

Perspectives on Fiscal Federalism

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Abstract: The conversations about fiscal federalism, decentralization and devolution have been evolving in the literature since the second half of the 20th century. In the United States and all around the world, the matter of governance and decentralization are on the agenda. This paper aims to find the routes of fiscal federalism by first understanding what is meant by federalism, as it does not simply refer to a form of governance, then laying out the classical foundations of this theory (trumped by Wallace Oates), and followed by some departures from the classical thoughts into some new streams of literature on the matter.

Key words: Public Finance, Fiscal Federalism.

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1. INTRODUCTION

The conversations about fiscal federalism, decentralization and devolution have been evolving in the literature since the second half of the 20th century. In the United States and all around the world, the matter of governance and decentralization are on the agenda. Decentralization has been seen as the main institutional framework, and is widely believed to provide benefits. "It is often suggested as a way of reducing the role of the state in general, by fragmenting central authority and introducing more intergovernmental competition, and checks and balances. In a world of rampant ethnic conflicts and separatist movements, decentralization is also regarded as a way of diffusing social and political tensions and ensuring cultural and political autonomy" (Bardhan, 2002). The idea of giving more fiscal authority to local governments is attractive; competition between jurisdictions is believed to minimize inefficiency, force local representatives to respond better to their constituents and give more for tax dollars paid. The individual, under conditions of decentralization and interjurisdictional mobility has more power over government; as public authority moves down to the lower levels the individual is better exposed to competition and choice, and can "vote with his feet".

This paper aims to find the routes of fiscal federalism by first understanding what is meant by federalism, as it does not simply refer to a form of governance, then laying out the classical foundations of this theory (trumped by Wallace Oates), and followed by some departures from the classical thoughts into some new streams of literature on the matter. The discourse around fiscal federalism becomes important in times where politically, countries are strengthening the powers of the executive, and when the administrative state has changed so much. It is the hope that this paper will clarify what fiscal federalism is and consider whether such a

reform is beneficial.

BACKGROUND AND HISTORY

Before we can discuss the relevance of fiscal federalism, let us first decipher what is meant by federalism. Elazar (1972) offers a definition for federalism. He claims that it can be defined as "the mode of political organization that unites separate polities within an overarching political system by distributing power among general and constituent governments in a manner designed to protect the existence and authority of both. In its simplest form, federalism means national unification through the maintenance of sub-national systems. In a large sense, it is a mode of political activity that requires the extension of certain kinds of cooperative relationships throughout any political system it animates" (2-3).

The federal system was created with the intention of combining the different advantages which result from the magnitude and littleness of nations (De Toqueville, 1980). Let us briefly discuss the set-up of such a multi-tier government. In the Rawlsian "original position" legislators formulate a constitution, which in this context would be a set of rules by which to govern public projects. The social objective is simply to maximize the expected net value of a project and the welfare. Hierarchy, is thus justified only if it generates positive social benefits to cover the costs of having another tier, only if welfare is improved and justified to add tiers under the central unit. The decision for or against decentralization depends on those rules the central legislature formulated for guidance and operations (Rubinchick-Pessach, 2005).

Numerous problems arise in such a system where one central financial authority contains constitutionally independent financial units within it (under it). In federalism, two of such financial systems operate based on the resources provided by the individual citizens. Each unit of government is operationally limited by its specific geographical boundaries and is dependant only on the resources provided by those within its area for the provision of public services. Subordinate units, if required to provide certain functions independently will end up with fiscal inequalities between them unless the fiscal capacities between units is equivalent (Buchanan, 1950).

This foundation of what a federation means allows us now to move forward in our progress towards what fiscal federalism is. According to Musgrave (1965) the traditional approach of fiscal theory was in the context of a unitary government. The general theory of taxation and expenditure was seen in unitary terms at first, following Keynes' theory that changed the focus more toward government finance for stabilization; yet no discussion of hierarchical fiscal units or multi level finance was yet introduced. Yet in the United States where the fiscal structure is highly decentralized traditional forms of finance had to be revisited; this involves both political and economic reinterpretations of fiscal federalism. "There are good theoretical reasons for reorientation of fiscal thinking in multi-unit terms. The very theory of social wants remains at the core of fiscal economics. Certain wants cannot be satisfied through the market, but must be provided for by government because the resulting benefits accrue to all members of the "group" independent of individual contributions. Membership in the group, however, frequently depends of spatial considerations" (Musgrave, 1965).

What Musgrave is directing our attention to is that certain types of public services concern a certain region or locality; thus supplying goods and services that should serve the needs and preferences as reflected by certain communities or regional units. We must also remember that these units may not be homogenous within a region and are heterogeneous by the nature of individuals being different from one another. "It follows from the nature of social goods that services are consumed in relatively equal amounts by members of a beneficiary group. Since the cost is shared among the members, it is the interest of the individual to associate with others whose preferences for social goods are similar to his own" (3). Musgrave's short introduction, and this particular argument link the conversation to Tiebout (1956) famous piece which makes an important foundational argument on which fiscal federalism will rest its blocks. Who then sets out to show that the arguments made by Musgrave (1965) in applied economic theory "market type" that solution is not applicable to the determination of expenditure on public

goods, that is national income allocated non-optimally is not applicable when speaking of local expenditures. Tiebout argues that local expenditures are not only at the central level; actually they are quite significant at the local levels. He posits that an individual will pick the community which best suits his pattern of preference of public goods. "The greater the number of communities and the greater variance among them, the closer the consumer will come to fully realizing his preference position" (Baker and Elliott, 1990). In the Tiebout model households are highly mobile, and they "vote with their feet", that is they choose where to reside based on what locality provides the fiscal package that would best fit their tastes and preferences. Tiebout (1956) further claims in his article that the policies that promote mobility and increase the consumers' knowledge will improve governmental expenditure allocation. Given full mobility of consumer-voters, "The solution, like the general equilibrium solution for private spatial economy, is the best that can be obtained given preferences and resource endowments" (Baker and Elliott, 1990). In fiscal federalism, where the provision of public goods is in the hands of sub-national governments tailored to the preferences of a heterogeneous population, is beneficial from the Tiebout model point of view. The outcome is individuals sorted into demand-homogenous jurisdictions which provide different amounts of public goods based on the preferences of each of these groups of individuals. At this point some main foundations have been set down and we can proceed with the specifics of classical fiscal federalism.

Classical fiscal federalism

On this part the author will mainly depend on the work of Oates as he is the main classical writer on this issue. In the introduction to his book, fiscal federalism he states that his study rests on Musgrave (1959) conceptualization of the role of the public sector. From Musgrave's perspective that a free market economy without a government sector is likely to malfunction, Oates comes to an understanding that the public sector has three primary economic problems; equitable distribution, maintaining stabilization and efficient pattern of resource allocation, these problems are interrelated. What Oates sets to achieve is a case of federalism, for that purpose he provides a comparative discussion of the advantages and disadvantages of having a completely centralized government versus a highly decentralized form of government (Oates, 1972).

A unitary form of government is much more capable than a decentralized government of meeting its economic responsibilities of stabilization, realizing equitable distribution of income and provision of efficient levels of output of public goods. Yet, the decentralized governments also have some advantages over its counterpart. They provide for public goods consumption tailored more to

the preferences of the constituents of the locality, and by promoting increased innovation and competition of local governments decentralization might increase efficiency in the production of public goods. Lastly, a system of local governments might provide for better public decision making, by compelling more recognition of the costs of public goods and services. Oates then suggests that we combine the advantages of both systems of governance under a federal organization, as this represents a compromise. The central government is responsible for the stabilization of the economy, for achievement of equitable distribution of income and for providing certain public goods that influence the welfare of all the members of the society. Its sub-entities will supply those public goods and services that are of interest to the residents of the specific jurisdiction (Oates, 1972; Baker and Elliott, 1990).

As Oates indicates, there is a difference between the economic and the political science meaning of federalism. His suggestion is the use of an economic definition; this is due to the economists' concerns are pattern of resource use and income distribution. Decentralization provides a mechanism where levels of public goods provision can be tailored to individual preferences; the economist's concern is merely that decisions regarding levels of provision reflect the interests of the constituents. Therefore, Oates defines federalism economically as;

"Federal Government: a public sector with both centralized and decentralized levels of decision making in which choices made at each level concerning the provision of public services are determined largely by the demand for these services of the residents of (and perhaps others who carry on activities in) the respective jurisdiction" (Oates, 1972).

To the economist constitutional structure assumes importance only to the degree that it affects responsiveness of the provision of local services to the local preferences (Stegarescu, 2005). Most importantly in Oates' view, most if not all systems are federal, from an economic perspective; the public sector of all countries could be federal and the distinction is only in the degree of centralization (Oates, 1972; Baker and Elliott, 1990).

The presentation of Oates' main article and claims are important to comprehend because a lot of the subsequent literature on the subject in following years made reference to his assertions. In a later piece Oates (1999) provides the brief points most pertinent to the basic theory of fiscal federalism. The hope in advocating for fiscal federalism (decentralization) is that as local governments are closer to the people they will better know and address the people's preferences, and will have an ability to find innovative new ways to provide goods and

services to the constituents of the sub units (jurisdictions). Yet the goal of restructuring the public sector is not only decentralization, but rather an alignment of governmental responsibilities and fiscal instruments with the proper level of government. The central question of fiscal federalism is which functions and instrument are suited for central government and which to the levels of that government?..

As we have outlined the functions of government earlier, a main point according to Oates is that efficient levels of local outputs at the local levels will likely vary across jurisdictions due to differing costs and preferences; if we are to maximize social welfare, local outputs will have to vary. The main basic principle of fiscal decentralization is that provision of public services should be located at the lowest level of government encompassing spatial relevant costs and benefits.

The decentralization theorem, "in the absence of cost-saving from the centralized provision of a good and of interjurisdictional external effects, the level of welfare will always be at least as high (and typically higher) if Pareto-efficient levels of consumption of the good are provided in each jurisdiction than in any single, uniform level of consumption is maintained across all jurisdictions. In this way the theorem establishes, in the absence of other kinds of offsetting benefits from centralized control, a presumption in favor of decentralized finance" (Oates, 1972).

The theorem rests if grounds of economic efficiency and simply presumes that centralized provision will entail uniform level of output across all jurisdictions. Yet there is an inherent assumption regarding access to information. Oates (1999) observes that there is a knowledge asymmetry, presumably the local level possess more information regarding individual preferences and cost conditions. Also, at the central level there is political pressure that constrains its ability to provide higher levels of services to some places and not others. And here he states a major assumption in his theory that constraints on central government tend to require a degree of uniformity in provision; the constraints prevent central government from providing optimal pattern of local outputs. Another important assumption of the theory is that the magnitude of welfare gains depends on the heterogeneity in demands across the jurisdictions and inter jurisdictional differences in costs (1123). Oates (1999) also observes that gains from decentralization, although enhanced by mobility, are not wholly dependent on mobility. He finds that even when there is no mobility the efficient levels of outputs of "local" public goods will typically vary across jurisdictions (1124). In the creation of his model it is important to note that Oates (1972) assumes that each government maximizes the surplus of the aggregate constituents, yet there is a possible problem in local provision and that is not paying attention to benefit spillovers to other districts. Another

assumption mentioned earlier is that a centralized system government provides uniform level of spending which cannot address local individual preferences.

The earlier discussed paragraphs attempted to give a brief review of the main relevant points that describe what fiscal federalism is about. Yet there are a lot of issues tied and related to the basic tenets of the theory. Most of the literatures in one way or another beg to determine whether decentralization is actually beneficial and if so in what ways is it advantageous to centralization. Shadbegian (1999) studies the validity of three theories concerning public sector spending. Grossman and West (1994) have also researched these hypotheses regarding government expenditure.

THREE HYPOTHESES REGARDING LEVELS OF GOVERNMENT SPENDING

The Wallis hypothesis

Increased fiscal decentralization would lead to bigger state and local governments. "since individuals have more control over public decisions at the local level than at the state or national level, they will wish to empower the public sector with a wider range of functions and responsibility where these activities are carried out at more localized levels of government" (Oates, 1985). His argument is based on the possibility of transferring governmental functions and responsibilities from the higher to the lower level of government. If indeed they are transferable then as decisions become decentralized, higher levels of government will spend less while lower levels will spend more (Shadbegian, 1999; Grossman and West, 1994).

The Brennan/Buchanan hypothesis

Budgetary decisions conform to the revenue maximizing monolithic government, Leviathan and not to the median voter. Brennan and Buchanan (1980) argue that the greater the level of decentralization the higher the level of competition among jurisdictions; the smaller the share of aggregate government expenditure. "Total government intrusion into the economy should be smaller, *ceteris paribus*, the greater the extent to which taxes and expenditures are decentralized" (185) (Shadbegian, 1999; Grossman and West, 1994).

Brennan/Buchanan collusion hypothesis

It is possible that as decentralization occurs, the component governments in a federal system are

colluding and forming a cartel, which dampens the competitive influence of decentralization to expand the budget. Brennan and Buchanan (1980) note that the possibility for collusion should be included in the "all things being equal" (185) and that it is expected that in a federal decentralized system there would be pressure on the lower levels of government due to the high levels of competition to secure arrangements and moderate competitive pressures (182). This argument has two testable implications: total government size will and *ceteris paribus*, increase with the level of collusion and the size of each level of government will and *ceteris paribus*, increase as the level of collusion increases (Shadbegian, 1999; Grossman and West, 1994).

Now that we have outlined these three very important hypotheses regarding government spending, based on the two articles earlier, many research efforts have been put forward to test these three hypotheses in the literature. Due to time constraints the writer will present the findings as they are articulated in the articles. Shadbegian (1999) tested the validity in order to suggest a model for the United States. The results show that the hypotheses complement one another and contribute to understanding of size of government. Using state level panel data the author was able to prove each one of the hypotheses.

Grossman and West (1994) were able to find in their empirical study simultaneous support for the Wallis hypothesis, as greater power passes down closer to the citizenry they are more willing to grant those governments a broader range of powers. As for the first Leviathan hypothesis, the authors found support and that federal share of aggregate spending decreases while local share increases with decentralization, and they also were able to support the collusion argument. Both articles conclude that decentralization by itself is not a strong enough constraint on the Leviathan, since competitive pressures of fiscal federalism are offset by collusion among all levels of government.

IS FISCAL FEDERALISM BENEFICIAL OR NOT?

While the basic arguments of fiscal federalism and as we have seen thus far the answer whether decentralization is beneficial or not as a policy is not so simple. Much literature has addressed this issue from many different angles, basic economic models were used and new models for federalism have been offered. A short review of this issue is offered in this part of the work. At the offset it seems that there are many political, social and economic factors that should be considered in addressing the issue of decentralization, yes or no?

The decision whether to decentralize or not depends on the constitutional definitions designed by legislature. This is true not just for the United States, but for whatever country is considering decentralization. Decentralization is a complex process and a product of many factors, as has been stated and including cultural heritage and geography. In an important study, Pannizza (1999) starts out by pointing that across countries there are different institutional arrangements and different levels of centralization. He sets to identify empirical regularities to explain cross-country differences in the levels of centralization; the findings indicate that country size, per capita income, ethnic fractionalization and level of democracy are negatively correlated with fiscal centralization. Building on Pannizza's model and testing fiscal decentralization within a country Arzaghi and Henderson (2005) hypothesize that the degree of variation of institutional and fiscal decentralization across countries is explained by basic economic and demographic variables. What they find is that per capital income, population, land area and population concentration in large cities largely affects decentralization. Income and population growth lead to decentralization along with population decentralization. Economic and demographic growth processes explain the variation in centralization. They also note that constitutional federalism encourages effective federalism and fiscal decentralization.

Wallis and Oates (1988) historically view the evolution of fiscal decentralization in the state and local sector. They view and test empirically different theories to explain differences in fiscal decentralization.

"We found that the extent of fiscal centralization varies inversely and significantly with population size and urbanization, we have found a positive relationship between fiscal centralization and the level of per capital income" (Rosen, 1988). Pannizza, and Arzaghi and Henderson indicate that the correlation between income per capital and centralization is inversely.

"Our overall econometric results point to these divergent forces. If population and urbanization continue to grow, this will create pressures for more decentralizes government" (Rosen, 1988).

Besley and Coate (2003) preserve the uniform cost sharing for public projects, but relax Oates' assumption regarding uniform public spending across regions. In their models they see central governments as comprising of locally elected representatives; doing this required modeling the behavior of the representatives and districts' choices about the type of representative to elect. Their findings suggest that detailed modeling of the political decision making is important to understanding the trade-offs between centralization and decentralization.

Heterogeneity and spillovers are correctly at the heart of the debate about the gains from centralization.

Earlier studies are few among many empirical studies that tackle the question of decentralization. As demonstrated, the finding point generally that under specific assumptions and using specific data sets there is evidence to support the advantage of fiscal federalism. But each study also points to its limitations and especially to differences across nations.

The literature points to gains and benefits; such as faster economic growth (Brueckner, 2006), but also to some drawbacks of federalism, such as sacrificing economies of scale and losses from interjurisdictional tax competition when revenues come from a mobile tax base and an inability to properly account for spillovers, just to name a few.

In rethinking federalism by Inman and Rubinfeld (1997) start off by saying that in the United States the resolution of tension of which level of government should play what function has been evolving for the past two centuries; from "dualism" (1790 to 1860) where states and central governments had comparable responsibilities; through "centralizing federalism" (1860 to 1933) where the federal responsibilities grew moderately; to "cooperative federalism" (1933 to 1964) marking substantial growth of social programs resulting from the depression; and since a period of "creative federalism" where federal government takes direct and active role in problems of lower level governments (43-44).

In lieu of a trend in the US fiscal structure toward centralization that the authors foresee the present three common principles of federalism; economic, cooperative and democratic federalisms.

They conclude that,

"Rethinking federalism means rethinking the terms under which sovereign citizens or states join together to form a "more perfect union". Whether one is struggling to form a political union for the first time...deciding to break away from an existing union...or to reform a stable one, decisions must be made along each of the institutional dimensions which define the federal constitution: the number of lower-tier governments, their representation to the central legislature and the assignment of policy responsibilities between the center and lower tiers. Whatever federal constitution is selected will have implications for the valued goals of government: efficiency, political participation and protection of rights (60).

The second-generation theory (SGT) of fiscal

federalism

Under the concepts of public choice and political economy that focuses on political processes and the behavior of political actors, the SGT began to develop. Unlike the first-generation theory (FGT) which largely assumed that public administrators work hard on achieving the common good, the SGT revolves around the willingness of the public to participate in political processes (both voters and officials) have their own objectives and purposes that they work hard to maintain in a political setting that provides the constraints on their efforts. New public management (NPM) is a theory of governance that is heavily influenced by market theory and economic decision-making, public choice, principal agent theory and transaction cost economics in particular (Hood, 1991; Kaboolian, 1998), rather than civic choices.

Ostrom and Ostrom (1971) as advocates of public choice, point to what they, see as Wilson's major thesis statement: "but there is one rule of good administration for all governments alike. So far as administrative functions are concerned, all governments have a strong structural likeness more than if they are to be uniformly useful and efficient, and they must have a strong structural likeness"(Wilson,1887).The authors emphasize that by good administration Wilson meant order of hierarchy in a rank system subject to political direction. The ranks will be a corps of technically trained civil servants; Wilson wanted them schooled and drilled "after appointment, into a perfected organization, with an appropriate hierarchy and characteristic discipline" (Wilson, 1887).

Locke's theory of self-interest has its own consequences in the field. One of the major founders of the national performance review, Kamensky (1996), states that the new public management is connected with the public choice movement whose central backbone is that "all human behavior is dominated by self-interest".

In addition, the SGT have evolved due to the information revolution in the age of globalization and financial crisis in the various countries all over the world. Information is power and the outcomes from collective- choice institutions depend in basic ways on the information that the various organizations and actors possess. In settings of asymmetric information, where some business partners or entities have knowledge of such things as preferences, cost functions, or effort, knowledge, governments alone cannot decide alone on how to draw their financial policies. The SGT is revolving around this information and how it can be obtained, analyzed and used to draw better well-framed federal fiscal policies (Oates, 2005).

The origins of the etymology of the term governance the authors claim are of two traditions, the study of institutions (multi layered structural context) including public choice; the second tradition is network theory (role of multiple social actors in networks). As O'Toole (1997) has shown, the phenomenon of networks has added intersubjectivity and interdependence, and a need for collaboration among actors with differing and at times conflicting interests and motivations.

CONCLUSION

This paper aimed to present some of the discourse and thought on the subject of fiscal federalism. The conclusion presented by Inman and Rubinfeld (1997) seems to pull the idea together. There is variation, there are political, environmental, social dynamics taking place within and across countries and throughout the globe. The theory of fiscal federalism seem to point to beneficial economic outcomes, yet it is not a definite replacement; under certain conditions at certain times it more centralization seems appropriate. Therefore, the question is not whether decentralization is beneficial, but rather when and to what degree? As was pointed in few places in the paper the written agreement (constitution) of the legislature is the key to the beginning of the conversation. Perhaps as technological, social, economic and political elements change within a country so should the degree of decentralization. Economically speaking, each county should strive to the utmost degree of decentralization as possible to most efficient, and to be as close to the current preferences of the citizenry, as suggested by Oates (1972).

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