THE ROLE OF INSTITUTIONS IN SUCCESSFUL FISCAL ARRANGEMENTS: THE CASE OF AUSTRALIA AND ARGENTINA

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Abstract

This paper discusses the role of institutions in successful fiscal arrangements by comparing the fiscal equalization system of two nations, Argentina and Australia. The paper shows that Australia's fiscal vertical and horizontal equalisation model is on the whole simpler, more transparent, efficient and accountable to that of Argentina. The paper also illustrates Argentina's agency problem in fiscal financial arrangements. A major challenge for developing countries like Argentina is to strengthen their institutional matrices. One way of achieving this is through the consolidation of Argentina's institutions. Another is to adopt an eclectic approach to 'institutional matrix' building. Looking at Australia's experience might be the way forward for Argentina's development.

Keywords: Institutions, Argentina, Australia, Fiscal System, Agency Problem

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1. Introduction

The correct functioning of institutions is central to the development of nations and is a major distinguishing feature between developed and developing nations. Developed nations possess a set of established economic and social rules that provide individuals with incentives that promote entrepreneurial drive to foster private initiative, while at the same time ensure that overall governance is consistent with the 'rules of the game' (Todaro and Smith, 2009, p. 77-78).Institutions play a significant role in determining whether transaction costs are low or high and potentially generate a structure of incentives that foster economic growth (North, 1990a). They give shape to property rights and provide markets with an environment where competition can exist and flourish**.** Furthermore, institutions influence the incentives that give rise to efficient economic performance (Acemoglu et al., 2004) and also provide a platform for good governance at government level. In the case of government institutions, when these do not operate efficiently and/or effectively, resources become wasteful and are often seriously misallocated. As a result, who gets services and how revenues are distributed may be poorly allocated. This often gives rise to the mismanagement and control of public enterprises.

Unlike the private sector, government organisations are not driven by the principle of profit maximisation. This prevents productivity maximisation in the public sector, so bureaucrats may respond by acting to protect and expand their own self-interest. This is often done by means of enlarging the size of their bureaucracies, hence, protecting "their own patch". This by and large, enables them to enlarge their perceived authority and reputation of their bureaucratic posts (Stiglitz, 2000). "Government bureaucrats may act in their own interests, and not necessarily in the interests of the citizens whom they are supposed to serve" (Stiglitz, 2000, p. 202). This is known as the principal agent problem, a situation which arises when government agents pursue their own goals rather than the goals of the principal, (Pindyck and Rubinfeld, 2009)", in other words, the goals of the citizens. To avoid these problems governments of advanced nations have put in place numerous procedures and constraints that limit the rise of the agency problem.

Both Australia and Argentina are federations and their economic histories have much in common. What seems to separate their relative economic success is the functioning of their institutions. (Esposto and Tohmé, 2011; Gerchunoff and Fajgelbaum, 2006; and Duncan and Fogarty, 1984). This paper addresses the issue of fiscal imbalances by comparing how Australia and Argentina, manage their vertical and horizontal fiscal imbalances.

In this paper, I argue that Australia's fiscal vertical and horizontal equalisation model is on the whole simpler, more transparent, efficient and accountable to that of Argentina. This is largely due to the agency problem which has emerged in the Argentine model as a result of poor administration, accountability and transparency in government relations between different government agents. One possible way of improving the Argentine model is to adopt aspects of the Australian system, in order to reduce wastage, resource misallocation in order to minimise the principal agent problem.

The paper is divided into the following sections. The next section of the paper provides a review of the literature related to defining and classifying institutions. In section three, a comparative discussion related to federal and fiscal arrangements in Australia and Argentina is presented. This is followed by a discussion of the problematic of the agency problem and asymmetric information in relation to federal fiscal arrangements. Section 5, provides a conclusion and a discussion of areas for further research in relation to governance and institutional theory.

2. Literature Review: The Role of Institutions in Economic Development

The interest of New Institutional Economics (NIE) in institutions has arisen from the realization that they influence the incentives that give rise to efficient economic performance, particularly at government administration (Acemoglu et al., 2004). Institutions are crucial in determining whether transaction costs are high or low. They alsocreate structures of incentives that generate and foster economic growth (North, 1990a). They give shape to property rights and provide markets with an environment where competition can exist and flourish**.** For example, without the existence of property rights, individuals could not invest in human or physical capital, develop or adopt new technologies or implement new ideas. Another important function of institutions is that they help allocate resources in the most efficient way by determining who gets profits, revenues and residual rights of control (Acemoglu et al., 2004, p. 2). When economic institutions do not allow markets to flourish, as in the case of the Latin American dictatorships during the 1970 and 1980s, resources were poorly allocated. On the other, hand, societies with economic institutions that enable innovation and the efficient allocation of resources are more likely to prosper. Institutions can flourish in environments where good governance is allowed to exist. This condition, hence, allows for the development and evolution of 'good and strong institutions'. When institutions are allowed to flourish, develop and evolve, the end result is sound economic performance and development (La Porta, 1999, p. 233). Conversely, when institutions are not allowed to evolve and flourish, this can have a regressive impact on the development of nations (e.g. the Soviet bloc prior to 1989 and Latin American nations under dictatorial regimes). Ali (2003, p. 350) argues that institutions that operate successfully will provide a setting that will have a substantial impact on economic growth, while poorly functioning ones will hinder it by inducing economic agents to engage in redistributive behaviours that hinder growth.

Institutions matter because they help solve a key economic problem of agents coordinating their economic plans and activities:

> [they] promote cooperative behaviour and overcome opportunism; make agents internalize externalities, and reduce uncertainty. They support the formation of social capital and of a historical experience of collective action which, in turn, positively affect the likelihood to credibility commitment in cooperative strategies (Gagliardi, 2008, p. 419).

Defining institutions

There is a strong consensus emerging that institutions play an important role in shaping the growth and development of nations. A body of work in the social sciences points to their role in promoting economic change and sustainability (Gagliardi, 2008, p. 416). Furthermore, they offer the justifications that explain differences in growth rates and development paths across developing and developed nations (Jutting, 2003). Many economists and other social scientists have put forward the notion that good economic institutions, particularly in the public sector, are crucial and instrumental to generating both economic growth and development (La Porta et al., 1999, p. 222).

Even with these realizations, the meaning of the term "institution" varies in the literature. Social scientists have not arrived at a definition that can be regarded as widely accepted, mainly due to the fact that a unified theory of institutions does not currently exist. As a result, defining institutions becomes a complex undertaking. Definitions abound, many of which are narrow, overarching or vague, while others confine themselves to describing organizational bodies. Institutions are not homogenous, they vary in shape, size, importance and role, they are not easily transportable or transferable (almost impossible in the case of informal institutions[14]) from country to country or from one region to another, and they differ significantly not only between developing nations, but also on the whole with those of developed nations. Institutions are difficult to define because they include the written laws and rules of a society, formal and informal norms and manners of behaviour, and distinct and varied beliefs about how the world is actually interpreted.

Gagliardi (2008) classifies definitions of institutions in three categories. The first category considers institutions as the *rules of the game* as described by North (1990a). The second classification is that of Nelson (1994) who defines institutions as the *players participating in the game*. This definition considers the role of those who have to apply the rules and ensure that those participating abide by them. Examples include universities, industry groups, government agencies and hospitals. Finally, the third definition considers institutions as

[14] Perhaps one exception to this rule would be norms, traditions and customs found in diasporas.

the *self-enforcing equilibrium outcome of the game*. Under this definition, they consist of two interrelated elements: the beliefs individuals form of other players and the organizations, which alter the rules of the game (Gagliardi, 2008, p. 417).

The last definition is closely linked to Aoki's "self-sustaining systems of shared beliefs" (2001, p. 10), mapping out not only the rules of the game but also the way in which it needs to be played. Notice that a component missing in the second and third definitional classifications is that organizations and institutions are not distinguished or delineated and hence it appears that both are the same thing.[15]

Given this proliferation of interpretations, it is convenient to keep a consistent view for the purpose of this analysis. This has been attempted by one of the main authors in NIE, Douglass North. According to him (1991), institutions are:

> the humanly devised constraints that structure political, economic and social interaction. They consist of both formal and informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights).

This definition is further explained by North as "the rules of the game in a society or, more formally … the humanly devised constraints that shape human interaction" (1990a, p. 3). This concept provides a roadmap indicating how human beings interact with each other as individuals or as social groups, and in political, social or economic exchange processes. North's definition is intrinsically historical in suggesting that much of the development of nations has been shaped by historical decisions (correct or otherwise), thus placing path dependence at the centre of institutional evolution:

> But economic history is overwhelmingly a story of economies that failed to produce a set of economic rules (with enforcement) that produce sustained economic growth. The central issue of economic history and of economic development is to account for the evolution of political and economic institutions that create an economic environment that induces increasing productivity (1991, p. 98).

North's view of institutions is twofold. Firstly, history matters because the process of institutional theory is incremental and path dependent. Secondly, institutions impact on economic performance by influencing the level of transaction costs. If correctly implemented, institutions are potentially capable of reducing uncertainty and providing a setting in which individuals and organizations can engage in economic transactions in such a way that transaction costs[16] are minimized and profit maximization is ensured.

Nevertheless, the view of institutions as the rules of the game has a striking limitation. Such a definition appears hazy, encompassing a spectrum ranging from social and religious practices to rules of behaviour to physical coercion (Portes, 2006). It renders the concept unclear, lacking concreteness and open to a wide variety of interpretations.

In trying to put order into such open-ended definitions, some authors have attempted to define institutions by creating categories or distinctions of different institutional forms. Hollingsworth (2002) classifies them into institutions, institutional arrangements, institutional sectors, organizations and outputs and performance. As an overarching classification, institutions are classified as norms, rules, conventions, values and lifestyles, among other things. Institutional sectors are arranged as markets, states, corporate hierarchies and networks and are compiled as financial systems, systems of education, health systems and business systems, while organizations and outputs and performance are often concerned with deliverables such as quantity and quality of products produced or provided. A limitation with this is that such taxonomies tend to be ad hoc and often lack clarity, creating much confusion by putting together different elements under the same category (Portes, 2006, p. 235).

Another approach is to separate institutional definitions into *formal* and *informal* rules. Typically, formal rules are written down, while informal rules tend to supplement these. Both pose constraints on society. As detailed by Jutting (2003), formal rules and constraints consist of constitutions, laws, property rights, charters, bylaws, statute and common law, regulations and enforcement characteristics (sanctions). Informal rules are extensions, elaborations and modifications of formal rules, socially sanctioned norms of behaviour (customs, taboos and traditions) and internally enforced standards of conduct (p. 11). Both formal and informal rules exist in developed rich and underdeveloped poor nations. In less developed countries and regions characterized by isolation and poverty, informal institutions (or communally understood arrangements) tend to substitute formal institutions**.** This is often because no formal ways of enforcing norms are available, while departures from socially sanctioned customs and ways are more easily dealt with (or punishable) in small groups. As societies develop and the number of agents (individuals or organizations involved in economic and social transactions) increases, market transactions

[15] North et al. (2007) make a distinction between institutions and organizations; however, the distinction seems rather unclear.

[16] Transaction costs were introduced by into economics Ronald Coase. They involve all the costs incurred in making exchanges, such as searching, bargaining and enforcing costs (Williamson, 1985).

become more complex. This requires higher levels of formal sets of rules.

Williamson (1985) provides a classification of institutions based on the formality of institutions. This consists of four hierarchical levels as detailed in Table 1.

The higher level imposes constraints downwards while a mechanism of responses is present and acts upwards from the lower to the higher level. The purpose of these institutions at each level is to define how society regulates its own operations. Level 1 institutions exert influence on the design of property rights, namely, level 2 institutions. Level 2 institutions are concerned with the rules of the game. They define and enforce property rights and often require a legal system for defining laws and enforcing them. Level 3 institutions are concerned with issues of governance. They craft order and reshape incentives, thereby building the governance structure of a society and leading to the building of specific organizations such as national or state governments, NGOs etc. At the bottom of the hierarchy are level 4 institutions which define the extent to which adjustment occurs through prices and quantities and determine the resource allocation mechanism. In this type of structure, rules are easy to change modularly. For example, changes to the social security system, rates of taxation and by laws can be changed without affecting levels 1 and 2.

Table 1. A hierarchical based classification scheme for institutions

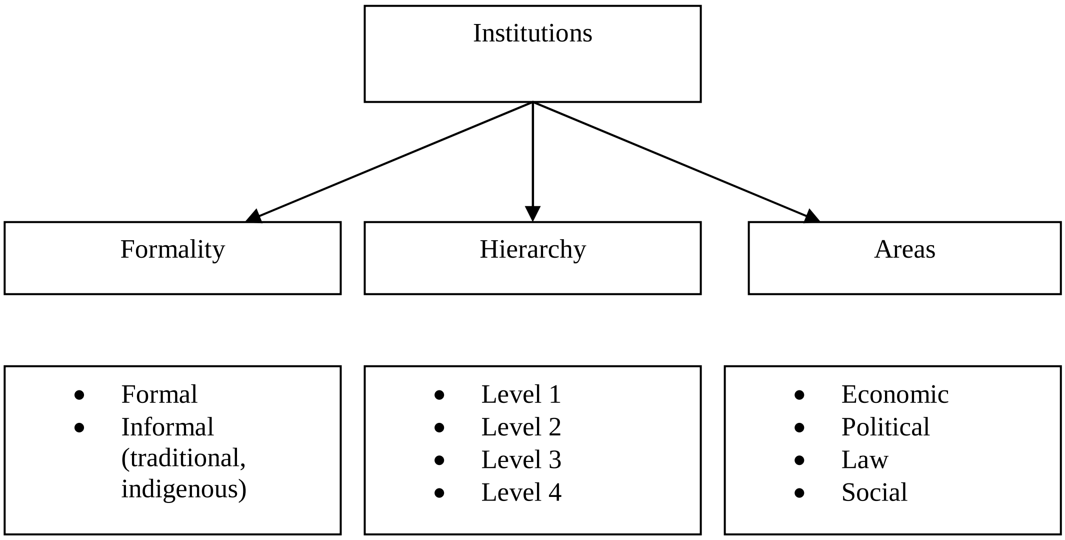
Level	Examples	Frequency of change	Effect
Institutions related to the social structure of the society (level 1)	Mainly informal institutions such as traditions, social norms, customs Exogenous	Very long-term horizon (100 to 1,000 years) but many changes also in times of shock/crisis	Defines the way a society conducts itself
Institutions related to the rules of the game (level 2)	Mainly formal rules defining property rights and judicial system Exogenous or endogenous	Long-term horizon (10 to 100 years)	Defines the overall institutional environment
Institutions related to the play of the game (level 3)	Rules defining the private business governance structure of a country and corresponding contractual relationships, e.g. business contracts, ordering Endogenous	Mid-term horizon (1 to 10 years)	Leads to the building of organizations
Institutions related to allocation mechanisms (level 4)	Rules related to resource allocation, e.g. capital flow controls; trade flow regimes, social security systems Endogenous	Short-term horizon and continuous	Adjustment to prices and outputs, incentive alignments

Source: Jutting (2003, p. 12).

An alternative way of classifying institutions is to differentiate them by their scopes. Jutting (2003) classifies them into four categories. *Economic* institutions deal with the allocation and distribution of resources and the functioning of markets. *Political* institutions are concerned with details about elections, electoral rules, political institutions, party composition of government and opposition, and political checks and balances. *Legal* institutions deal with the type of legal system, and the definition and enforcement of property rights. Finally, *social* institutions deal with issues related to rights to access such as health benefits, education and social security arrangements.

Figure 1 summarizes the ways in which concepts used in defining institutions are organized.

Figure 1. Ways of classifying institutions



Source: Jutting (2003, p. 14).

Theorizing about institutions

Economists, historians, sociologists and political scientists have developed numerous theories of institutions. La Porta et al. (1999) divide these into three main categories: economic, political and cultural.

Economic theories of institutions suggest that these are created whenever the social benefits of doing so exceed the costs of not having them (North, 1981). Property rights over natural resources are created when these become scarce, and when the costs of enforcing such rights fall below the benefits. Governments will tend to protect private property when the returns to such protection exceed the costs. Implicit in this theory is that institutions are efficient, and that the problem is due to their absence. This does not take into account the existence of inefficiently performing institutions, which inevitably result in inefficient government, of which there are many examples in economic history and development studies. Acemoglu et al. (2004) argue that economic institutions are endogenous and are created as a result of the cooperative decision making of a society designed to respond to economic change. Typically, decisions about how to shape institutions will have an impact on the rest of the society and on particular groups who are affected by those institutions. As a result, conflicts occur between social groups. The group with the most political power will have a stronger say as to which form the economic institution will take (p. 3).

A second group of theories of institutions is *political*. These generally state that institutions and policies are shaped by those individuals or groups of individuals who are in power in order to protect their own interests and to amass influence, power and wealth. The role of government becomes a means of controlling assets and people, converting this control into more wealth. Marxist economists and sociologists take this analysis further, arguing that societies are divided into social classes and policies are designed by those in power or ruling classes to either maintain their privileges or improve them. It can also be argued that, just like economic institutions, political institutions are endogenous, because they are determined or created by social, political, economic and cultural influences of society (Acemoglu et al., 2004, p. 5).

The final group of theories is those formed as a result of *cultural* influences. This group emphasizes the idea that different societies have different values, embodied in preferences and beliefs, because of different shared experiences. Culture is seen as a key determinant of those values. As a result, these differences play a key role in shaping economic performance. Two of the best-known exponents of this theory are Weber (1930) and Landes (1998) who have argued that the origins of Western economic dominance are due to a particular set of beliefs about the world that are linked to religious differences. La Porta et al. (1999, p.224), following the work of authors including Weber, Landes and Putnam (1993), use religion as a proxy for work ethic, tolerance, trust and other social characteristics that are regarded as crucial in developing efficient governmental institutions. Their findings indicate to a large extent that successful government performance can be shaped by political and cultural factors.

A recent theoretical proposition that attempts to amalgamate economic, political and cultural factors as determinants of efficient institutional (government) performance is proposed by North et al. (2007, 2006). This suggests that the economic and political success of some nations is closely linked to those institutions that shape their economic, political, religious and other interactions. In trying to understand the historical success of some nations relative to others, the organization of the state is central to the discussion. Organizations are distinguished from societies and are categorized as not being the same as institutions. Instead, they are concrete, “made up of specific groups of individuals pursuing a mix of common and individual goals through partially coordinated behaviour” (North et al., 2006, p. 20).

Organizations are required to perform two specific functions: to act and to make choices. The most important organization is the state, whose main responsibility or function is to provide social order. North et al. (2006, 2007) argue that there are three types of social orders: the *primitive social order* of hunter-gatherers, the *limited access order* (LAO) and the *open access order* (OAO). The evolutionary transition from one order to the next appears to be linear and may be interpreted as being path dependent. These three orders structure society in a variety of ways. The primitive social order is quite limited in that it has no capability to support complex organizations and is considered to have existed before the LAO.

LAO states exhibit a number of characteristics. One is the ability of certain elites (individuals or groups) to seek economic rents by manipulating the legal, economic or political environment for their own self-interest. This manifests itself in the form of market interference by promoting or gaining monopoly power, excess corruption and promotion of certain other privileges. LAOs are classified by North et al. (2007) in three categories. The first, *fragile states*, are those which are unable to restrict violence or maintain social order and hence face severe civil unrest. Iraq, Syria and Afghanistan are some current examples. The second, *basic LAO states*, are those which possess the ability to restrict violence and where the elites are closely tied with the operations and running of the state. Such operations include trade, exploitation of natural resources and provision of public goods such as health and education. Particular rents end up in the hands of elites that are closely aligned with those in power. The final classification, *mature LAOs*, have the ability to support a large variety of organizational structures, including legal, economic and political. Domestic business organizations, NGOs and other non-state organizations are free to operate but competition and entry into markets and mobility is difficult to achieve, as these are often restricted by elites who are closely aligned or embedded with those in power. Argentina and other Latin American countries are regarded as falling into this category, since in many ways they support a variety of more or less autonomous organizations, while corrupt practices allow easier access to their markets.

OAO states, for their part, operate in an environment characterized by economic, political and cultural openness to organizations. Entry and mobility into markets occurs without difficulty or constraints, competition is ubiquitous and the encouragement of thriving markets is commonplace. The OAO state maintains and supports a competitive economy, property rights are clearly defined and competition is allowed to flourish:

> Open access orders maintain their equilibrium by allowing a wide range of economic and social interests to compete for control of the polity. Creative economic destruction produces a constantly shifting spectrum of competing economic interests. The inability of the state to manipulate economic interests sustains open political competition: politicians cannot cripple their opponents by denying them economic resources. The creation of rents by the political system will motivate the economic interests adversely affected by the rent creation to organize politically. Because organizations mobilize and coordinate their members when interests are threatened, open access to organizations of all types, especially economic, helps maintain political competition (North et al., 2007, p. 2007-8).

Australia, along with other nations classified as developed, falls into this category.

Institutional performance: Australia and Argentina

Exactly what role have institutions played in Argentina’s fall from being in the top ten in terms of income per capita at the beginning of the 20th century to 58th in the world in 2011 (IMF, 2012)? Prados de la Escosura and Sanz-Villarroya (2005) argue that institutions have played a major part in this pronounced decline. Institutional instability conditioned capital accumulation and economic growth in Argentina, and as a result the country’s relative position in the world deteriorated. In particular, this instability had a negative impact on the comparison with seemingly similar economies, such as Canada and Australia. While an intuitively sound claim, a major challenge is to measure the extent of the connection between institutions, investment and growth implied here. The authors adopt the methodology of Clague et al. (1999) who proxy institutional stability with contract intensive money (CIM), a measure that indicates how contracts and property rights are complied and secured in an economy. The association between institutional stability (CIM), investment and growth in Argentina indicates that institutional instability had a negative impact on investment. In a counterfactual exercise, the authors demonstrate that a higher value of CIM would have led to relatively cheaper capital goods and this would have caused a higher rate of investment. They conclude that poorly defined property rights held back investment and led to lower economic growth.

A similar view of the role of institutions as a determinant of economic development is put forward by Mitchell (2006). He argues that the state is the best actor to provide collective action in order to coordinate resource allocation when factor endowments are not abundant. One explanation for Australia's economic success has been the role of the state in providing public goods such as infrastructure. Examples include investment in railways and roads for the development of the mining industries, and scientific research designed to improve crop yields in a land lacking good quality soils and well known for its dryness. For the state to provide these goods, its fiscal institutions must be able to tax with a high level of credibility and to borrow sustainably:

State credibility goes to the core of the state's institutional capacity, and thus institutional explanations for development. Fiscal institutions are important physical representations of state credibility. Less credible states are limited by weak fiscal institutions, and compulsion is highly ineffective in collecting revenue (Mitchell, 2006, p. 5).

Prior to Federation in 1901, each Australian colony had its own distinct taxation system, most of which were reliant on customs and excise duties. Customs duties acted as trade barriers, limiting trade between the colonies. These were abolished after Federation. In 1915, Australia introduced a federal income tax, designed to fund the war effort. Similar taxes were already levied by the states. Over a relatively short period of time, this form of taxation became Australia's most important fiscal institution. By the end of the Second World War, legislative changes had been introduced to ensure federal control of taxing powers and further limiting those of the states (Reinhardt and Steel, 2006). Argentina introduced income taxation in 1932, but from the mid-1950s its significance as a fiscal institution began to wane.

Mitchell (2006) argues that a healthy income tax system is a good indicator of the credibility of the state because tax collection requires cooperation from individuals as well as an organized and efficient system. Australia's income tax system is characterized by high levels of voluntary compliance even when it is known by the taxpayer that tax evasion has a low probability of detection. Torgler and Murphy (2004) found that people who trusted the Australian parliament or legal system also had also a high level of confidence in the tax system, and that this confidence had increased between 1981 and 1995. In contrast, according to Mitchell, tax compliance in Argentina is poor and evasion levels are high. Poor tax compliance means that the state is unable to collect its revenues for the purposes of financing projects, and its role as a provider of public goods is severely curtailed. As a result, the state's credibility as a provider of public goods with the population becomes heavily tarnished.

In Argentina the inefficient income tax system makes project funding a difficult task for governments, and its credibility as a serious agent of distribution of resources is further diminished. This is a major problem, and the comparison with Australia shows that both state credibility and institutional capacity have a positive influence on economic development.

3. Federal fiscal arrangements in Argentina[17] and Australia

Australia and Argentina are federations with similar economic arrangements. Federalism, as a form of government and of fiscal administration, is a crucial element in the development of Australia's and Argentina's economy and society. Both have relatively small populations living in large and sparse areas of land. This is more so for Australia than Argentina, but nevertheless both nations in comparative terms have relatively low concentrations of population other than in their major metropolitan centres. Australia's federal system is made up of three levels of government, namely, federal (or Commonwealth), state and local. Argentina's government structure is quite similar, in that it is organized in terms of a central federal government, provinces and municipalities.

A common feature of federal systems around the world is that of running fiscal imbalances. There are two types of fiscal imbalances, vertical and horizontal. Both Australia and Argentina suffer from such imbalances. Vertical fiscal imbalances arise because different levels of government have different abilities as well as limitations in raising revenues to finance different expenditures. Horizontal fiscal imbalances arise because the states or provinces that make up the federation experience divergent costs in the provision of public goods and services and do not have the capabilities to raise revenues to match these expenditures (Dollery and Worthington, 1996, p. 81). The way fiscal equalization is organized in Australia differs considerably from that of Argentina. Australia has in place a relatively sophisticated, simple and efficient system of equalization that has evolved since Federation. This evolution has come about as a result of the growth in the size of government and demands placed on governments in terms of the provision of public goods.

Much debate exists in relation to the advantages accorded to the Commonwealth to manage the financial intergovernmental relations. According to Matthews and Jay (1997), the debate is basically split into two camps. Some authors place much emphasis on the advantages while others focus on the disadvantages. The main advantage is that it provides the Commonwealth with the fiscal powers for the promotion and maintenance of stability and economic growth. The second advantage is that it provides for a uniform income tax arrangement. This simplifies the

[17]The section on Argentina draws on the work of Saiegh (2007).

administration of the tax system as well as providing uniform treatment of taxation across the states and territories. Critics of the current system argue that it robs the states of the independence required of a federation; it leads to high levels of resource allocation by governments and unnecessarily high levels of bureaucracy and replication; both state and Commonwealth governments of all political persuasions use constitutional areas of dispute to deny responsibility, creating a culture of "blame game" or "passing the buck"; and that many vital services such as education, transport and water are not correctly administered and provided, avoiding jurisdictional responsibility (Mathews and Jay, 1997, pp. 12-13; Bennett, 2008, p. 138).

Grewal (1995) argues that vertical fiscal imbalances are a serious problem for the functioning of Australia's federal system. He shows that although by conventional measures these may have improved prior to 1995, their impact on the states' tax structure has worsened. Since the Second World War, argues Grewal, the states have become heavily dependent on payments by the Commonwealth. Furthermore, these payments have not provided a practical or feasible means of revenue for the states.

Bennett (2008) argues that Section 96, a last minute addition to the constitution designed to deal with issues of financial emergency, began to be used for "top up" payments to the states. This practice began as early as 1910 when the Commonwealth provided a grant to Western Australia. In the 1920s, South Australia sought special assistance from the Commonwealth. Given the demand for extra grants from the states, the Commonwealth in 1933 set up the Commonwealth Grants Commission which is required to recommend how the Commonwealth's purpose grants are to be distributed among the states and territories. The so-called equalization principle was applied to the states under Section 96 so that they could request further financial assistance from (Hancock and Smith, 2001, p. v). During the Second World War the Commonwealth government took over all the income taxes levied by the states and created a uniform income tax system. The transfer of the states' largest tax base to the Commonwealth forced it to make larger grants to the states and the structure of Commonwealth payments to the states and local governments took different shapes, namely, general purpose payments and specific purpose payments. These are detailed in Table 2.

Table 2. Structure of Commonwealth payments to state and local governments

Name	Examples	Description
CURRENT GRANTS General revenue assistance	Tax sharing grants Special revenue assistance Financial assistance grants Tax reimbursement grants GST revenue grants	Payments made to the states for purposes of recurrent budget support with essentially no constraints as to manner of expenditure
Specific purpose payments – recurrent	Large number of payments in functional areas	Effectively Commonwealth own expenditures, but delivered through taxes
CAPITAL GRANTS	General purpose/specific purpose capital	Funds provided for capital purposes. General purpose discontinued now.
ADVANCES	Loans from Commonwealth to states payments for asset purchases	

Source: Hancock and Smith (2001, p. 2).

The states receive the general purpose payments from the Commonwealth and spend them according to their wishes. Specific purpose payments on the other hand are required to be spent subject to specific conditions.

The election of the Whitlam government in 1972 saw the introduction of fundamental reforms. Many of these reforms have been seen as controversial in terms of Commonwealth and state relations. Whitlam regarded the Australian constitution as outdated and in need of much reform (Bennett, 2008, p. 130). His government introduced a statute which ensured that the concept of equal fiscalization principle was enshrined into legislation. States could still request special assistance by entering into deals with the Commonwealth.

The Fraser government elected in 1975 made further changes winding back Commonwealth grants to local governments and took steps to strengthening fiscal equalization. The structure of grants to the states became more stable in the 1990s and general revenue assistance was matched to inflation and population growth (Hancock and Smith, 2001**).**

The Fraser government was replaced by the Hawke (later Keating) government in March 1983, which lasted just over 13 years. The new government had high expectations of solving Australia's economic problems, caused by high inflation and unemployment, high interest rates, increasing international debt and large current account deficits. However, according to Matthews and Grewal (1997), the government acted like "ultra-conservatives with their policies closely resembling those of the Thatcher and Reagan regimes in the UK and the USA respectively" (1997, p. 790). It was characterized by microeconomic reform designed to improve efficiency and competition between the public and private sectors, with the states and the Commonwealth governments working closely through the Special Premiers' Conferences and later the Council of Australian Governments (COAG). Another important reform was the deregulation of the financial system, which included the floating of the Australian dollar and the privatization of the Commonwealth Bank (Matthews and Grewal, 1997, p. 794).

The Howard government, elected in 1996, introduced a broad based goods and services tax (GST) in 2000. The effect of this was the abolition of numerous inefficient state taxes and reductions in income tax. All GST proceeds go to the states and this has had the effect of abolishing Financial Assistance Grants. Constitutionally, however, the Commonwealth has the power to change any arrangements made unilaterally.

Although the vertical financial structure of Australia has been criticized due to its vertical imbalance, a major drawback of moving away from this system is that it would take away the concept of equity of individuals residing in different states. As Hancock and Smith conclude:

> While an appropriate equalization system is a necessary but not sufficient condition for attainment of broad-based horizontal equity, it appears that the current system makes an important contribution to horizontal objectives (2001, p. 102).

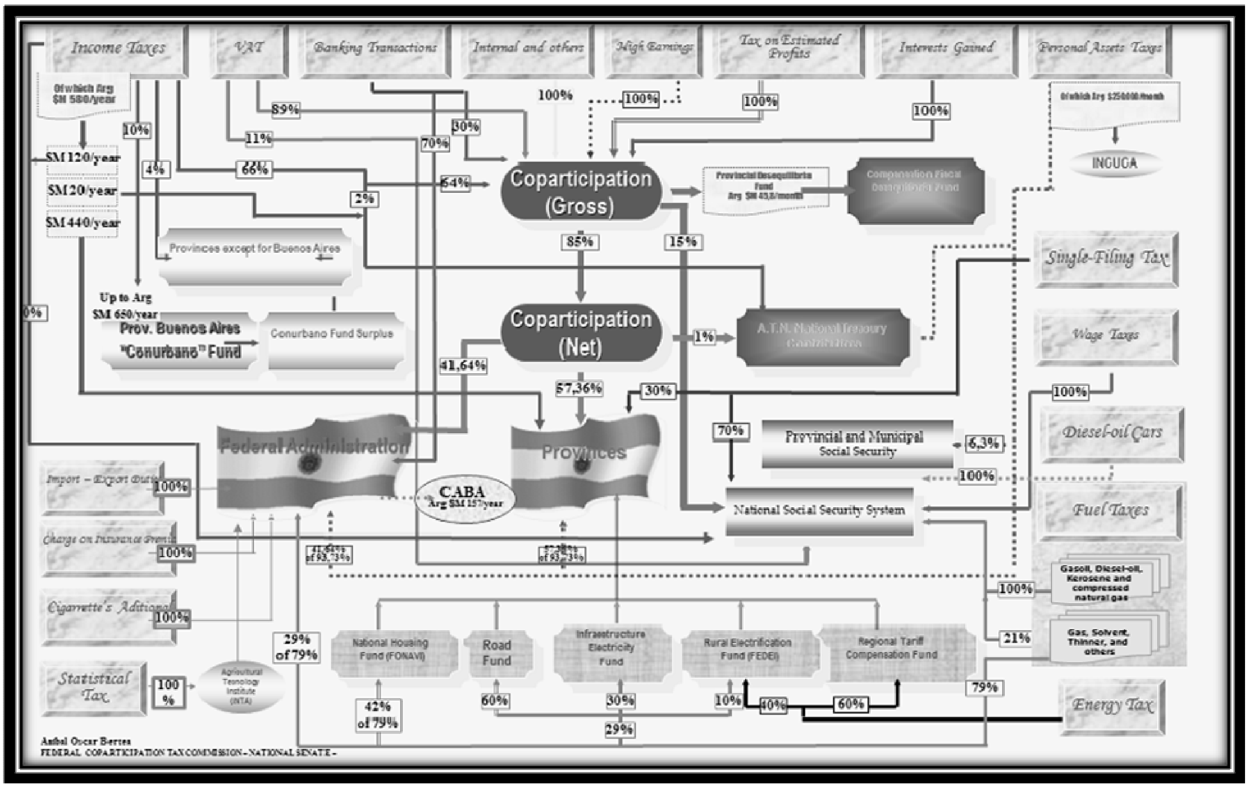
Australia's federal system continues to evolve. COAG has implemented a new framework for federal financial relations. The aim is to modernize payments for specific purposes and drive the economic and social reforms pursued by the Rudd government elected in 2007. The COAG agenda comprises the following goals: deliver better services for all Australians, wherever they live; address social inclusion, including in respect of homelessness and Indigenous disadvantage; develop human capital; increase labour force participation; build national productivity; reduce costly waste and duplication in service delivery; create more effective markets for resources; increase international competitiveness; move towards a seamless national economy (Commonwealth of Australia, 2009, p. 8).

Argentina's current federal system of governance evolved after it formed its first autonomous government in 1810 and later formalized its independence from Spain in 1816. Until the federal republic was created in 1853, there were violent struggles over the shape and form that the constitution should take. Modifications were made in 1860, giving the provinces autonomy on how they administered their territories. The federal government still retained the power to intervene in the provincial territories (Saiegh, 2007, p. 91). Some changes have been made to the constitution, but in essence the spirit of its functioning remains relatively the same. The Argentine republic consists of 23 provinces and the autonomous city of Buenos Aires, which is also the national capital. Each province is self-governing, with its own constitution and elected governor and legislature. According to Saiegh

> The vertical imbalance is not only large but also asymmetric among the provinces. Fifteen … provinces finance less than 30 percent of their spending. Argentina addresses this fiscal imbalance through a complex system of intergovernmental transfers. Its most important component is the tax sharing agreement, called coparticipación (2007, p. 97).

The Argentine constitution stipulates that much of the tax collection occurs at the subnational level. The provinces, however, have allowed much of the practice of revenue collection to fall under the responsibility of the federal government. For example, 83 percent of total tax revenues are collected by the federal government. This contrasts with only 17 percent for the provinces and an insignificant 0.4 percent at the municipal level. In spite of this imbalance, the provinces and municipalities are responsible for spending nearly half of all public sector obligations (Saiegh, 2007, p. 96).

Figure 2. Argentina's Coparticipación labyrinth



Source: Saiegh, 2007, p. 99.

Discussion: Saiegh's Labyrinth, the Agency Problem in Fiscal Financial Arrangements

Argentina's fiscal and tax transfer systems are characterized by their complexity and their lack of clarity and transparency. It has been termed the "federal fiscal labyrinth" because of its unintelligibility and intricacy. In trying to explain its convolution, Saiegh constructs a diagram consisting (Figure 2) of 20 rectangles, eight irregular octagons, three ovals, countless lines and arrows, together with other geometrical figures – all of this in order to explain the complexity of the *coparticipación* labyrinth. This complexity and lack of clarity embedded in the fiscal transfer system has led to much criticism, particularly by international agencies, such as World Bank and the IMF (Saiegh, 2007). Figure 2, highlights numerous systemic deficiencies, including: high deficits, increasing indebtedness, and procyclical finances of provincial governments; bailouts carried out to rescue financial mismanagement in many provinces; poor provincial and national tax collection; distortive national taxation; highly distortive provincial taxation; inefficiencies in the fiscal mix and difficulties for national fiscal adjustment; Inefficiencies in the provision of local public goods; insufficient capital spending by the provinces (Saiegh, 2007, pp. 98-100).

Saiegh's Labyrinth provides a good example of the institutional challenges and difficulties faced by many developing nations, particularly as it relates to the organization of their governance institutions. The Argentine system's high level of complexity is characterized by asymmetric information between government agencies, thus giving rise to the agency problem in governance. These asymmetries arise out of a lack of transparency and accountability between agents emanating from the distortion and withholding of information between government agencies. This lack of transparency generates a perception, according to Transparency International (2011) of higher levels of corruption in the Argentine government system. For example, in 2006, according to the Corruption Perception Index (CPI) Argentina was ranked as the 93rd most corrupt country in the word, with perceived corruption having risen to the lacklustre achievement of the 100th most corrupt country in the world, equaling countries such as Gabon, Indonesia and Madagascar, among others. Compare this to Australia and New Zealand being ranked as the 9thand least corrupt country in the world, respectively.

An explanation for this poor performance is that these agencies are often run by bureaucrats who ensure that their self-interests come before the very people they are required to serve, namely, Argentine citizens. This has the effect of increasing transaction costs. These costs are associated with ensuring that the government sector operates efficiently and to the benefit of its citizens (Stiglitz, 2000, p. 318). As a result of this, government resources are misallocated thus generating market distortions emanating from the incongruent and inept distribution of government resources. This creates serious points of tension between citizens and government officials, giving rise to questions of the legitimacy of the system hence, generating disrespect, illegitimacy, and lack of trust for government officials. As a result this brings the whole system of Argentine governance into disrepute, creating negative spillover effects articulated in the form of lack of trust by international agencies such as the United Nations and the World Bank and by potential international investors who find Argentina as a difficult place to do business.

In spite of these governance difficulties, Argentina remains a nation that performs quite strongly relative to many other developing nations. It is important to remember that Argentina ranks 45th in the Human Development Index rankings, noting that the first 25 positions are occupied by highly developed economies. The pertinent question to ask is how much better Argentina would be if its transfer system and other governance arrangements were organized in a more transparent and efficient manner. Perhaps, the best model to follow, would be to look at arrangements found in nations that possess similar economic attributes. One such model, in spite of its imperfections, in my view, is Australia.

A roadmap for improvement and change: disentangling Saiegh's labyrinth

In order to disentangle Saiegh's labyrinth two key ingredients are required: transparency at every level of government and 'good governance'. The United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) defines 'good governance' as the "process of decision-making and the process by which decisions are implemented (or not implemented)" (UNSECAP, 2012). For good governance to operate effectively and efficiently UNESCAP presents 8 key elements or characteristics. These characteristics are a good starting point to begin a process of "good governance" in Argentina.

Participation: Participation needs to be both broad and inclusive and needs to allow men and women to participate directly or through intermediate institutions or representatives. This form of participation requires that people have access to information and must be conducted in an orderly manner.

Rule of law: Strengthening existing legal frameworks in order to assist the smooth and transparent operation of legal institutions. This implies impartiality and enforceability of rules and laws so that these are implemented fairly and objectively in each of its jurisprudence.

Transparency: is required to create a culture of transparency at every level of government, including the private sector. This means allowing citizens the ability to access information that relates to every level of governance. It suggests openness and understanding of how rules and regulations are implemented. It means creating mechanisms for the open availability and accessibility to information and decisions, especially to those who will be directly affected by norms and regulations (new or existing). Reducing and minimizing red tape is also a means of providing transparency and efficiency, particularly as it relates to the public sector.

Responsiveness: 'Good governance' must ensure that institutions and processes meet and serve the needs of stakeholders, and that issues raised by stakeholders are dealt with within a sensible period of time.

Consensus oriented: Societies possess a wide range of views and stakeholders. Thus for 'good governance' to flourish, it is important that mechanisms for mediation and conflict resolution are set in order to arrive at a broad consensus that benefits society at large, thus avoiding a 'winners and losers' situations. This allows for the creation of sustainable societies where both the rights of individuals and minority groups are respected. This will help to guarantee 'sustainable human and social development'.

Equity and inclusiveness: Argentines need to be encouraged to participate and made to feel that they are included in the process of governance. This requires broad participation of different groups, particularly the most disengaged and most vulnerable. Fortunately, democracy in Argentina continues to evolve, especially since the role of the military as an alternative form of governance appears has lost any form of credibility as a result of its violent and incompetent past.

Effectiveness and efficiency: The role of institutions is to provide 'good governance'. To that end, Argentine institutions need to produce results that benefits society as a whole by reducing wastage, corruption and government inefficiencies.

Accountability: Accountability is an essential element for good governance and needs to be embedded in the Argentine political culture. Both government and private institutions and organisations in a civil society are required to be accountable to their stakeholders. In order to make accountability work effectively and efficiently the elements of transparency and the rule of law need to be operating in good order and reviewed on a continuous basis. As a result, accountability processes will be allowed to flourish and evolve into efficient and effective forms of accountability.

While the above characteristics will not be easy to implement overnight, a good look at how the Australian system of governance operates, can serve as a good model of governance.

Conclusion

Australia has often been described as "the lucky country". Much of its luck however, has not been a coincidence, or fluke, or as a result of some form of divine intervention, but rather the product of the implementation of visionary ideas generated by the fathers of Australian Federation, who developed strong institutions. A key to their success can also be attributed to the creation of solid mechanisms of review of process and administration, of checks and balances that has allowed these institutions to evolve and flourish over time to deal with the challenges posed, as North describes, 'the non-ergodic world', that is, a world that is continuously changing and uncertain in nature.

The economic development of nations does not follow a linear or a smooth pathway. This is particularly so for nations that have experienced periods of strong economic instability resulting from dictatorships and lack of respect for economic and democratic institutions. This unfortunately, has been the case for Argentina and the majority of Latin American nations. A major challenge for countries like Argentina is to strengthen, as North argues, their institutional matrices. One way for achieving this is through the consolidation of Argentina's democratic, social, economic and financial institutions. The other, is to adopt an eclectic approach to 'institutional matrix' building. One way, of doing this, is by looking at the experience of countries like Australia and adapting their successful experiences to the Argentine context. This requires both institutional and "fiscal reforms to reduce the enormous gap between the requirements and the available resources … needed to build states that are able to respond to the development challenges". (OECD, 2012, p. 10).

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