalization in federations is rather subjective).

The key institutional/constitutional feature of German fiscal federalism is the upper house or Bundesrat, which is a house of the länder in that it is made up of direct representatives of the länder governments. All legislation pertaining to the länder, including the tax rates on shared taxes, must receive the imprimatur of the Bundesrat.
Canada

In contrast to Germany, the Canadian provinces have no formal role in the operations of the central government: members of the Senate (upper chamber) are appointed for “life” (up to age 75) by the government of the day, and, as a result, the Senate is not a federal chamber in a meaningful sense. Provincial concerns and issues tend to be articulated through the provincial legislatures and their premiers. Canada also differs from the typical federation in that there is an explicit and extensive listing of provincial powers under the constitution. Beyond this, other features of the Canadian federation propel it toward decentralization. The province of Quebec, with one-quarter of Canada’s population, is linguistically, culturally, and institutionally distinct. Quebec has long advocated states’ rights, which in turn has moved Canada toward not only greater decentralization, but greater asymmetry as well. (Quebec has its own, separate, personal income tax, whereas the rest of the provinces piggyback their tax rates on Ottawa’s personal income tax system.)

The Canadian federation is highly decentralized on both the expenditure and tax fronts. For example, the provinces levy their own personal and corporate taxes and their own sales taxes (except for Alberta), and, in general, control the natural resources within their borders. Hence, the Canadian system of intergovernmental transfers accommodates this decentralization.

Focusing first on Canada’s equalization program, the constitutional principle is less comprehensive than that in Australia: Parliament and the government of Canada are committed to making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable tax rates. Canada does this by providing equalization payments to the poorer provinces in order to bring their per capita revenues up to the so-called five-province standard (close to the national-average standard). Unlike Australia, however, the revenues of rich provinces are not “leveled down” to this five-province average, nor does Canada equalize for needs on the expenditure side. These equalization payments are wholly unconditional.

More interesting, perhaps, is the Canadian approach to vertical imbalance. When introduced in the 1950s and 1960s, vertical balance grants were of the shared-cost, conditional variety. Over time, as the programs that they were associated with became established in the various provinces, the federal government relaxed the conditionality. Currently, all vertical transfers are rolled into a single block fund, and the moneys can be spent where the provinces wish. However, a national set of social policy principles continues to guide all provincial spending, especially in the area of health.

Because of the decentralized nature of the Canadian federation, Canada has had to engage in creative measures to preserve and promote its socio-economic union. For example, all provinces adhere to a mechanism that allocates corporate revenues across provinces for those enterprises that
operate nationally. And recently (February 1999), the provinces and Ottawa have signed a framework to improve Canada’s social union. The key coordinating institution has been what federal scholars refer to as executive federalism: the frequent meetings (more than 1,000 annually at last count) of federal and provincial officials (or executives) in areas of mutual concern and interest. More recently, the provinces have mounted their own national institution, the annual premiers conference, which is moving the provinces toward addressing some pan-Canadian goals. Nonetheless, the internal Canadian socioeconomic union remains less fully developed than that of Australia, for example.

The United States

The federal system in the United States probably suffers least from vertical fiscal imbalance, in part because U.S. states engage in a narrower range of activities than do Canadian provinces, for example. What is most fascinating about the U.S. approach to intergovernmental transfers is the absence of a formal revenue equalization program, although, on the expenditure side (for example, with respect to defense), regional considerations enter into allocation decisions, as they do in other federations.

One view of the U.S. approach is that Americans simply ignore any horizontal fiscal imbalances. Another view is that there really are no horizontal imbalances since any meaningful differences in per capita revenue across states are capitalized in property values, wages, and rents. Wallace Oates, one of the foremost scholars of U.S. federalism, takes this latter view:

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\text{[E]xisting fiscal differentials (e.g., varying levels of taxable capacity) across jurisdictions will tend, to some extent at least, to be capitalized into property values so that those who choose to live in fiscally disadvantaged areas are compensated by having to pay lower land rents; from this perspective, horizontal equity under a federal system is, to some degree, self-policing. The need for equalizing grants in a federation is thus questionable. Perhaps it is best to regard their role as a matter of “taste” (Oates 1983, pp. 95–96).}
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It may well be that assuming full (or 100 percent) capitalization of differences in fiscal capacity is going too far. But so does the existing equalization literature, which, in general, assumes zero capitalization.

However one comes out on this issue, it is clear that the U.S. intergovernmental fiscal relations (or, rather, the lack of such) accord well with the laissez-faire U.S. constitutional rhetoric of “life, liberty, and the pursuit of happiness.”
Recapitulation

Intergovernmental transfer arrangements are anything but arbitrary. Indeed, they complement the existing tax and expenditure allocation in a manner that integrates overall fiscal federalism in directions consistent with the implicit or explicit values and norms of the respective federal system. They are, in effect, part and parcel of the constitutional-institutional machinery that reflects and embodies the deeper societal values of the federation.

To be sure, the intergovernmental arrangements in the various federations represent the status quo. And in most of these federations, challenges are emerging on the transfer-intergovernmental front. For example, the Australians are about to introduce a value added tax, the proceeds of which will be allocated to the states. Whether this will be on a derivation basis or equal-per-capita basis, for example, is not clear. The likelihood is that it will be run through the Commonwealth Grants Commission. In Germany, the richer länder, such as Bavaria and Baden-Wurttemberg, are upset that they retain too small a share of any revenue increase they generate and have taken the equalization program to the German constitutional court. In Canada, the richer provinces are complaining that the federal government is mounting too many poor-province preferences in programs other than equalization. And so on.

This is to be expected in the best of times. But with the pervasiveness of the forces of globalization and the revolution in knowledge and information, all federations are examining their fiscal federalism arrangements in general and the nature of intergovernmental transfers in particular. What this means is that the arrangements (expenditure assignment, tax assignment, and intergovernmental transfers) will, on a continual basis, have to find their appropriate role in the deeper political logic and interests of the federation as it evolves. But what the comparative experience reveals is that the nature, magnitude, and incentives within the system of intergovernmental transfers, independent of the tax and expenditure assignment, can play a critical role in ensuring that the federal-state interface can accommodate the direction and values that the federation itself is pursuing.

Implications for Mexico

What implications does the role of intergovernmental transfers in developed federal systems hold for Mexico in its ongoing decentralization? Perhaps the most important lesson is that transfer arrangements can be designed to accommodate and integrate a wide range of expenditure and tax assignments in ways that are consistent with the overall equity and efficiency goals of the federation. For example, at the margin the system of transfers can embody incentives that encourage further decentralization. Or they can be tailored to produce the desired degree of fiscal equality
across the Mexican states. Or by creative use of conditionality, they can ensure that all citizens have access to those public goods and services that ought to attend Mexican citizenship.

Beyond this, the transfer system can be designed in ways that will accommodate a smooth transition between the current status quo in tax and expenditure assignment and the longer-term evolution of subnational expenditure and tax devolution. To be sure, there is a sense in which intergovernmental transfers are, at any point in time, the necessary residual element in the interplay of subnational tax and expenditure assignment. However, and more important, transfers can do much more than merely bridge any vertical and horizontal imbalances resulting from the mix of subnational expenditure and taxation: they can and should ensure that the entire federal-state fiscal interface is in line with the deeper political and social logic of the federation. In this important sense, they are much more than a residual element in fiscal federalism.