

## I. Federalism as a Form of Polycentric Governance

- A.** Thus far in the course, we have analyzed:
- i. the positive properties of a single tax or expenditure program in isolation
  - ii. the normative properties of such taxes and expenditures
  - iii. the normative or "economic" case for government services and regulation: externalities and public goods problems
  - iv. and, the politics that underlie the main (large and well known) tax and expenditure programs selected by elected governments.
  - v. All these analyses were grounded in relatively simple and general models of rational decision making.
- B.** We now turn to settings in which governments are not monolithic unitary organizations, but rather decentralized, federal, or confederal governments.
- i. Such policy making structures are common: within most countries, there are regional and local governments, as well as central (national or federal) governments.
    - ◆ For example, within the US, there are national (federal), state, county, and town governments. Similar divisions exist in most countries.
  - ii. In most cases, the rules of the central government constrain the authority of the regional and local governments.
  - iii. Nonetheless, in cases in which the various governments are independently elected--rather than appointed by the central government in some way--and the local governments have significant control over local fiscal and regulatory policy, the result is a decentralized, "polycentric" system of governance.
- C.** In federal systems of governance, the central government is formally sovereign, rather than the "member" states, but the states have independent formal legal (constitutional) status.
- i. Federal states, thus, include a hierarchy of governments with more or less overlapping jurisdictions, but more or less independent policy making procedures.
  - ii. Some federal systems are more decentralized than others, because their local governments are less independent and/or have less authority than in others.

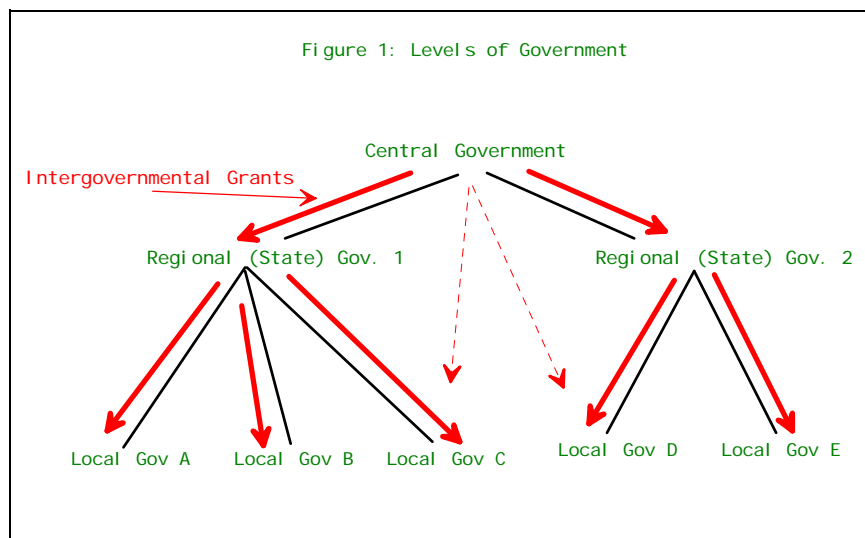
- a. For example, in some cases a subset of local officials are appointed by higher levels of government.
  - b. In other cases, local governments have relatively little ability to make tax, expenditure, or regulatory decisions.
- iii. The parliaments of most federal governments include a chamber that represents state (provincial, lander, etc.) interests.
- Some political scientists insist that a truly federal government always have a chamber in the national legislature that represents state interests.
  - However, such a structure is not necessary for what economists refer to as "fiscal federalism."
  - What is required for fiscal federalism is simply some local independence and some authority to make fiscal (tax and/or spending) decisions.

## II. Public Finance in Federal Systems

- A.** In cases in which several of the "levels" of government have independent taxing and/or spending authority, a country or nation state can be said to exhibit **fiscal federalism** (Oates 1972, 1977, 1999; see also Mueller in Congleton and Swedenborg 2006).
- i. Fiscal federalism does not require political federalism, but it does require "polycentric" governance.
    - a. Within the US, individual state, county and town governments (local voters) can usually control local taxes and expenditures.
    - b. Similar decentralized control over taxes and expenditures also exist in Canada, Australia and Switzerland.
  - ii. The greater is the independence of local governments and the broader is their fiscal and regulatory authority, the more decentralized is a federal (or other polycentric) government.
  - iii. In other less decentralized federal systems, control over many local taxes and expenditures is exercised by higher levels of governments.
    - a. Independent state and local governments exist, but they are not able to set many (or any) local tax rates or may have very limited control over local expenditures.
    - b. Fiscal federalism exists in such countries as well, if local governments can make some independent fiscal decisions.

iv. Within "unified" governments, local governments may also be more or less independent and more or less free to determine taxes, expenditures, borrowing, and regulations.

- Such states may be considered to be "federal" in the fiscal sense because taxing and/or spending authority is distributed between national, state, and local governments.)



**B.** Federal systems of governance have both “vertical” and “horizontal” relationships among governments.

- With respect to “vertical” relationships: some services and taxes may simply be mandated by higher levels of government.
  - Local governments are constrained in what they can do by state laws.
  - State governments are constrained in what they can do by national laws.
  - In the diagram above, the red arrows can be thought of as "mandates" placed on local governments and/or as grants (subsidies) paid to local governments.
- In addition to mandates and prohibitions from higher levels of government, there are often subsidies from "upper" levels of governments to "lower" levels of governments that create new opportunities for local governments to provide services without having to raise local taxes.

**C.** Among the vertical relationships given most attention by economists are intergovernmental grants and political feedbacks.

- One important strand of state and local public finance explores the effects of "intergovernmental grants" on state and local policy choices.
    - Illustration of the effect of an intergovernmental grant on local expenditures.
  - Another concerns the political effects that "states" have on higher levels of government, insofar as state voters and their representatives have "regional" rather than national interests (See Knight in Congleton and Swedenborg 2006).
    - The existence of intergovernmental grants and targeted grants tend to induce local and state governments to lobby in favor of such programs.
    - One possible result is "Pork barrel politics" a.k.a. the "fiscal commons problem" (discussed below).
  - Still another concerns how bargaining between levels of government affect the extent of centralization observed (Congleton, Bacarria, and Kyriacou 2003).
  - In addition to the vertical relationships, there are several “horizontal” relationships that are of interest to economists.
    - For example, to the extent that "tax base" is mobile across local governmental jurisdictions, **intergovernmental competition** over taxes, expenditures, and regulation tends to emerge.
      - ◆ If community A has higher taxes than Community C, people from community A will tend to move to community C--unless the services in community B are noticeably better than those in community C.
      - ◆ (The effects of competition between government are discussed below.)
    - There are also regulatory externalities that tend to be associated with local governments.
- D.** The economics and politics of these fiscal relationships not only allow us to understand federal governments operate but also help us analyze how federal systems should be designed.

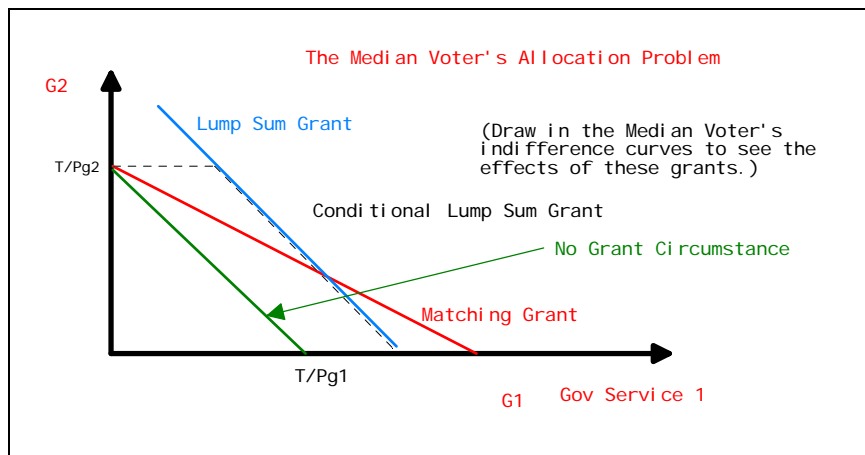
### III. The Effects of Intergovernmental Grants

**A.** Modeling the effects of intergovernmental grants requires a model of local governmental decision making.

- i. Within democracies, these can be based on the median voter model, perhaps augmented by the effects of interest groups and intergovernmental competition (see below).
- ii. The median voter model ( and median legislator model and governor models) allow the decisions of government to be modeled as if they were made by a single person.
- iii. This, in turn, allows us to use diagrams from microeconomics to represent the effects of conditional and unconditional grants on local governments.

**B. The median voter and intergovernmental grants.**

- i. As was the case for ordinary subsidies, intergovernmental grants can be "lump sum" or "marginal" (block grants or matching grants).
  - As true of ordinary subsidies, grants may also be conditional or not.
- ii. Both conditional and unconditional matching grants affect relative prices of alternative government services.
  - Both conditional and unconditional block grants have income effects but not relative price effects.



- iii. How intergovernmental grants change the public budget constraint is illustrated above. How such grants affect public policy require adding the indifference curves of the "pivotal policy maker."
  - a. For most of our purpose the relevant indifference curves are those of the median voter (or directly elected city planner).

- b. (Add indifference curves to diagrams like that above, and analyze how different kinds of grants tend to affect the level and distribution of government services within a community.)
- iv. For the most part, the empirical evidence on the effects of grants is consistent with such one person (median voter) models of government decision making.
- v. There is however one puzzle, often termed the "fly paper effect" (Hamilton 1983, Bailey and Connolly 1998, Jacoby 2002).
  - a. Block grants, which resemble lump sum grants, increase government services by more than one would expect based on standard consumer models.
  - b. The grants "stick" to the programs they are aimed at, rather than inducing tax reductions that the median voter model seems to predict.
    - ♦ That is to say, in a community that spends 10% of its income on government services why aren't 90% of block grants used to reduce taxes?
    - ♦ (There are several theories that can be used to explain this, but all require more complex models of governance than our simple median voter model, and not all are very convincing.)

**IV. The Fiscal Commons Problem (aka the Pork Barrel Dilemma)**

- A. The existence of intergovernmental grants creates incentives for state and local governments (and state representatives and senators) to lobby for programs that benefit their own states--even if they do not benefit the nation as a whole.
  - i. The federal government funds specific highway and water projects that benefit only a particular city or metropolitan area, but which are paid for by taxes imposed on everyone in the country.
    - a. Programs that often have regional rather than national benefits include: flood insurance, hurricane relief, ports and harbor spending, railroad and airport subsidies.
    - b. Many highway and irrigation projects, national parks, and museums also mainly produce local benefits.
  - ii. Groups will press for targeted projects that generate benefits for them that are lower than their own tax costs.
    - a. Such targeted programs (ear marks) can lead to inefficient policies at the national level, because central government expenditures are normally funded with general revenues.

- b. *In such cases, the national funding of local projects induces a good deal more lobbying than would occur if the projects were funded at local levels, because local benefits are more likely to exceed local tax costs if other taxpayers are paying most of the cost.*
- iii. Most central government revenues are raised through broad-based taxes, as with the income tax, corporate income tax, and sales (VAT) tax.
  - This implies that the cost of targeted programs are spread over the nation or state as a whole, even if benefits are only locally distributed.
- iv. Adopting such targeted programs requires majority support within the central government's legislature.
  - a. Thus, not every possible project that has local support can be funded.
  - b. However, it is possible that a majority of voters (or legislators) receives net benefits that are smaller than the costs imposed on the minority opposed to the project or program of interest.
  - c. It is also possible for majority coalitions to be assembled for a group of earmarks that have benefits that are smaller than their costs for the nation as a whole.
  - d. This problem is sometimes called the "fiscal commons" problem or the "pork barrel dilemma."

**B. Illustration of the Pork Barrel Dilemma**

- i. Consider two programs with negative social net benefits, but majority support from two narrow coalitions.
  - a. Each project has total costs that exceed its total benefits, but that regional benefits are greater than regional costs under central government financing, because of the use of general taxes.
  - b. For the purposes of illustration, assume:
    - that a regional **highway costs** 10 billion dollars and provides 1 billion dollars of benefits to region A and 6 billion dollars of benefits to region B.
    - Assume also that a regional **water project costs** 12 billion dollars and generates 8 billion dollars of benefits for region A, but only 2 billion dollars of benefits for region B.
- ii. The following game matrix can be used to illustrate this pork barrel dilemma.

<b>the Pork Barrel Dilemma</b>		
Region B	Build Road	Don't Build Road
Region A	A, B	A, B
Build W	(-2, -3)	(+2, -4)
Don't build W	(-4, +1)	(0, 0)

- a. The payoffs to the region B and region A coalitions consist of their own narrow benefits from their projects less half of the total cost of the projects adopted.
  - If neither project is built, no benefits and no costs are realized.
  - If just the road is built, then region A gets  $(1 - 10/5) = -4$  in net benefits. Region B, on the other hand pays its share of the costs and receives only very small benefits  $(6 - 10/2) = +1$ .
  - If just the water project is built, then region A gets most of the benefits but pays only half the costs,  $(8 - 12/2) = +2$ . Region B gets its small benefit at the cost of half of the water project,  $(2 - 12/2) = -4$ .
  - If both projects are built, Region A gets  $(1-4) = -3$  and region B gets  $(2 - 4) = -2$  in net benefits.
- b. Each coalition has incentives to press for passage of their project, regardless of what the other coalition does.
  - ◆ Notice that the payoffs in this case resemble those of a Prisoner's dilemma game.
  - ◆ Each group has a dominant strategy
- c. **As a consequence, each project is adopted at the Nash equilibrium of this game.**
  - **However, both coalitions would be better off if neither of the projects were actually built!**
- iii. The fiscal commons problem arises because of fiscal externalities. One region's centrally funded programs impose costs on other regions, who have to pay for those projects even though they receive little if any benefit.

iv. This problem can be avoided by (i) making the regions fund their own projects, (ii) by rigorously using cost benefit analysis, or (iii) by adopting a generality rule (see Buchanan and Congleton 1998).

- a. (Explain why these three solutions would all solve the dilemma.)
- b. (Are there other solutions that would also avoid the PD outcome while allowing projects with positive net benefits to be built? For example, how might user fees or benefit taxes be applied?)

### C. Overlapping Tax Bases: Another Fiscal Commons Problem

- i. In cases in which government fiscal authority is decentralized, there can be competition between levels of governments, and in some cases governments at the same level, over a tax base.
  - ◆ The problem of over using a given tax base is a fiscal externality problem is similar to the fiscal commons problem for expenditures outlined above, but in this case generates over taxation rather than over supply of services
  - ◆ (Of course, both phenomena may occur with the same federal government.)
  - ◆ The common tax base problem is one possible rational choice explanation for taxation beyond the level that maximizes revenue in a Laffer Curve diagram (Flowers, 1988).

## V. Intergovernmental Competition: the Tiebout Model

A. Charles **Tiebout** (1954) pointed out that intergovernmental competition between local governments can be very similar to competition between firms in competitive markets.

- That is to say, intergovernmental competition can generate patterns of local public services and taxes that are Pareto efficient.
- i. Tiebout uses migration and changes in local tax bases to characterize a **perfectly competitive** version of intergovernmental competition at state and local levels.
    - a. He assumes that moving from one community to another is costless and motivated entirely by differences in local public services and taxes.
    - b. He also assumes that competition for residents produces a wide range of fiscal packages to choose from.
    - c. In this model, "tax and service competition" can be very similar to "price and quality competition" in private competitive markets.
  - ii. In the limit, "voting with one's feet" produces a competitive equilibrium among communities in which:

- a. Each community provides its bundle of public services at least cost.
  - b. Every community is ideally sized to produce its bundle of services.
  - c. Each community's residents are "homogeneous" in their demand for local public services.
  - d. Each voter-resident pays the marginal cost of his own services.
- iii. Such tax and service combinations meet the Lindahl conditions for efficient provision of public services (as well as the Samuelsonian ones).
- iv. Note that this process does not require an effective political system to achieve Pareto efficient results, only very mobile tax payers who can take their part of the tax base with them.
    - ◆ In order to tax mobile resources, communities (towns, states, and countries) have to provide services commensurate with their tax costs.
    - ◆ Otherwise "public consumers" will **vote with their feet** and move to other places that provide better value for their tax dollars (taking "their tax bases" with them).
  - v. Intergovernmental competition does not always work as well as Tiebout suggests, but this idea has informed a good deal of discussion about the desirability of decentralizing the provision of services.

B. Tiebout's model provides one of the strongest arguments in support of decentralized governance.

- Decentralizing the provision of local services potentially allows voters to get just what they want from government--no more and no less.

C. Although Tiebout may be a reasonable first approximation for competition between local governments (and condo associations) within a metropolitan area, clearly **there are limits to its applicability**--just as there are limits to the applicability of his theory of perfect competition in ordinary markets.

- i. How sensitive are the Tiebout results to the assumptions?
  - a. Clearly, the cost of moving between governments is not trivial, and tends to vary with the level of government.
    - ◆ Does this imply that none of the predictions will hold up?
  - b. Or is there enough mobility into and out of communities within many regions to put competitive pressure on local governments?
    - ◆ A large number of persons are always moving for other reasons and may choose communities in large part for the combination of services and taxes offered.

- ii. **Economies of scale** or networks may reduce the number of competing "town-firms" that can be sustained in a "Tiebout world" in a manner that reduces the range of choice available to voter-taxpayer-consumers.
  - ◆ The menu of government services that voter-taxpayer-consumers can choose from may be more limited than the Tiebout model implies.
  - ◆ The effect of economies of scale parallel those in the microeconomic analysis of perfect competition vs. monopolistic competition, oligopoly, and monopoly.
  - ◆ In such cases, local politics will again be an important determinant of citizen welfare.
- iii. The existence of intergovernmental **externalities** may also imply that some services are under provided locally and others are over provided.
  - a. The logic closely parallels our earlier analysis of externalities between individuals and/or firms.
    - ◆ NIMBY problems may also emerge.
    - ◆ Transfer programs may be underprovided.
  - b. Solving externality and public goods problems may require "treaties-Coasian contracts" or "interventions by other levels of government."

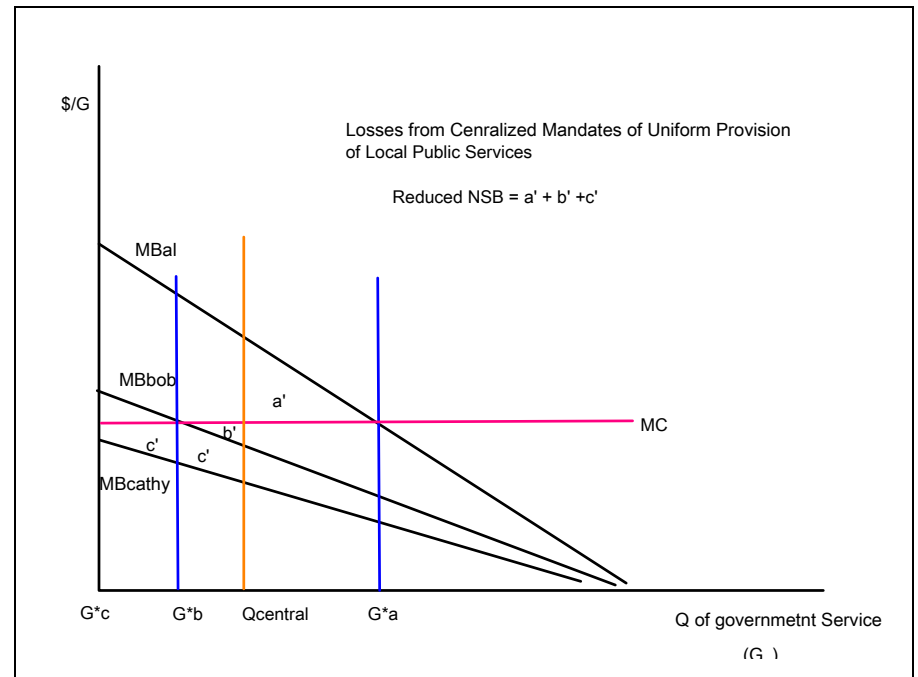
**D.** The existence of economies of scale and externalities provide an **economic rationale for federal systems** with several "levels" of government with responsibilities for providing services in different sized jurisdictions.

- ◆ If Tiebout worked perfectly, it would imply that an efficient federal government would be composed largely of local governments with a very small central government with the sole task of guaranteeing citizen mobility among communities.
- ◆ (Explain why)

## VI. The Economic Logic of Assigning Fiscal Responsibilities to Different Levels of Government

- A.** The Tiebout case for decentralization suggests that services should be provide by government's with the smallest jurisdictions (territories) sufficient to realize all economies of scale for the service of interest.
  - a. Oates (1972) develops this point more formally with his decentralization theorem.
  - b. The EU adopts this idea with its "subsidiarity principle."

- B.** The optimal size of governmental that provide particular services can be analyzed by studying economies of scale in producing the services of interest.
  - i. Services with global economies of scale should be provided by the national government (national defense, macroeconomic policy, redistribution)
  - ii. Services with that require relatively large service areas or numbers of customers should be produced by state governments. (regional highways, higher education, etc.)
  - iii. And services that can be effectively provided in relatively small service areas or for relatively small customer bases should be provided by local governments. (police and fire protection, elementary education, local roads, sanitation services etc.)
    - ◆ (Note that the simple production-based arguments imply that particular services should be provided by only a single level of government.)
  - iv. Addressing problems of intergovernmental externalities and economies of scale will require governments with larger jurisdictions than those that provide local fire protection.



**C.** Wallace Oates (1972) argues that if policy or service X has an effect on region Z, then the whole region should be managed by one government.

- i. Similarly, it can be argued that the "service district" (regionally governed) should be large enough to realize all economies of scale in producing the service of interest.
  - a. For example, some forms of education, police services, and environmental regulation have only local effects.
  - b. The Oates-Tiebout analysis suggests that responsibilities for those services should be local rather than state or national.
  - c. (Variety is good in the Oates-Tiebout framework.)
  - d. (Would fiscal equalization make sense in this framework? Discuss.)
- ii. On the other hand, other services tend to have regional effects as with commuter networks, other forms of air and water pollution, and some forms of police authority.
- iii. Large--but not national--externality problems, such as lake or river water pollution can be best addressed by state government or regional consortiums of states.
- iv. There are evidently great economies of scale in military force, which suggest that national governments should have responsibility for this service.
  - Similarly, insofar as the advantages of free trade zones increase with size, so the national government should have responsibility for maintaining free trade within the nation.

## VII. Externalities between Governments:

- A.** There are cases in which a government cannot adopt Pareto efficient regulations or service levels--even if it wants to--because part of the problem is generated by persons or companies outside their jurisdiction.
- i. In such cases, regulation itself can be an externality generating activity.
    - For example, a town's regulations on water pollution may impose externalities on towns further down stream.
    - Similarly, the environmental and trade regulations in one nation state may impose benefits or costs on residents of other adjacent countries.

ii. Consequently, there may be unrealized gains to trade between governments regarding appropriate regulation.

- In a median voter model, in effect the median voters would have reasons to coordinate their policy choices.

**B.** There are two general methods for dealing with such **governmental externality problems**.

- i. First, the affected parties may attempt to negotiate a "Coasian" contract that "internalizes" the externality. That is to say, the governments may negotiate a treaty where the countries "trade regulations."
  - a. For example, in the various international environmental treaties, countries agree to strengthen various environmental regulations to deal with an international externality.
  - b. State and local governments may negotiate with each other and sign agreements to coordinate policies or to create a "special use district" of the same "size" as the externality. (Examples include airport and transit authorities (NY, NJ and CN) and water commissions (US and Canada, Sweden and Denmark) etc.

**C.** Another solution possible within a country is to "ask" higher levels of government to regulate the matter of concern.

- a. Adjacent counties may ask states to regulate "county externalities," states may ask the federal government to regulate "inter state externalities."
- b. In Europe the regulation of many international externalities is coordinated by the European Community.
- c. However, this solution is of limited value for international regulation and public good problems because there are no world or continental governments.
- d. The results of Coasian contracts can be highly imperfect (relative to Pareto optimality) in international settings. Discuss some of these.
  - [We will analyze the demand for treaties and their effectiveness later in the course.]

## VIII. Ideal Divisions of Policy Making Authority

- A.** These production and externality-based economic arguments, however, neglect the advantages of variation in the services provided and also the **political costs** associated with larger regional governments with greater monopoly power.

- i. There are political costs associated with merging quite different areas into a single metropolitan area.
    - a. The community becomes more heterogeneous.
    - b. Monitoring costs tend to increase.
    - c. Each voter has a smaller effect on service levels through his locational choice and voting behavior.
    - d. Competition tends to fall as the number of government service packages diminishes.
      - (Indeed, come "community mergers" may be just cartelizing behavior by local politicians who attempt to escape from competitive pressures.)
  - ii. It also bears noting that carefully assigning fiscal responsibilities to specific levels of government is only one method of addressing these kinds of problems.
    - ◆ Other solutions also exist, as noted in our previous analysis of solutions to externality problems.
    - ◆ One can also use mandates and Pigovian subsidies and taxes (conditional grants) to address intergovernmental externality and public goods problems.
    - ◆ The federal structure can also be left a bit open ended so that communities and states can form "consortiums" or "regional authorities" to address regional interests. (Treaties or Coasian Contracts).
  - iii. There are advantages to variation in services as noted by Tiebout and the decentralization theorem of Oates.
- B.** The best (utilitarian or contractarian) assignment of authority for providing services to specific levels of government (should) take account of both economic and political costs.