Fiscal Federalism

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Abstract. *The central budget of a country collects only a fraction of the total fiscal revenues and executes only o fraction of the national public expenditures, the rest of the revenues and expenditures becoming the responsability of subnational governments. The economist Charles Tiebout developed a theoretical model which although makes an imperfect description of the reality, shows that people's mobility is being influenced by tax rates and the amount of state/local expenditures. Thus, he suggests that the degree of responsibility that can be appointed to the local budgets should subscribe to the tax – benefits ratio, the extend of the positive externalities and the scale economies of public goods. Also, the issue of revenues distribution among communities is being raised, being identified three kinds of grants used by the public authorities: matching grants, block grants and conditional block grants. In the concept of fiscal federalism there can be found a limited analogy between national public finance theory and international public finance theory, with the international taxation as the pivotal element.*

Key words: optimal fiscal federalism; the Tiebout Model; intergovernmental grants; international taxation.

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Fiscal federalism *describes a system of taxes, on one side, and public expenditures, on the other side, where the responsabilities of collecting the revenues and of the expenditures is divided between different levels of government.*

1. Fiscal federalism at national level

At country states level, there are different levels of government, starting from the national ones to the smallest local units of government. We have, for example, *the national level* (or federal, for the federal states) and *local level,* depending on the size of a country and its political and administrative structure.

According to this system of organization, national governments assist subnational governments to the equitable and harmonious distribution of public goods and the fiscal burden, and also to the regulation and control of externalities.

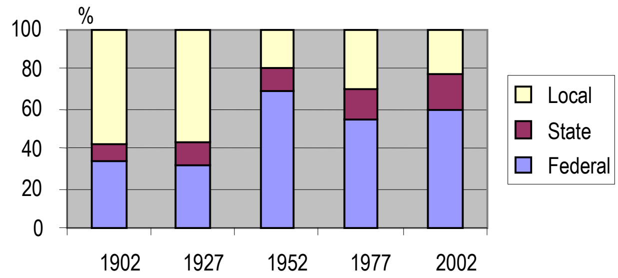
A very important feature of public finance is *the optimal fiscal federalism*, where the question of what kind of activities should be performed at federal level and which ones at state/local level is being raised. It is more convenient that some services are the responsability of state and local authorities, because it ensures a better connection of the real needs to the offered services, leading in the end to increasing the efficiency of providing public goods and services. On the other hand, it is not wrong to assert that in some circumstances fiscal federalism may not serve the best national interest. The disadvantages are displayed by the possibility of emerging problems regarding the reaching to the final beneficiary of some key public services. In the end, the great challenge is represented by the development of a transparent funding system for the subnational administrations.

1.1. Fiscal federalism in The United States of America

From the historical point of view, the federal government of The United States of America played a relatively limited role in many aspects of the economical and social live. As it can be observed from the below figure, in 1902 the federal government represented only 34% of the total governmental expenditures (federal, state and local), while to the local and state governments were appointed 58% and 8%, respectively. *The federal government* was restricted to expenditures for *national defence, external relationships, postal services. State and local governments* were held responsabile for *education, police, public roads, social security, medical care, hospitals,* etc. Different levels of government were operating in their area of action, and rarely interfering with one another. The expenditures of state and local administrations were mainly financed from their own resurces. Less than 1% of their revenues came from budgetary grants.

The situation changed dramatically in the next 50 years. In 1953, the federal government represented 69% of the total expenditures and the local and state governments 20% and 11%, respectively. Moreover, 10% of the state and local authorities' revenues came from grants. This shift was due to three *factors.* First of all, in 1913 it was permitted to the federal government *to tax individual's income,* which was forbidden until then by the Constitution. Secondly, in 1930 were launched several *programs as a response to the Great Depression of 1929-1933.* There were initiated several projects that simply changed the relationship between the different levels of government. Budgetary grants increased exponentially and many projects, as the motorway project, were financed by the federal government, but were locally administrated. And not least, the government introduced *programs of assistance and social security,* of which the most important *The Social Security Program for Helping Elderly People and The Budgetary Grants System, which aim was to encourage each state to provide social assistance to elderly, blind people or with other disabilities.*

The fraction of public expenditures, at federal, state and local level, in all the public expenditures, remained relatively constant in the last 50 years. Financing at federal level increased, especially due to the introduction in 1960 of several social programs, that were financially suported both by federal and state governments. Today, federal budgetary grants account for approximately 20% of the revenues of the local and state authorities, each.



Source: Gruber, (2005), "*Public Finance and Public Policy",* figure 10-1, p. 249.

Figure 1. *The shift of fiscal federalism (% of total governmental expenditures)*

The revenue sources and the categories of expenditures for the state and local administrations vary very mucy from the ones of the federal administration.

- For the expenditures, at *state and local* level, the largest expenditures are the ones with *education,* followed by *medical care and citizens' safty.* On the other hand, the largest *federal* spendings are with *medical care, social security and national defence.* The federal government role in financing education is very small.
- For the revenues, *the states* collect for their budget only 17% of their revenues from income tax, while this category is the main revenue source for the *federal* adminstration. An important revenue source at *local* level is represented by *the property tax,* levied on land and bildings.

1.2. Fiscal federalism in countries all over the world

Compared with other developed countries, subnational governments of the USA collect revenues in a greater proportion and also spend o greater fraction of the total budgetary expenditures than other countries. A recent study conducted by the member states of the OECD (Gruber, 2005, p. 250), shortly presented in the adjacent table, shows that the average of the *revenues* collected at the subnational budgets, in the year 2001, was 22% of the total budgetary resources. As for the expenditures, the differences are less obvious, with an average of expenditures of the subnationale budgets for OECD of 32%, compared with 40% in the United States.

Expenditures/revenues of the state/local governments in total expenditures/revenues (2001)

Table 1

	Expenditures (%)	Revenues (%)
Greece	5	3.7
Portugal	12.8	8.3
France	18.6	13.1
Norway	38.8	20.3
United States	40	40.4
Danmark	57.8	34.6
OECD average	32.2	21.9

Source: Gruber, Jonathan, (2005). "*Public Finance and Public Policy",* table 10-1, p. 250.

A high level of centralization is recorded in many countries, for example in Mexic, Austria, Norway, first of all because local authorities do not have the legal rights to levy taxes on citizens, this rights being designated to the central authority.

In Romania, fiscal federalism took place at the begining of the 1990s, but, in fact, begun to function starting with 1998, along with the new Local Public Finance Law. This law gave legislative rights to local budgets equal with to ones of the state budget. This way the aim was the consolidation of the local fiscal autonomy, by clarifying and extending the local control of the revenues, expenditures and the budgetary process. With regard to the revenues, there have been a few amendments which reduced the new legislation's benefits. In 1999, the state budget law reinstalled grants and in 2002 the state budget law inserted grants for education, roads and residences.

In recent years, an amplification of the fiscal federalism process was recorded all over the world. In America, intense efforts, that intended to transfer the control and the financing responsabilities of the public programs, have been carried out. In countries like Hungary, Italy, Koreea, Mexic and Spain efforts have been carried out to transfer the responsabilities to the local level even for medical care, education, social security. Consequently, in many countries, local budgets' expenditures increased, most of the times financed from central budget's grants.

1.3. Optimal fiscal federalism according to the Tiebout Model

In 1956, the economist Charles Tiebout tried to find those elements that define the reach of the optimal level with respect to providing private goods and services and that lack the providing of public goods and services. One of the detected element was *competition*, the lack of it leading to an inefficient outcome (Tiebout, 1956, pp. 416-424).

Tiebout stressed out that the situation changes if public goods are provided to the population by the local authorities (cities, towns) or the state authorities. He asserts that, in this case, the competition increases, because each individual has the power of decision. If he doesn't like the goods provided by a town, he can easily move to another, without this affecting his life. He went as far to affirm that, in some circumstances, public goods can be provided locally with maximum efficiency. The same principle which states that private goods reach the optimal level when the market is characterized by fair competition can also be applied for public goods. The towns that don't ensure an efficient level of this goods may find themselves in the situation of losing their inhabitants, who will be looking for new towns that can ensure the maximum of their efficiency.

Although the model is interesting, applying it into practice faces o series of difficulties. Moreover, it shouldn't be neglected the fact that the model is based on a number of hypothesis that are not in agreement with reality, for example *the perfect mobility of individuals, financing public goods with a fixed-sum tax, the assumption that public goods do not have externalities.*

In practice, it is very difficult for an individual who established himself in a community to move. Maybe the most unrealistic hypothesis is that individuals have all the information with respect to the benefits provided by the local administrations or the information with respect to the taxes each individual has to pay. Additionally, for the Tiebout Model to be applied, each person should have the possibility to choose freely from many towns the one that satisfies him concerning public goods and services. Plus, the model supposes the existence of a large number of towns, in which individuals can group themselves according to their similar preferences. However, it is impossible for a population to be divided in groups that have the same preferences.

Concerning the second hypothesis, financing public goods with a fixed-sum tax, regardless of the income, spendings or the wealth of the taxpayer, this from of taxation is seen as being extremely inequitable, because it doesn't take into account the contributive situation of each taxpayer, being rarely used for financing budgetary expenditures. In 1990, the British prime minister Margaret Thatcher tried to introduce a fixed-sum tax, and the result was street demonstrations, which led to the Thatcher's Government resign.

Furthermore, it is assumed that public goods affect only that town, without producing any effect on the vicinity, a fact totally wrong. O series of public goods generate externalities, as for example *the police*, meaning that if the police department from a city is not well organized, the criminal activity may extend to the nearby towns, *public road maintenance,* meaning that if the streets from a town are unpolished, then the drivers from nearby towns can suffer damages when they are passing through. And maybe the most relevant exemple of public goods with externalities is *education,* because the entire population of a country benefits from educated citizens.

Although the Tiebout Model makes an imperfect description of the reality, it is still true that *people's mobility* is being *influenced by tax rates and the amount of state/ local expenditures.* If the assumption regarding the population's behavior is a correct one, the next step is finding a principle by which a local authority can guide itself when providing public goods and services.

The Model states that *the degree of responsibility* that can be appointed to the local budgets is commanded by the following *three factors:*

1. *Tax – benefits ratio.* This ratio reflects the perception of the residents concerning the correlation between the taxes they pay and the public goods and services that they in the end receive. *The goods that reflect the highest tax – benefits ratio,* as local roads, should be provieded at this level. Property taxes, the main revenue at local level, if they are considerable, represent important sources used for increasing roads' quality, from which the residents of that town will still benefit. *Goods with a weaker tax – benefits ratio,* as social benefits for people with low income, should be the responsabilty of federal or state authorities. If the residents of a town can see the direct benefits they acquire from paying the fiscal obligations to the local budget, especially in the form of property taxes, they will be willing to pay them in the future. But if the connection is not perceived, they will move to a town that levies lower property taxes. Besides, if the local authorities introduced a social security program, individuals with high income would like to leave the town, moving somewhere else where there isn't such a program and therefore the local authority levies smaller property taxes on its citizens.

2. *The extend of the positive externalities.* If goods and services provided in a public manner affect in a considerable degree other communities, then the responsability for these goods should be designated to the superior forms of government (federal or state).

3. *The scale economies of public goods.* Goods, such as national defence, have great scale economies and can not be efficiently provided at local levels.

Analysing these factors, Tiebout concluded that at local level expenditures should focus on programs with little externalities and lower scale economies, for example road maintenance, garbage collection, keeping the streets clean. Local communities must have a limited role in providing public goods that are based on distribution (as social programs) and that have large scale economies (national defence).

1.4. Revenue distribution among communities and categories of tools used

The Tiebout Model gives a general framework for the approach of one of the most important problems of fiscal federalism: if there should be a distribution of revenues among communities. In a perfect world, there shouldn't be any distribution of revenues among local budgets. Each community has created an efficient structure for providing public goods and any distributing process leads to a decrease of the efficiency. Taking into consideration that the reality isn't a perfect one, there are two arguments in favor of distributing revenues among the communities with high income/expenditures and the ones with lower income/ expenditures: *the failure of the Tiebout Model* and *the presence of externalities.*

The assistance granted at state level is partly based on the differences between the income per person and the tax rates. Federal and state assistance expands at local level of government in order to provide the needed public goods and services. The government is often called to assist the authorities at lower levels, which can not alone adjust their budget. The states also resort to federal subsidies in order to withstand the budgetary problems. The process is applied on a large scale and is called *fiscal equalization.*

A particularity of the public federal authority in America is that it doesn't use grants for fiscal equalization, this process being however used within the states for the local authorities' financial support.

National assistance is extended to communities level, as we previously reported, also because of the externalities. For example, a town may wish to build an industrial plant, in the vicinity of another town, the latter being affected be the pollution resulted. The national or state government can interfere, exercising its regulatory power, requiring for the implementation of antipollution measures or for establishing the industrial plant somewhere else.

The national government assists and subsidizes states and towns with grants. There are three sorts of grants (tools) used by the authorities, as followed:

- *Matching Grants.* These make a correlation between the amount of grants transferred to local communities and the amount of present expenditures for providing public goods. For example, matching grants of one to one ratio for education mean one dollar funding from federal budget for each dollar spent for education at state or local level. Correlative ratios vary mainly between 0.01 and 1.
- *Block Grants.* In this case, the money are simply transferred to local communities, without constraining the way this money can be spent.
- *Conditional Block Grants.* The assigned money to local communities are aimed to be used only in a particular manner.

A great part of the ideea of granting national assistance to subnational political entities may establish the foundation for an international fiscal federalism, in an international public finance system framework.

2. Fiscal federalism at regional and international level

2.1. Analogy with the national federalism

A limited analogy between national public finance theory and international public finance theory can be found in the concept of *fiscal federalism.* This issue has resemblances in countries that record shortage in the balance of payment and receive structural adjustment loans from international organizations. It can be said that a form of fiscal federalism operates within the assistance system granted to the national governments by the international organizations or within the international agreements for pollution control, as is the case for Montreal Protocol, which regulates the emission of substances that damage the ozon layer and the climate.

This fact suggests that, at international level, some economical and environmental problems, as common goods[1] management and environment protection, should mainly be the responsabiliy of particular international organizations, like The United Nations.

The more the form of government that executes the expenditures is in the same time the entity in charge with collecting the needed resources, the more efficient the operative decisions are. This would mean for the international organizations to possess independent instruments in order to obtain resources for funding the programs that are wished to be implemented.

2.2. Implementation of the international taxation – a necessity for an optimal fiscal federalism

Notwithstanding, to be able to talk about fiscal federalism at international level, first it has to be defined *the general framework of international public finance,* a relatively new and intensely debated among academicians and economists concept. Of all the general framework's elements[2], like *market failure, revenue distribution's equity, macroeconomic stabilization, the political process, international organizations, international taxation and international common goods, taxation* is the pivotal element of an efficient international finance system. At national level, collecting public revenues is done on compulsory and regular basis, elements of critical significance that lack however from the international organization's system that grants assistance. They take their revenues on voluntary basis, this system proving inefficient most of the time. To define the concept of *international taxation,* at least the following elements should be considered: *defining the taxation base, determine the tax rates, methodes of collecting revenues, the conditions that need to be accomplished before enforcing a convention or a treaty, the penalties for disregarding the conditions and the withdrawal proceedings.*

To ensure enforcement of taxes at international scale, the most important feature is, inevitably, of political nature. State countries hold on very much to their sovereignty and are not immediately eager to submit to an international authority. International taxation confronts itself with a series of political obstacles, but the opportunities are enormous. At national level, many of the present fiscal system components were once impracticable, and in the United States, as we mention before, taxes on individual's income were considered unconstitutional. The resistance to changes will continue to put its mark also on the international taxation system, but the long term trend of the political attitude with respect to funding some objectives is a positive one. It seems that the implementation of an international taxation system is only a matter of time. At least theoretically, approximately all countries expressed their agreement regarding a mandatory regulated contribution to the international organizations' budget. A positive example in this regard is the one of the European Union, where there is already implemented in practice a harmonized regional system of taxation and the European Union has a limited economical jurisdiction over the national governments in the same manner as The Federal Government of the United States of America has jurisdiction over state governments.

3. Final considerations

In any country, the central budget collects only a fraction of the total fiscal revenues and executes only o fraction of the national public expenditures. The rest of the revenues and expenditures become the responsability of subnational governments, for exemple state and local ones. Carrying out a comparison with other developed countries, the United States designate a large responsability to the subnational governments.

It can also be discussed about fiscal federalism at international level, its defining and implementation having as the starting point the fiscal features of the national level. Because many countries from all over the world face imbalances, they should be assisted with the help of grants, in the same way state or local authorities benefit from such subsidies. While matching grants are the best way of encouraging a particular behavior for the subnational governments, for maximizing the community's welfare the most advised are the unconditional block grants. If we add to all of this the fact that there are externalities, positive or negative ones, that affect the whole population, a certain fraction of a country's revenues should be collected at international organizations' level on compulsory basis, for the development of the global interest programs and for internalizing of externalities

Notes

(1) Physical elements outside the national jurisdiction. Goods, for example fishing in international waters, exploitation of marine and flying space for shipping and flying, Antarctica and the Southern waters of the Ocean, the geostationary orbit and the electromagnetic spectrum, are suggested to be included in The United Nations Programs.

(2) As they were identified by Ruben P. Mendez (1992) in his book *„International Public Finance – A New Perspective on Global Relations”,* Oxford University Press.

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