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Fiscal federalism

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Fiscal federalism is concerned with the division of policy responsibilities among different levels of government and with the fiscal interactions among these governments. Public service provision by lower-level governments can be efficiency-enhancing, although competition for mobile resources can also interfere with efficient resource allocation both in the public and private sectors. Intergovernmental transfers affect the overall equity and efficiency properties of public policies. Global economic integration and political and economic reforms in developing and transition economies – which have institutional contexts very different from those of the mature federations – present important challenges for a 'second generation' of federalism research.

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The institutional context of fiscal federalism

Fiscal federalism has long been a topic of keen interest in the United States and Canada. In both nations, subnational governments have traditionally played major roles in the provision of important public services, notably in the areas of education, health, social services, transportation, public safety, and economic development. In addition to non-tax revenues, subnational governments in both countries have had significant sources of tax revenues, with state/provincial governments relying heavily on retail sales taxes and taxes on personal and business income and with local governments depending on property taxes. Higher-level governments (national in relation to subnational, and state/provincial in relation to local) have supported the finances of lower-level governments with extensive programmes of intergovernmental fiscal transfers in order to promote the provision of particular public goods and services, to supplement (or perhaps displace) lower-level government taxes, and to advance broad social welfare objectives. Although they are subject to constitutional, statutory, and regulatory constraints, state/provincial and local governments exercise substantial fiscal autonomy with respect to expenditures, taxation and borrowing. National and subnational fiscal policies have been developed and implemented within the context of continuously evolving but fundamentally durable market, political, and legal institutions, underpinned by stable democratic constitutional structures.

There are long-established federations (and long traditions of scholarly research on federalism) in other parts of the world as well, but interest in fiscal federalism has become particularly intense in developing and transition economies since the early 1990s, no doubt in part because of broad reform initiatives that have reduced the role of the state in economic planning and control (Wildasin, 1997a, ch. 2). In many of these countries, constitutional, economic, and political reforms have led to significant decentralization of tax, expenditure, and borrowing responsibilities, often accompanied by the development of new systems of intergovernmental fiscal transfers. In contrast to the mature North

American federations, the newly (or increasingly) decentralized and liberalized economic and fiscal systems of many developing and transition economies are being implemented in the absence of the background political, legal, and market institutions found in more developed nations. The development and restructuring of federations around the world has presented many practical challenges and, for scholars, important questions regarding the design of federal systems, the implementation of fiscal reforms in such systems, and the interactions between basic social institutions and the public sector in federations.

Fiscal federalism is also a subject of increased interest and concern in the European Union. Fiscal decentralization has accompanied economic and political reforms in several European nations. In addition, the interactions of tax, expenditure, debt, and monetary policies among EU member states continuously raise questions concerning international policy coordination and the development of EU-wide supranational institutions. Controversy surrounds the issues of national sovereignty and the upward transfer of powers from national governments to EU executive, legislative, and judicial bodies. In important respects, however, the EU can be viewed as an emerging federation in which EU-level political and fiscal institutions are gradually developing within the context of an increasingly integrated and expanding system of developed and transition economies. From this perspective, the EU itself is a (so far relatively limited) higher-level government in relation to the national governments of its member states.

Fiscal federalism is thus a subject of great interest throughout the world. Wide international variation in the institutional context of federalism has stimulated what Oates (2005) calls a ‘second generation’ of fiscal federalism research, differentiated from ‘first-generation’ research by its heightened attention to political, constitutional, financial and macroeconomic institutions. For example, issues of fiscal discipline, soft budget constraints, and subnational government borrowing, little discussed within the context of traditional federalism research, have received considerable attention in recent years (Inman, 2003; Wildasin, 1997b; 2004), especially with reference to newly decentralizing fiscal systems. Because the policy issues and institutional context of federalism varies widely throughout the world, a rapidly-growing literature deals with fiscal federalism in an international context, often focusing on unique policy issues facing individual countries (see, for example, Bird and Vaillancourt, 1998; Martinez-Vasquez and Alm, 2003; and Rodden, Eskeland and Litvack, 2003, which contain many studies of federalism problems in developing and transition economies).

As the foregoing remarks suggest, problems of fiscal federalism touch upon almost all aspects of fiscal policy, in almost all nations (especially the large nations and economic regions) of the world. The subject is correspondingly very broad. The following paragraphs highlight recurring themes that have occupied researchers for many years as well as selected issues that are likely to be the subject of active enquiry in coming years. The discussion begins with fundamental issues regarding the economic functions of different levels of government, noting their implications for the organization of the public sector. The potential efficiency gains from decentralized policymaking as well as the limitations of decentralization are discussed next, emphasizing the importance of resource mobility and fiscal competition as a crucial feature of the decision-making environment facing lower-level governments. Finally, directions for new research are briefly discussed.

The organization of the public sector

What economic functions can, do, or should be performed by different levels of government? This fundamental question has been a focus of the federalism literature from its inception. There has been a broad normative consensus (Oates, 1972) that, of Musgrave's (1959) 'three branches of the public household,' the highest-level government (normally a national government, but possibly a supranational entity like the EU) should take responsibility for stabilization functions (that is, macroeconomic and monetary policies), that allocative functions (the provision of public goods and services and correction of market failures) should be undertaken by governments whose jurisdictional boundaries are co-terminous with the geographical scope of the regions affected by these policies, and that higher-level governments should be responsible for policies that target the distribution of income. Subnational economies are comparatively more open than national economies, which means that the impacts of stabilization policies are diluted through capital, labour, and financial flows when undertaken by lower-level governments; see, for example, Mundell's (1961) classic work on optimal currency areas. Similarly, the mobility of labour and capital constrains the ability of (small, open) subnational governments to alter the net distribution of income. For example, high taxes on the rich in one jurisdiction create incentives for the rich to locate elsewhere, while the provision of generous cash or in-kind benefits for the poor attracts beneficiaries (Stigler, 1957). In addition to distorting the efficiency of resource allocation, the spatial reallocation of resources in response to local redistributive policies limits the set of feasible policies as well as their impact on net incomes. Lower-level governments may, however, serve effectively to provide public goods and services in the amounts that are most efficiently adapted to local benefits and costs, which normally vary among locations in accordance with differences in demographic composition, incomes, and technologies (Oates's 'decentralization theorem').

Allocative efficiency at the local level

The decentralization theorem shows that non-uniform provision of public goods, varying in accordance with local benefits and costs, may be more efficient than uniform provision. In principle, however, an omniscient and omnipotent central planner could implement optimal non-uniform policies, obviating the need for distinct administrative units of lower-level government. Such a planner could manage all public sector functions (in fact, all economic decisions) for the entire world. A key idea in the literature of fiscal federalism, however, is that lower-level units of government may be better informed about and more responsive to local demands. The *information* needed for efficient decision-making, and the *incentives* to use this information, may differ by level of government, just as markets provide incentives guiding decentralized market decisions for households and firms in ways not achievable, in practice, by central planning mechanisms.

This idea is developed explicitly, if informally, in Tiebout (1956). Tiebout draws the analogy between consumers shopping for commodities in the marketplace and households choosing residences from among a collection of localities. Writing soon after and in response to Samuelson's classic contributions to public goods theory, Tiebout asserts that households reveal their preferences for local public goods when they choose where to reside. Different localities provide different levels of public services, as illustrated by local school districts in the United States that offer different qualities of elementary and secondary education. Households with high valuations for education can outbid others for residences in localities with good schools, thus leading to a sorting of households by demand for public services. According to Tiebout, this matching of demand and supply leads to efficient provision of local public goods.

Tiebout's paper identifies local governments as distinct economic units that can perform important allocative functions in ways that central governments cannot. Tiebout is not specific, however, about exactly how local decision-makers determine public goods levels – whether by voting or through some other mechanism. Many subsequent contributions (see, for example, Wildasin, 1986, for a survey and references), including both theoretical and empirical analyses, explore in detail the phenomenon of 'Tiebout sorting' and the implications of community stratification, by income, race, religion, age and other household attributes, for variation in local public expenditures. Median voter models (and variants thereof) commonly provide a theoretical starting point for empirical analyses of the demand for local public goods. Linkages between housing markets and local fiscal policies, as revealed by hedonic price relationships, suggest that local voters have incentives to support policies that preserve property values. In the extreme, these linkages may obviate altogether the need for households to participate in the collective decision-making process, by providing profit-maximizing property developers and other market participants with the information and incentives to make efficient policy choices, resulting in completely market-driven provision of public goods (Fischel, 2001 discusses land use regulation, property development and their interactions with community formation and local policymaking.)

In addition to the information and incentives that may result from the mobility of households and firms, emphasized by Tiebout, decentralized policymaking may also provide a framework for experimentation and learning about policy alternatives and their consequences as well as for learning about the performance of policymakers themselves (Besley and Case, 1995).

Limits to decentralization: efficiency and distributional considerations

Tiebout's analysis and much subsequent research highlights the potential benefits, especially with respect to the efficiency of public good provision, from competition among lower-level governments for mobile households and firms. The potential disadvantages of fiscal decentralization have long been recognized, however. For instance, the economic service areas for local public goods may not closely match jurisdictional boundaries. Local health, educational, or transportation policies may benefit residents of neighbouring localities or society at large, spillover benefits that local decision-makers may ignore. These externalities can potentially be internalized through voluntary policy coordination among neighbouring governments. Such coordination can be costly, however, resulting in inefficient decentralized public good provision. Within a federation, a higher-level government can use intergovernmental grants (generally, conditional grants, especially matching grants that reduce the marginal cost of public good provision for recipient governments) in order to induce more efficient provision of externality-generating local public goods and services (Breton, 1965). If the spillover benefits from a public good are sufficiently widespread, a higher-level government may assume complete responsibility for its provision. Such centralization of a governmental function involves a trade-off between the potential benefits from internalization of externalities and the potential informational disadvantages of centralized collective decision-making for a larger and more heterogeneous population (Alesina and Spolaore, 2003).

A second possible drawback of decentralized policymaking arises if there are significant limitations on the fiscal instruments available to lower-level governments. In the competition among lower-level governments for households and businesses, taxes (or non-tax revenue instruments such as user fees or licenses) perform a 'price like' function by rationing access to public services. Taxes may also introduce inefficiencies of their own, however, not only through 'classical' tax distortions (distortion of *in situ* labour/leisure, consumption, savings, and investment decisions) but more especially through their effects on the locational choices of households and businesses. For example, subnational government income taxes may inefficiently drive profitable businesses and high-income households into low-tax jurisdictions, and retail sales taxes may encourage inefficient cross-boundary shopping. Fiscal competition for mobile factors of production or consumers may discourage taxation of these resources, changing the composition of the subnational revenue structures toward less-mobile tax bases if these are available and potentially constraining the overall level of government revenues. Underprovision of public goods may result, which, as in the case of spillover benefits, may potentially be remediated with well-designed fiscal transfers from higher-level governments (Wildasin, 2006a; Wilson and Wildasin, 2004; Wilson, 1999). On the other hand, if Leviathan governments are likely to engage in excessive spending, fiscal competition may impose useful constraints on their revenue-raising powers (Brennan and Buchanan, 1980).

A further difficulty for federalized systems arises from the fact that many public policies, by their nature, intermingle allocative and distributional impacts, so that a clean separation of allocative and redistributive functions between higher- and lower-level governments may be unattainable. Health, education, transport, economic development, and many social services involve allocative functions (service delivery for geographically limited areas) but also promote distributional goals. Particularly when competition among lower-level governments results in the formation of communities that are relatively homogeneous (with respect to income, race, age, or other socioeconomic characteristics), the efficiency gains from decentralization may be realized in part precisely through increased disparities in public service provision. The demand for education, for example, is a normal good, so that stratification of localities by income produces disparities in educational quality between rich and poor localities, as efficiency requires. In the United States, concern about the fairness of inequality in education, partly as expressed in state government constitutions, has resulted in extensive litigation leading to judicial mandates for policy reforms, notably including extensive programmes of equalizing fiscal transfers from state to local governments (Inman and Rubinfeld, 1979). More generally, the equalization of fiscal transfers from higher- to lower-level governments provides a mechanism through which to limit horizontal inequities in the fiscal treatment of households in rich and poor jurisdictions and the locational incentives to which they give rise (Boadway and Flatters, 1983).

As noted earlier, factor mobility imposes constraints on the ability of governments to redistribute incomes. The integration of capital and labour markets can improve the efficiency of factor allocations and thus raise output and welfare, an important potential benefit that underpins policy initiatives, such as economic integration within the EU, that seek to remove barriers to factor mobility. Factor mobility also affects factor prices, giving rise to potentially important first-order distributional impacts. Thus, economic integration affects not only the cost of 'decentralized' redistribution – which, in a global context with international factor mobility, includes redistribution by national as well as subnational governments. By affecting factor prices and the underlying distribution of income, it also may increase or decrease the benefits of redistributive policies. International capital mobility and the migration of younger workers (both skilled and unskilled) from developing and transition economies to aging developed nations thus create new policy trade-offs, particularly for the extensive redistributive systems of North America and Western Europe (Wildasin, 2006b), the consequences of which will unfold in coming decades.

Directions for future research

As noted at the outset, the challenges of policy and institutional reform throughout the world have stimulated new interest in fiscal federalism. The incentives embedded in the institutional structures of the mature federations seem to have ensured that subnational governments maintain sufficient fiscal discipline to avoid major widespread or recurring fiscal crises, while preserving their ability to exercise significant policy autonomy with respect to the level and composition of their taxes, expenditures, and debts (Buettner and Wildasin, 2006; Inman, 2003; Wildasin, 2004). Such institutions cannot be taken for granted, however, and many informed observers see potential risks from fiscal decentralization in the evolving federations of the developing and transition economies, including risks from excessive (that is, inefficiently high) spending or borrowing by subnational governments. An appropriate mix of revenue and expenditure assignments, intergovernmental fiscal transfers, borrowing flexibility, and policy autonomy is needed in order to realize the potential efficiency gains from fiscal decentralization (McLure and Martinez-Vasquez, n.d.; Weingast, 2006). The interplay between the market environment (especially financial markets and institutions and capital and labour mobility), the assignment of fiscal and regulatory authorities by level of government, and the constraints that influence political decision-making is not well understood and promises to be the subject of extensive study in coming years.

The integration of national and international markets for labour and capital, of crucial importance for federalism, appears to be increasing over time, and affects the competitive pressures facing governments at all levels. The global configuration of age-imbalanced demographic structures (young poor populations in developing countries and old rich populations in developed countries) implies that international migration incentives are unlikely to diminish in the foreseeable future. The fiscal systems of developed nations, with their extensive systems of intra- and intergenerational transfers, will face growing challenges in coming decades as a result of population aging, even as competition for capital investment and mobile high-income households may increasingly constrain their capacity to finance redistribution (Wildasin, 2006c). Policy coordination, perhaps through newly developed governmental structures (for example, at the EU level), may provide opportunities for national governments to limit the degree of fiscal competition, helping them to finance the liabilities arising under existing redistributive systems. Alternatively, or in addition, national governments may explicitly or implicitly shift some expenditure responsibilities to lower-level governments as they manage growing fiscal imbalances arising from demographic change. In any case, growing fiscal imbalances are likely to form the backdrop for public finance in developed countries in coming decades, offering opportunities for fruitful analysis of the dynamics of factor mobility, factor market integration, dynamic fiscal adjustment, and institutional change within and among nations.

David E. Wildasin

See also: PUBLIC FINANCE; LOCAL PUBLIC FINANCE; INTERGOVERNMENTAL GRANTS; TAX COMPETITION; POLITICAL INSTITUTIONS.

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