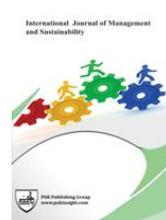




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### FISCAL FEDERALISM AND ITS ROLE IN OPTIMIZATION OF THE FINANCIAL SYSTEM COUNTRY

**George Abuselidze**

*Doctor of Economics, PhD Finance, Money Circulation, Credit, Professor at Shota Rustaveli State University  
(Georgia) Georgia*

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#### ABSTRACT

*To optimize the financial system is exceptionally important to achieve an effective balance between revenues and expenditures of all-the central, regional and local budgets. Socio-economic development of regions cannot be accomplish without financial relations. "Fiscal federalism" multilateral and, respectively complex mechanism, which describes the financial device of rights and obligations between the "center" and "region", the rules of their relationship at all stages of the budget process, regulatory and legislative methods of budgetary resources redistribution. In the process of formation, distribution and exercising of public finances socio- economic relations between the State, legal entities and individuals are build and at the same time subjective interests are realized.*

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**Keywords:** Fiscal federalism, Foreign models of interbudgetary relations, Budgetary alignment

**JEL classification numbers:** F65, G17, H77

#### INTRODUCTION

After accomplishment of independence of one of the most difficult and considerable problems was and still is a state budget, questions of optimization of its incomes and expenses and its transformation into the most powerful tool of renovation and country development. in order to optimise the financial system of the country, great importance has to provide an effective balance between revenue and expenditure of the central, regional and local budgets. the country's social and economic development is impossible without effective fulfilment of financial relations by which economic development of separate territories and regions should be provided. The financial history and practice of the developed countries obviously shows that all

three levels of the budget should be allocated so that the expense and the income of means of structure have been as much as possible provided by financial resources. The humankind throughout a centuries of the development has created efficient system of mobilization and the expense of financial resources which for today is known as fiscal federalism

The object of this paper is the Fiscal federalism.

The aim is to analyze the foreign models of intergovernmental relations, focusing on the issue of budget balancing through a system of transfers. Methods of research: Comparative analysis of scientific literature, Historical approach, deduction, synthesis, statistical analysis.

## **LITERATURE REVIEW**

The fiscal federalism and multi respectively, complex mechanism, whose essence consists in the unit cost of the rights and duties between the "center" and "region", the rules of their relationship at all stages of the budget process, regulatory and legislative methods of redistribution of the device of budgetary resources, so and in the socio-economic relations existing between the State and legal entities and individuals that are formed in the process of formation, distribution, disposal and use of public money and resources while at the same time, there is a realization of belonging to this system of subjective interests (Abuselidze, 2006).

Under the influence of political, historical and national factors in the world has developed many budget systems, significantly differing from each other. Organization of budget management is directly related to the model of government. In unitary countries, budgetary systems, characteristic of a high level of centralization of budgetary resources and a minor amount of the budget of the rights and responsibilities of local budgets, with a high proportion of financial assistance from the central budget. In states with a federal structure is part of the fiscal management of relations of fiscal federalism, involving a more balanced distribution of power and responsibilities between levels of budget system, the relative independence of the budgets of their equity in the state budget system, the organization of budgetary redistribution that is downstream of financial aid budgets in different ways (Pronin, 2000).

An interesting and useful for the analysis of models of fiscal federalism is produced by British experts C. Smith and G. Hughes, grouping countries of the Organization for Economic Cooperation and Development (OECD) in accordance with such features as the similarity of approaches to the management of intergovernmental relations, particularly the philosophy of fiscal federalism is used, the ratio of Role of central and sub national governments. As a result of the 4 groups were divided 19 OECD countries:

Group 1 - 3 of federal - Australia, Canada and the United States and the two unitary - Britain and Japan of the state;

Group 2 – the Nordic countries - Denmark, Norway, Sweden and Finland;

Group 3 – Federated Western European countries - Austria, Germany, Switzerland;

Group 4 – southern and western European countries - Belgium, France, Greece, Italy, Netherlands, Portugal and Spain.

Despite the arbitrariness of this division, budget systems are grouped into certain common features. The first group is characterized by relatively high autonomy of regional and local authorities, based on broad tax powers. The second group - especially the high proportion of non-central government involvement in the financing of social spending. The third - a substantial degree of autonomy of the budgets of different levels, in combination with a developed system of cooperation. Fourth - a large regional financial dependence on central government.

It is assumed that in the future are different models of fiscal federalism will find their names, there will be new classification. Meanwhile, in very general terms one can distinguish two types of models - the decentralized and cooperative.

## **Survey**

Upon further consideration of foreign models of intergovernmental relations focuses on the issue of balancing the budget through the transfer system as example foreign countries such as USA, Canada, Germany, Switzerland and Italy. Share of transfers from the center to the regions of the gross national product in these countries differ significantly. Therefore, in the U. S., with a model based on competition, the figure is 3.7%, insignificantly lower than in Germany - 4.3%, using a model of cooperation. Switzerland, turning to the federal model of organization based on competition, has a slightly higher rate of inter-regional transfers - 4.4%, whereas in Canada the figure is about 3.5%. Qualitative characteristics of each national system of regional equalization cannot be described by the size of transfers between local and regional levels of government. It is therefore necessary to consider how transfers are distributed. In all the systems of the federal budget relations correspond to the principles of subsidiarity (as close as possible to the authorities of the cost to consumers of services) and fiscal independence of the federal level and the subjects of the federation. The main differences are, on the one hand, in the target fiscal equalization, on the other hand, the tax policy.

In the U. S., the arrangement of the tax capacity of the state is not the main goal of transfers between the states. Therefore, there is no horizontal fiscal comparison between strong and weak states in financial terms. Vertical channels of financing are also weakly connected with the financial capacity of the State - the recipient. Financial differences are likely amplified under the influence

of transfers from the federal government: the majority of transfers are allocated on the condition that states and municipalities provide its share of funds. In fact, the states with the largest tax potential and also receive the largest transfers from the federal government. The level of state spending, so closely associated with their own tax base, which results in higher costs prosperous state for education and social security.

A characteristic feature of the American model is the absence of a federal program budget alignment. It is included as a component in some targeted programs, such as, for example, grants to school boards. Support state and local governments through the federal budget is also due to tax expenditures, by which is meant the loss of the federal budget, resulting from exclusion from the tax base for federal taxes of its individual elements. In the first place, graduating to such elements include amounts paid by taxpayers to the budgets of state and local governments in the form of income tax and property tax, as well as funds received by them in the form of interest payments on the bonds of state and local governments. Thus, if a state decides to increase the income tax rate coming into the state budget, the tax base will decrease federal income tax and the federal budget will receive less money. Such loss of the federal budget is in fact financial assistance to states. Estimating the size of financial assistance that will be passed through such channels in the federal budget in 2009, 98.7 billion dollars ([Ministry of Finance USA, 2012](#)).

In Germany, contrast to the U.S., the horizontal and vertical transfers lead to almost complete equalization of differences in the financial security of the Federation. Here, too, there are common problems, as the co-financed by the federal center and the federation. But a regional budgetary alignment plays a major role in determining the ability of the subject to offer a comparable level of federal services. In Germany, for fiscal equalization of land taken for a basis is not necessarily exactly the calculated expenditure need of each land. Based on the fact that the lands which have at their disposal the average per capita income, unable to finance the average cost per capita. Additional expenditure needs should be considered in the case of land with very high or very low population density means a higher estimated proportion of the population.

The total budget alignment land is held in three phases. In the first phase, 25% of revenue from VAT, from which nearly half is attached to the land, shall be apportioned among the lands in need of financial assistance, and the remaining 75% interest in land - in terms of population. In the second phase, followed by transfers to the "rich" lands "poor." Weak land transfers are carried out stepwise as follows: the amount required to achieve 92% of their budget Mittelland level of per capita income comes through the redistribution of sales tax, to achieve a mark of 95% through the provision of compulsory transfers without any conditions, and from 95 to 100 % - through the provision of transfers, differentiated according to the specific financial needs.

In the third phase of the per capita income of land in need of financial assistance, through transfers aligned to the average level of per capita income for the country. For lands with very low population and the so-called "new" land of East Germany recognized the special needs of consumables, which are financed in the form of the Federation of special transfers. Align the budgetary provision of land is mostly indirect, i.e. through the distribution of income from the VAT directly through federal transfers, and to a lesser extent by transfers between the lands. Of the approximately 50% of total revenues from the VAT payable to the budgets of land, 75% are distributed per capita. The rest is distributed among the lands that have a per capita tax revenue lower than 92% of the average per capita tax revenues in all countries.

Federal Ministry of Finance acts as a clearing center for the implementation of the direct horizontal equalization schemes through transfers between the lands. First, on the basis of preliminary estimates of tax revenues have preliminary estimates of transfer payments, and then these data are the sum of the quarterly transfer payments is constantly updated. Later predicted data on tax revenues are replaced by data on actual income for the year equalization schemes and accordingly adjusted the amount of transfers. Thus, the changes are recorded in the tax capacity of the land due to unforeseen structural events or sharp fluctuations in the economy. Any land, experiencing financial difficulties, immediately receives the financial assistance from the federal budget ([Ministry of Finance Germany, 2012](#)).

The system of fiscal equalization of the federal government, Canada has its own characteristics due to the fact that the budget areas - the provinces, in addition to tax and nontax revenues are transfers from the federal budget. Total revenue and expenditures are determined by the transferred financial assistance. It uses two types of transfers: fiscal and monetary. Money transfer is a transfer of funds from the federal budget to the budgets of the provinces. The tax transfer occurs when the government reduces the federal tax rates, while providing the right of provinces to raise their bets on the relevant taxes the same amount.

The volume of transfers and the method of distribution is usually set at 5 years, and funds transfers are reviewed annually. The Government of Canada transfers to provincial transfers in three main programs:

1) On health care and social assistance. This transfer is intended and used to support health care, higher education, social assistance and services to the territories and provinces. Financial assistance for this program is transmitted in the form of tax and cash transfers;

2) To equalize the less affluent provinces in terms of providing public services to the public. This transfer is inappropriate. The transfer is determined by the procedure established by federal law. Originally based on estimates of its income per capita is estimated fiscal capacity of each province. Next, the standard per capita fiscal capacity taking into account the capacity of the five provinces of "middle income". Provinces with a per capita are below the standard potential of transfer for pulling up the average. The procedure for calculating equalization transfers is set for 5 years, the standard potential is calculated annually;

3) The financing of the territorial program. Under this program, a special transfer passed the northern territories (not province), which differ from the provinces that they have much higher costs of providing public services, high rates of population growth and poorly developed tax base. This transfer is non-earmarked and allocated to improve the fiscal capacity of territories ([Ministry of Finance Canada, 2012](#)).

One of the countries to take in 80 - 90 years, significant efforts to reform the centralist model of financing sub central budgets and which had had some success in this case is Italy. In this country there are four levels of government: central, regional, provincial and municipal. Sub central government formed in 20 regions, 99 provinces, and 8100 municipalities. Management sub central authorities by the Ministry of the Treasury (for regions) and the Ministry of Internal Affairs (for the provinces and communes).

Feature of government is to give Italian regions of the country's Constitution the status of "autonomy" and giving them legislative powers in some areas of socio-economic development. This is to some extent closer to the subjects of the Italian federation in federal states, although the legal status of the Italian regions are not identical to the legal status of states in the United States lands in Germany, Canada and the provinces cantons in Switzerland ([Ministry of Finance Italy, 2012](#)).

Despite the relatively high degree of decentralization of government functions, in Italy there is a highly centralized financial and budgetary mechanism for income generation sub central transfer redistribution authorities and government revenue through the central budget. In general, through the channels of the consolidated state budget is distributed in Italy to 48% of GDP.

Office of nationwide tax in Italy is entirely run by the central administration. Local income tax is no exception. Funds from the last budget sent to the central administration and only then transferred sub central authorities through the mechanism of transfer of budget reallocation of funds.

Sub central Italian authorities are in a strong financial dependence on central government budget. According to statistics, in the Italian sub-budgets depend on the budget of the central administration of current income by an average of 25%.

To finance sub central authorities in Italy in the central budget are formed specialized, centralized funds, such as the "National Fund for Health Development," "The National Transport Development Fund", "General Fund", "compensation fund", "equalization fund".

In addition to the funds of central funding, there are several different types of transfers, which are listed sub central authorities of the respective funds. These include: "not due" or "ordinary transfers," "conditional transfers" or "subvention," "governing transfers", "additional transfers", "special transfers" and "emergency transfers."

In Australia, where the Finance higher centralized, are used to align the system of centralized payments identified by the uniform distribution and equalization formula, which aims - to meet the budget requirements of all states to provide uniform nationwide standards for public services. During the 80s in France, was introduced so-called automatic allocation of grants for which funds local teams sent automatically, according to the developed criteria, the same for all teams. Thus, in the field of public transfers has used the principle of a universal approach. Another important feature of the French experience in determining budgetary flows associated with their separation in two directions: on the operation and investment.

The process of allocation transfers between funds and regions in Italy is subject to certain rules. Under current law, the main role in the allocation of central transfers belongs to the central administration. The mechanism of the distribution of transfers is quite complex. In order to obtain the necessary funding for each region in the framework of participation in the budgetary process of the country should at a certain time to develop and submit to the ministry budget package of sectoral programs of the regional nature. These programs should be tailored to the goals and priorities of national economic policy, to consider the possibility of their implementation at the regional level. During program development, consultations with experts of the central government are held. If you agree with the government financing programs for them is "the list" that is, in turn, occupied in the list of the government.

Implementation of the concept of fiscal federalism is based on a combination of two complementary trends - competition between the regional authorities in the market of social services and aligning conditions of this competition, and ensuring the entire country national minimum standards.

## RESULTS

As international experience shows the financial and budgetary practices and provide lever formation of a unified purpose and a common idea of individual regions and provinces, cities and districts, the whole population. Based on this today, when Georgia violated the integrity of the country, the most effective and efficient means for combining the regions is to carry out economic, in particular, such financial, budgetary, tax, customs, credit, payment, etc. policies that encourage all areas, regions, cities, districts, villages, the population of Georgia to the association, including a dance center, will create a unified political, social, economic, cultural, spiritual, and ultimately a national space.

For Georgia, at this stage, the integrity of the country's "classic" of fiscal federalism is the best premature, and such a model, which provides unity and the maximum satisfaction of people's material and cultural well-being. We think that, given this principle should take root in Georgia financial and fiscal federalism. What is the "center" at this stage, again to maintain dominance and should not happen, not only the transfer of financial levers, but touching them as all tier member of the main stem of economic stability in the country - well-known "financial Trinity" (the national currency, the national Bank, State budget present in its unity and separately one of the biggest and most powerful levers unity and creativity. So there should not be allowed no initiative in implementing cash flow, banking policy and the budget process, nor by the "regions" and not from the "center" (Abuselidze, 2004). So Georgia must necessarily have a single powerful Ministry of Finance, which will be in the tax, customs and official life, to be perceived in the same section the system of fiscal federalism, which will be built on the principle: "Fiscal federalism is needed for the future of Georgia and the transfer of a single fiscal rights of the parties is necessary for their normal functioning and organic connection with the center."

Everyone knows that Georgia through a variety of climatic conditions in their regions is a unique country in the world, what would envy, and the country owning vast territories, but it puts its stamp on the national economy of different regions, the development of regional economies. In such circumstances, with the help of local finance State may equate levels of economic and social development of territorial units, which are compared with other regions due to certain historical and natural conditions were among the retarded.

In our opinion, to the regional (local) budget work with the appropriate rights to his device on the principle of fiscal federalism, since this central and regional budgets, distribution of tasks to be undertaken, taking into account your own income send their budgets and take responsibility for the preparation, approval and implementation of the budget.

Based on the foregoing, the socio-economic development of the territorial units of the country is impossible without perfect financial units, which should ensure the economic balance of individual parties.

## **INFERENCE AND RECOMMENDATIONS**

In the socio-economic development of the territorial units of the most important is the division of competences between the center and the regions. We believe competency should be solved in three ways: a) special competence center, and b) issues relating to the special powers in the region (territorial units), and c) issues relating to a single management. Here as it should be noted that the Constitution of Georgia clearly formulated questions, relating to a special central government, but said nothing about the competence of national and its territorial units (Abuselidze, 2006).

In our opinion, such a model is acceptable demarcation of competencies, which will provide the definition of specific competences of central and local authorities, and those powers that are not within the purview of any one of them, refer to the issues of unified management.

In our opinion, the basis for demarcation of the financial powers of the center and regions, we can put two basic principles: according to the first principle must delimit the financial center and the ratio of the region, which is primarily meant for each of them the existence of an independent budget and stable sources of replenishment orders and the possibility of an independent their own finances. But the problem of maintaining the economic balance, which is the guarantor of national independence and the main factor in the socio-economic development, should not fall out of the daily routine. It previous ideology is the basis of the second principle of delimitation of central and regional finance, according to which the state within its territory have to ensure that financial equalization of territorial units, starting with low development, with the average of the country.

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