

## Fiscal federalism

Richard M. Bird  
University of Toronto

*The analysis of the problems that give rise to, and arise from, the existence of more than one level of government within the same geographical area.*

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As originally developed by Musgrave (1959) and Oates (1972), the “theory of fiscal federalism” concerns the division of public-sector functions and finances in a logical way among multiple layers of government (King 1984). Much of the literature of fiscal federalism consists of relatively unrelated treatments of such issues as the “decentralization theorem” (Oates 1991), models for the assignment of powers (McLure 1993), discussions of intergovernmental spillovers and intergovernmental grants (Break 1980), fiscal mobility and migration (Wildasin 1991), and vertical fiscal imbalance and dependence (Hunter 1977). The theoretical discussion of local public goods that has taken place in the context of the Tiebout model (Wildasin 1986) is not part of “fiscal federalism” as defined here because it is concerned only with governmental relations at the same jurisdictional level. A more general, and relevant, theoretical framework to approach some of these problems might be the theory of overlapping clubs (Cornes and Sandler 1996), but as yet this has been little developed (Casella and Frey 1992).

Initially, stabilization and distribution were considered to be essentially “central” functions, with the only role for “subcentral” (state and local) governments arising in the allocative sphere. From this perspective, the main analytical task of fiscal federalism is to define the appropriate functions and finances of local governments as efficiently as possible—that is, in such a way as to maximize community welfare (often represented, for analytical convenience, by the Median Voter Theorem). In a territorial variant of the Benefit Principle, it was suggested at an early stage that each jurisdiction could be most efficiently mapped in terms of the spatial dimension of the services it provided. Thus, there would be “local public goods,” “state public goods,” and “national public goods,” with the presumed beneficiaries of each financing their provision in an appropriate way (Olson 1969). In practice, the overlapping and multidimensional nature of most public-sector activities makes it difficult to apply this approach very rigorously, particularly because few lower-level governments have sufficient

own-source revenues to finance the services logically assigned to them.

Given the greater interjurisdictional mobility of the base of the income tax relative to that of the consumption tax, and of the latter relative to that of the property tax (and the efficiency problems arising from tax exportation, when not precisely offset by benefit spillovers), most analysts suggest that the local public sector should be financed basically by user charges and “local” taxes, especially the property tax, and states by consumption taxes, with the income tax being left largely to the central (federal) government (Musgrave 1983). But this division of revenues means that state and local governments are likely to end up with greater expenditure responsibilities than can be financed from their own revenues. An important element of fiscal federalism from the beginning has thus been recognition of the probable need for intergovernmental grants to close the revenue gap. Considerable attention has been devoted to the appropriate design of such grants (Wilde 1971; Ahmed 1997), as well as to empirical analysis of their effects on local spending patterns (Gramlich 1977; Rubinfeld 1987).

The theory of fiscal federalism applies as well, or as badly, to local service units in a metropolitan area as to states in a federation. In principle, however, there are important analytical and policy differences, not only between local-metropolitan problems and federal-state problems but even between “tight” federations such as Germany and “loose” federations such as Canada—with the United States somewhere in between (Bird 1986). These differences arise in part from the differing nature and rigidity of the constraints imposed by political institutions. The question has attracted considerable attention in recent years, in part because of the emergence of nascent “federal” institutions in the European Union. However, fiscal federalism has little to say as yet about the dynamics of institutional change in emerging (or disintegrating) federations. Moreover, it offers little guidance in dealing with such important real-world intergovernmental finance problems as the appropriate size and scope of operation of local and intermediate-level governments in the newly emerging countries of the former Soviet bloc (Bird, Ebel, and Wallich 1995), where, for example, the potential impact on stabilization (Gramlich 1987) is a major concern.

In contrast, much good work has been done within this analytical framework on some of the problems arising from the common metropolitan area situation of divided political jurisdictions within an economically integrated region. A structure that puts people’s places of work and residence

in separate political jurisdictions, while making the latter primarily responsible for the most important local expenditure, education, has obvious implications for both efficiency and distribution (Wildasin 1986), as has been much explored in the literature on education finance. There is still much to be done, however, to satisfactorily explain local redistributive policies (Tresch 1981)—through, for example, education—and their impact on migration and other important economic variables (Wildasin 1991).

Much has been written about the virtues of decentralized government, from both a political and an economic perspective (Tullock 1994), but most of these supposed virtues can, in the conventional fiscal federalism framework, be achieved as well by regionally based central officials as by locally elected politicians. Perhaps some of the answers lie in the new “supply-side” theories of government (Breton 1996) that are beginning to be developed in the broad “public choice” framework (Mueller 1992), because there is considerable similarity between the assumptions underlying public choice theory and federalist theory (Ostrom 1971). As yet, however, little progress has been made with respect to articulating these arguments in either normative or positive terms in the conventional fiscal federalism analysis, other than as simple assertions.

Nonetheless, some important lessons have emerged from the fiscal federalism literature (Inman and Rubinfeld 1997). In particular, considerable progress has been made with respect to the appropriate assignment of tasks and finances in multilevel governments, especially with respect to the design and effects of intergovernmental grants (Wildasin 1997). While there is considerable variation in detail from state to state—let alone across countries—on the whole the observed assignment of functions to local and state governments accords broadly with the dictates of theory, with local governments being broadly responsible for “place-specific” services such as streets, water and sewerage works, refuse disposal, and fire and police services. In addition, in the United States, local governments are also generally responsible for providing primary and secondary education, although as a rule with substantial fiscal assistance from state governments; in other countries, education is often provided primarily by intermediate-level (state) governments and sometimes even by central governments. A common pattern everywhere is for one level of government to be involved in delivering a certain service while other levels are involved to varying degrees in financing and regulating it (Ter-Minassian 1997). Work on understanding the desirability and effects of alternative institutional structures of providing particular services is still in its infancy, though.

Local governments rely heavily on property taxes for revenue, while state governments rely on a mixture of sales and income taxes, and the federal government mainly on income (and payroll) taxes. The division of revenues differs in other countries: Although almost everywhere local governments get property taxes and central governments most income taxes, in some countries local income taxes—like national sales taxes—are much more important than in the United States (Owens and Panella 1991). Such taxes are invariably “piggybacked” on national taxes—that is, they take the form of surcharges. Only Switzerland comes close to matching the diversity of the state and local income and sales taxes found in the United States. Most other countries, whether formally federal or not, have much more territorially uniform fiscal systems. Although there is clearly vertical competition between levels of government for revenue, most attention has been paid in the literature to horizontal tax competition, perhaps because as a rule local governments have access only to those revenue sources that higher-level governments do not want for themselves.

Local governments almost invariably depend in part, and sometimes very heavily, upon transfers from upper-level governments to finance the services for which they are responsible. The appropriate level and design of such transfers has been an important concern in the fiscal federalism literature. Some argue, for example, that a system of unconditional fiscal equalization grants is an essential component of an efficient (and equitable) fiscal federal system (Boadway and Flatters 1982). Others assert that there is no place for such transfers (Oakland 1994). The theoretical literature suggests that the only clear efficiency case for intergovernmental payments is to compensate local governments for benefit spillovers to ensure that they provide the optimal amount of the public service in question. In practice, however, virtually no examples of the open-ended conditional matching grants called for by this theory are to be found in any country (Ahmed 1997). On the contrary, most countries (other than the United States) have some system of unconditional transfers intended to equalize some concept of fiscal capacity. Moreover, most conditional matching grants are limited in amount and probably best interpreted in a principal-agent framework (Ferris and Winkler 1991)—that is, as the equivalent of mandated functions being paid for, in large part, by transfers but with some local payment being called for. The latter is to ensure that local fiscal effort is maintained and also that, at the margin, local politicians remain electorally accountable for their actions to their constituents, as well as to the granting authority.

At the policy level, the Advisory Commission on Intergovernmental Relations (ACIR) (1990) carried out pioneering studies on fiscal disparities (sometimes referred to as “horizontal imbalance”), fiscal capacity, and fiscal effort. Curiously, this work has had its greatest policy impact in other federal countries such as Canada, where since 1967 a version of the ACIR’s “representative tax system” concept has formed the basis of the federal-provincial equalization system—which itself was based in large part on a system developed in Australia in the 1930s (and since extended from revenue to expenditure equalization). Similar systems of federal-state transfers, often based on formulas and usually unconditional in nature, are characteristic of most federal countries (Shah 1994). Apart from the brief experience with a small “revenue-sharing” system in the 1970s (Juster 1977), the United States is unique among federal countries in that it has never had a system of federal-state equalization transfers—although there are, of course, many federal-state conditional transfers, as well as some experience with fiscal equalization at the state and local levels.

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*Cross references:* [benefit principle](#); [education financing, state and local](#); [fiscal disparities](#); [fiscal equalization](#); [median voter theorem](#); [tax and revenue effort](#); [tax exportation](#).