Chapter Summaries

Chapter 21: Fiscal Federalism – the Assignment of Functions among Governments

Federalism refers to a tiered system of governments in which each government has some authority over the governments immediately below it in the fiscal hierarchy. Chapter 21 discusses the conventional wisdom on how to *assign the functions of government* among the various levels of government, proceeding along Musgrave's three-way demarcation of government functions: the stabilization (macro) function, the allocation (efficiency) function; and the distribution function (equity). The chapter begins with the *stabilization* function.

1. Economists cede the stabilization to the national government by default. Only the national government can hope to articulate macro economic policy goals and formulate policies to meet them.
2. The state (provincial) and local governments are severely handicapped in the following ways in their ability to engage in macroeconomic policies:
   a. The size of their "foreign" sectors increases as one moves down the fiscal hierarchy. Much of the demand for their producers' products comes from beyond their borders (exports) and much of what their businesses and citizens buy is produced beyond their borders (imports). They are like small island nations surrounded by many larger nations.
   b. They cannot engage in commercial policies, such as tariffs, quotas, and export subsidies, to influence the flow of imports and exports across their borders (at least not in the U.S.; they are unconstitutional).
   c. If the states (provinces) and localities do not issue money, and they do not in the U.S., then they cannot engage in monetary policies.
   d. This leaves only fiscal policies. But states (provinces) and localities cannot typically issue debt to finance current operating expenses, unlike the national government. The must have balanced operating budgets because most states'

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constitutions require it. Even if they did not, however, the financial markets would lend to states and localities only to finance capital expenditures, not to finance operating expenses (except only temporarily). Thus these governments are limited to balanced budget changes in expenditures and taxes and, with the balanced budget multiplier approximately equal to 1, the changes that would be required to have a significant effect on their economies are not politically feasible.

The chapter turns next to the *allocation* functions of government. Here the conventional wisdom follows the advice of George Stigler given in testimony before Congress in the late 1950s.

3. Stigler assumed, at least for the United States, that the people believe in two principles: participatory democracy (democracy works best the closer the decision-making process is to the people); and states rights (state (provincial) and local governments have the right to chose the public services and tax mix that they want. Based on these two assumptions, Stigler argued that the allocation functions should be assigned to the lowest level of government consistent with economic efficiency. The lower limit to the assignment comes down then, to the geographic extent of the decreasing costs for natural monopolies and of the external effects of externality generating goods and services.
4. Decreasing costs are exhausted at the local or regional level for most natural monopolies.
5. The extent of various externalities varies widely, from local (libraries) to national (national defense). Wallace Oates proposed the ideal assignment as achieving a perfect correspondence between the extent of an externality and the governmental jurisdiction that tries to correct for it. Inefficiencies are almost certain to arise if the jurisdictions are either too broad (e.g. the national requirement in the U.S. that all cars have the same pollution control equipment no matter where they are driven) or too narrow (e.g. factories in three states bordering a lake dump pollutants into the lake but only one state acts to reduce the pollutants emitted by the factories in its state).

The chapter then considers the *distribution function*.

6. 6. The conventional wisdom again cedes the distribution to the national government by default. Allowing states (provinces) and localities to redistribute gives rise to two problems:
   a. *Potential incompatibilities* (e.g. the national government wants to redistribute from group 1 to group 2 and a state government wants to redistribute in the reverse direction).

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   b. *The competition problem* (e.g. a city tries to provide income support to its poor citizens by taxing its rich citizens and the rich citizens move to the suburbs where they are not asked to redistribute, thereby reducing the city's tax base and making it even more difficult for the city to support its poor).

   Therefore, only the national government has a social welfare function and it taxes and transfers among individuals to satisfy the interpersonal equity condition of equalizing the social marginal utility of income across all people in the nation.

7. Oates' prescription for an ideal federalism is to let the national government redistribute and have the lower level governments pay for the allocation functions assigned to them with benefits-received taxes, to avoid any redistribution at all within the lower levels of government.
8. The text notes three objections to the conventional wisdom of allowing only the national government to redistribute:
   a. The efficient provision of decreasing cost/natural monopolies requires a benefits-received price (tax) equal to marginal cost, which does not cover the full costs. Without a social welfare function, the lower level governments have no principle to guide them in raising the revenues to cover the losses.
   b. A government has no political identity without a social welfare function, the only political element in the mainstream theory of the public sector. It is simply an agent.
   c. State (provincial) and local governments surely do care about the distribution of income within their jurisdictions and the distributional implications of their policies.

   In light of these objections, the text proposes an alternative assignment of the distribution function as an ideal arrangement under federalism.

9. Not all governments can have a social welfare function defined in terms of their own citizens' utilities or the incompatibility problem is sure to arise. There has to be some restriction on social welfare.
10. The restriction proposed is that social welfare under federalism be dynastic in structure: The local governments have social welfare functions of the standard form, with their arguments the utility functions of their citizens. The states (provinces) have social welfare functions whose arguments are the social welfare functions of the localities within the states (provinces). The national government has a social welfare function whose arguments are the states' (provinces') social welfare function.
11. Under the dynastic structure: the local governments tax and transfer lump-sum among their citizens in the usual manner to equalize the social marginal utilities of income across all their citizens; the states redistribute resources lump-sum across their localities to equalize the social marginal utilities of all the states' citizens; and the national government redistributes resources lump-sum across the states to equalize the social marginal utilities of all the nations' citizens.

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12. There can be no compatibilities among jurisdictions with a dynastic social welfare structure. There can be competition problems across localities and states, but only if the state governments in the first instance and the national government in the second instance allow them to happen. For example, rich citizens who try to leave a central city to escape redistribution cannot escape if the state transfers resources from the richer suburbs to the city.
13. The alternative model of redistribution has one big advantage over the conventional model – it allows a central role for grants-in-aid from states to their localities and from the national government to the state governments. Grants-in-aid are an important fiscal device in most federal nations. For example, in the U.S. in FY 2004, grants-in-aid accounted for 32% of state revenues and 39% of local revenues, and most of the major grants-in-aid had a distributional motivation.
14. The alternative model is not without its problems. Local redistribution polices would likely be highly variable in their support of the poor, and some people are skeptical about leaving redistribution decisions in the hands of local officials.
15. The U.S. is ambivalent regarding its preference for the conventional or the alternative model. Transfer programs such as the Earned Income Tax Credit, Food Stamps, and Supplemental Security Income are federal programs that transfer directly to individuals, in line with the conventional model. Medicaid and Temporary Assistance to Needy Families are combined federal/state (and in some states, local) programs, in line with the alternative model. Also, many states give extra funds to their poorer communities within their grant-in-aid programs, which is also in line with the alternative model.

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