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Source: *Nebraska Journal of Economics and Business*, Autumn, 1971, Vol. 10, No. 4 (Autumn, 1971), pp. 3-13

Published by: Creighton University

Stable URL: https://www.jstor.org/stable/40472398

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ECONOMICS OF FISCAL FEDERALISM*

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The recent rise of interest in fiscal Federalism stems from a variety of sources. At the academic level certain developments in the economics of public finance, in the making over the last two decades, naturally pointed in this direction. The renewed concern of fiscal economists with issues of allocation and expenditures (as against stabilization and taxation) drew attention to state and local finances as a field of research. It is here, after all, where the provision of social goods primarily occurs. Developments in the theory of social goods, in pushing beyond the polar case where equal benefits are enjoyed by all, pointed to differences in the spatial benefit characteristics of various public services. This, then, led to a normative theory of fiscal structure, based upon spatial considerations. Other features adding to the analytical interest in local finance were: (1) the role of location choices as a mechanism by which preferences for social goods may be revealed, and (2) the operation of intercommunity fiscal agreements as a real world illustration of the small-number case in the theory of social goods.

At the same time interest in fiscal Federalism was fanned by other developments. One of these is the increased interest in decentralization as a way of life. My generation of public-policy-oriented economists has been essentially centralist in approach. In part, this was due to our concern with macro problems which by their very nature must be handled at the central level. But it was due also to a political climate in which centralized action stood for positive policy responsibility, while decentralization stood for minimizing public sector activity and public interference. I am not persuaded that this nexus has ceased to hold, but one must take note of the voices for decentralization which now come from all sides of the political spectrum. "Let each commune do its own thing" is anticentralist, no less than the states' rights doctrine of old, even though the two may be antithetical in their views of what constitutes the proper size of the public sector at the local level.

Finally, concern with issues of fiscal Federalism has been the inescapable result of the fiscal distress in which many jurisdictions, hard-pressed urban centers in particular, find themselves. The situation is one which

*The C. Woody Thompson Memorial Lecture delivered at the opening session of the annual meeting of the Midwest Economics Association, Chicago, April 29, 1971.

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cannot be met without a transfer of fiscal responsibilities and/or resources. Such a transfer, by its very nature, must be implemented through the Federal budget.

Given these various strands of interest in the Federalism issue, what can be said about its basic economics, and what policy measures are needed to resolve the current difficulties?

I. SPATIAL ASPECTS OF SOCIAL GOODS

To begin with, consider the provision for social goods, leaving distributional aspects for later consideration. Should such goods be provided on a centralized or a decentralized basis? If all social goods were such that the benefits were equally available to all, independent of their location, the problem would be simple. Provision, wherever made, would necessarily be "central" and should be determined on a nationwide basis. But such is not the case. It is feasible to light one street corner more brightly than another, to have better fire-fighting services in this town than that, to have a better state university in one state than another, and so forth. The spatial incidence of social goods differs. They may thus be arranged depending on whether their benefit incidence is local, statewide, regional, or national. The question arises, therefore, of what goods should be provided where and by whom.

If preference patterns regarding social goods differ between communities, there is everything to be said for permitting them to differ in their provision for social goods, just as individuals should be permitted, in the absence of externalities, to arrange their consumption patterns to their own liking. This suggests a fiscal structure where local goods are provided locally, regional goods are provided regionally, and national goods are provided nationally. In short, the budget should be determined and paid for by the residents of the particular benefit area.

Let me call this the principle of reciprocity. Provision for various services will thus involve varying degrees of centralization, that is, service areas of various radii of coverage. Differences in fiscal patterns between jurisdictions will reflect differences in effective demand (that is, in preferences and incomes) of the residents. Efficiency will be served, moreover, by permitting people with equal preferences for social goods to live together, since this permits them individually to obtain the desired amount of social goods at a lower price. Whereas in the world of private goods it may be advantageous to have atypical tastes, the opposite holds for public goods. Moreover, since political decisions can only approximate individual preferences, similarity of tastes also reduces the risk that individuals will be faced with budget decisions that they consider nonoptimal.

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This spatial model of fiscal structure has its attraction, but it oversimplifies matters. One difficulty is that benefits from services provided in any one jurisdiction may not be limited to residents of that jurisdiction, but spill over to residents of other jurisdictions. This may be the case because jurisdictions are inefficiently designed, at least from the fiscal point of view; or it may come about because the spatial patterns differ for various types of public services. The reciprocity principle would thus call for different but overlapping jurisdictions for each service. A person residing in any one location would be a member of various "service clubs," aimed at providing him with different services. For some services, he would join with close neighbors only, while for others the neighborhood concept would be extended to involve a radius of 10, 100, or 1,000 miles. The system would be exceedingly complex and might not be desirable even if feasible. Complete separation of services would render the decision process more difficult, as the bargaining feature of changing the budget mix would be lost. Moreover, jurisdictions are historically given and not created on the basis of fiscal rationality alone. State or city boundaries do not neatly coincide with benefit areas.

Thus spillovers remain and must be dealt with. They must be made to enter into the calculus of the decision-making unit if service levels are to be set efficiently. Such spillovers are the public sector counterpart of externalities in the provision of private goods where each household is its own jurisdiction. Such jurisdictional externalities may be accounted for by direct bargaining between the units involved. Since numbers are typically small, bargaining may work (if not necessarily optimally), even though it is not operational in the large-number situation which is typical for most social-goods problems. Nevertheless, mediation by a higher level government—which, for our purposes means a government whose jurisdiction covers the combined areas—may be called for.

Similar problems arise in the spillover of burdens. The logic of our spatial model rests on the proposition that the provision for social goods be determined (voted upon) and financed by the group of people who will benefit. Reciprocity implies that the taxes used to finance such services should be borne by this group. The burden should not be "exported" to the outside, so as to obtain public services free of charge or at a reduced cost to the beneficiaries. Just as the spatial incidence of benefits is the key to locating expenditure functions, so should the spatial incidence of tax burdens be the key to determining which tax instruments are used properly at various levels of government. National services are to be paid for by taxes with nationwide incidence, while local services are to be paid for by taxes with a local-burden incidence. To some extent, this

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results automatically from the nature of jurisdictions, since a jurisdiction can tax only within its borders. But burden spillouts may occur through trade and "foreign" ownership of capital. Such burden spillouts are not to be permitted in the ideal system, unless they are charges for intermediate public goods which lower the cost of the exported products and hence should be paid for by "foreign" consumers. Enforcement of this rule again calls for supervision by a higher level of government, the current efforts for tax coordination among the member states of the European Common Market being an interesting case in point.

Note that in this dream world of fiscal efficiency, location decisions would not be independent of fiscal considerations. Such considerations would be included, not as a distorting element but so as to secure a more efficient solution. Association with others of similar social-goods preferences is efficient. For this to be the case, the principle of reciprocity must hold not only between groups of cost bearers and beneficiaries, but also for each individual. Taxation must be based on benefits secured. The price charged to a beneficiary must be equal at the margin to his benefit derived, and since this condition may be met by more than one pricing rule, the same rule must be used by all jurisdictions. If any one jurisdiction undercharges or overcharges relative to others, location decisions are distorted.

Such of course is the case in the real world, where taxes are not imposed on a benefit basis, and burden distributions by income level differ among communities. These inefficiencies would be avoided in a unitary system, where the cost-benefit patterns are the same everywhere, but this would be at the cost of losing the gains from variety which are possible under the multiple system. Which system is better on balance thus cannot be decided on a priori grounds. Under optimal arrangements the multiple system is clearly preferable, but in the actual setting a unitary solution may be superior. One would have to examine, for instance, how much less variety there is in local services in centralized countries such as the Netherlands or the United Kingdom than in a decentralized system such as ours.

II. DISTRIBUTIONAL CONSIDERATIONS

So far I have assumed that the state of income distribution is given and that individual preferences are to be weighed accordingly. We must now drop this assumption. Fiscal policy is concerned not only with provision for social goods but also with adjustments in the distribution of income. How is fiscal Federalism to handle this function, and is there a problem of adjustment not only between poor and rich individuals but also between poor and rich communities?

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Policies to adjust the distribution of income among individuals must be conducted on a nationwide basis. Unless such adjustments are very minor, regional differentiation leads to severe locational inefficiencies. Moreover, regional measures are self-defeating, as the rich will leave and the poor will move to the more egalitarian-minded jurisdictions. Progressive income taxation at the upper as well as transfers at the lower end of the scale—if substantial in scope—must be uniform within the entire area over which there is a high degree of capital and labor mobility, which means they have to be a function of the national government. Failure to meet this condition, as we shall note presently, is responsible for much of the fiscal distress with which we are now confronted.

This much is evident, but there remains the puzzling question whether national concern with distribution should go beyond the state of distribution among individuals and include intercommunity distribution as well. Does the existence of poor communities call for equalizing measures among them, as distinct from that of equalization among rich and poor individuals? Given an individualistic social welfare function, policy must ultimately be concerned with the welfare of individuals rather than of groups, so that the answer to this question would seem to be in the negative. Such at least is the case in a world of private goods. The question is whether the same holds for a world with social goods.

The distribution issue, basically, relates to the distribution of welfare, and not the distribution of income. Since the former depends on the pricing rule as well as on the distribution of income, the latter (in order to achieve the desired welfare distribution) must be set with reference to the prevailing pricing rule. In a world with private goods only, this rule is given by uniform marginal cost pricing. Now let social goods be introduced and suppose that these are priced (by means of the tax system) so that each person pays in line with his marginal evaluation. With the same amount being "bought" by all, differential prices will be paid. High-income people will tend to pay a higher unit price than low-income people. This being the case, the same distribution of welfare now calls for a less equal (pre-tax) distribution of income. In a world with public goods, less pre-tax income equalization is needed to achieve a given state of equality in welfare than in a world with only private goods.[1]

This is all that need be said if social goods are national in scope and centrally provided. But now consider the case of local social goods. For any one person their unit price will be the less, the higher is the income of his coresidents. Under our pricing rule, a person with a given income will

[1]The term "pre-tax income" here refers to income before tax payments for public services, but after redistributional (tax-transfer) adjustments.

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be better off if he resides with rich than with poor neighbors.[2] This much we can conclude, but what follows regarding the overall state of interindividual distribution, including the residents of both towns? The fact that High Town has a higher average income than Low Town means that local provision of social goods will tend to increase inequality among the total population, including residents of both towns. But this does not answer our problem. The question is whether this result simply calls for a more equal income distribution (as compared with the unitary system) among individuals, or whether it calls for a transfer from the residents (rich and poor) of High Town to those (rich and poor) of Low Town. Only in the latter case will the distinction between poor and rich communities be relevant for policy purposes.

The answer at a normative level at least is the former. If the interindividual distribution of income were adjusted properly, no redistribution between communities would be needed. The reason is that the proper state of interindividual distribution would allow (as part of the pricing rule) for the unequalizing effect of local public goods on welfare. This allowance in turn would have called for a more equal income distribution, and having provided for this, a second round of adjustment would not be called for.

But however this may be, the distinction becomes vitally important once we discard the unrealistic assumption that the desirable state of interindividual distribution has been established by national policy. The local fiscal authority must then act as the social conscience of last resort. It must assume responsibility for such redistributional functions as welfare, health care, and other public services. These needs rise as average community income and hence fiscal capacities fall. Thus extreme imbalance between fiscal capacities and needs has developed among communities and becomes steadily worse. As higher income residents of poor jurisdictions are burdened more heavily relative to those of richer jurisdictions, they leave, and the tax base deteriorates further. The result is a downward spiral of deepening fiscal distress.

While the distinction between rich and poor communities does not call for distributional measures in a normative setting in which a "proper" interindividual state of distribution is assumed to prevail, it is of crucial

[2]If the tax allocation is by majority decision (rather than a strict benefit rule), this conclusion must be qualified. If the demand for social goods is income elastic, an individual residing with coresidents of equal income runs less risk of being confronted with a budget vote which deviates from his preferences. This runs counter to the consideration noted in the text so that his tendency to choose richer neighbors will be dampened.

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importance in our actual setting, where this condition is not met. Policies of fiscal equalization are needed, involving revenue transfers from jurisdictions with a high ratio of capacity to need to jurisdictions with a low ratio. Fiscal Federalism cannot function properly without either a central policy of interindividual or (second best) intercommunity equalization.

III. MERIT GOODS AND OTHER MATTERS

To complete the picture, I must add a word about the role of public merit goods in the Federal system. In a unitary system the merit-good problem is whether government wishes to interfere with individual preferences by encouraging the consumption of particular goods, be they social or private. In the Federal system, we have the additional question whether the Federal government wishes to interfere with local community decisions and encourage the provision of certain local-type social goods. The central government may do so because of spillover effects to the rest of the nation.[3] Or it may be that for some reason certain local social goods are more highly valued from a national than a local point of view. Local preferences are to be interfered with and Federal preferences are to be superimposed. The case is quite analogous to other merit-good situations where certain private goods are to be subsidized or taxed in interference with private preference.

Federal policy may aim at assuring minimum performance levels for such services as health and education, or the purpose may be to encourage local provision by reducing the cost of a particular service to the local community. The appropriate device in the former case is a block grant, earmarked directly for the provision of the particular service; in the second case it is a matching grant, similarly earmarked for the service in question.

The essential point is that certain specific services are to be considered as being of particular merit from the national point of view and hence to be deserving of special support. The appropriate instrument, as just noted, is a categorical grant. To propose a general grant is to argue that, in fact, all local public services should be considered Federal merit goods. This I find difficult to accept. While all local public services may be in short supply, this does not suggest to me that there is an equal need to expand all of them. On the contrary, if the deficiency is great, limited means should be directed toward those services which are most in need of expansion.

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[3]It might be argued that correction for spillovers is not really a merit-good problem, since it does not involve an interference with preferences but merely a correction for benefits which are not internalized.

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By the same token, the case is for the matching- rather than for the block-grant variety. If increased purchases of particular local social goods are to be encouraged, more can be done, with a given budget constraint, by reducing their price to the local community than by making a block grant. The latter may be used for tax reduction, which will increase purchase of private goods, no less than for the increased provision of social goods.

The four major ingredients to my recipe for fiscal Federalism may be summarized as follows:

1. *The principle of reciprocity.* Various social goods should be provided for at the local, regional, or national level, depending on the range of their spatial benefit incidence, so as to let provision be decided and the cost be borne by the residents of the particular area in which the benefits accrue.

2. *The principle of centralized redistribution.* Adjustments in the distribution of income should be the responsibility of central policy, since it is only here that such measures can be conducted effectively and without causing severe efficiency losses.

3. *The principle of fiscal equalization.* In the absence of an adequate interindividual distribution policy, the central authority must secure some degree of fiscal equalization among poor and rich communities.

4. *The principle of Federal merit goods.* The central government may wish to encourage the supply of certain locally-provided social goods, either because these involve spillover of national benefits or because they are considered of special merit from a national point of view, with matching grants the appropriate instrument for this purpose.

IV. THE PLACE OF REVENUE SHARING

What do these principles of fiscal Federalism imply for the current debate over revenue sharing? The Administration's proposal (and with but minor differences, the original Heller-Pechman plan and other variants) provides for a block grant of about $5 billion, to be distributed to the states on a per capita basis, with minor allowance for tax effort. Part of the funds are to be passed through to local governments, in line with their

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past shares in total (state and local) expenditures in their state. While the per capita formula is redistributive, it is but modestly so and even the Javits plan which goes farthest in this respect does not get very far.

The Administration's basic case, as that of others advocating similar plans, is that the sharing of Federal funds will bring badly needed fiscal relief at the state-local level, that this relief should be given so as to leave states and localities free to decide how the funds should be used, and that population is a simple and otherwise acceptable distribution base.

The question is not whether this proposal, taken by itself, is a good thing. To appraise the plan, its merits must be compared with those of alternative uses of these Federal funds. The alternative of Federal tax reduction would be clearly inferior. Reduced Federal tax dollars do not mean increased state-local tax dollars, but a net reduction in overall fiscal resources. This would be unfortunate, as the Federal funds are needed for purposes of equalization and to provide nationally important public services. But to argue that the proposed revenue sharing is preferable to Federal tax reduction is damning with faint praise. The point to be made is that better uses of these fiscal resources are available and should be preferred.

I begin with the simple fact that Federal fiscal resources are strictly limited. The vision of a substantial fiscal dividend—or budget margin, as the current, less glamorous, lingo calls it—which would be available for all sorts of major new programs is rapidly vanishing. For the next two or three years the margin is $3 or $4 billion only, and even by 1976 the prospective excess of full employment revenues over the cost of present programs is at best $20 billion. (This allows for termination of Vietnam hostilities but not for domestic cutbacks in other defense expenditure.) Moreover, even this margin may well not materialize, since it reflects in large part a surplus in the Social Security trust funds. Given this restraint, the proposed type of revenue sharing does not rate the high priority which is assigned to it.

As I see it, Federal finance of poverty programs, including welfare, must come first. While the Administration's plan for welfare reform points in the right direction, the additional funding is very small and inadequate. Much larger amounts, say $20 to $30 billion, will be needed, especially if the expanded program is to be in the form of a negative income tax. Next, I would favor substantial Federal participation in the financing of elementary education, designed in particular to assure adequate minimum standards on a nationwide basis. These objectives, combined with other new requirements, such as environmental programs, will easily exhaust or exceed the available margin. Yet until they are met, I am not prepared to

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divert scarce funds into a broadside grant which in the end will do very little to relieve the fiscal crisis.

Let me note once more that, as long as central finance fails to deal adequately with interindividual distribution, concern with poor communities remains of paramount importance. As it now stands, there are vast differences in the capabilities of various jurisdictions to meet their fiscal responsibilities. While it is true that poor jurisdictions are frequently located in high income states—as is the case with the distressed core cities of the eastern seaboard—this gives little reason for comfort. It is fair enough to call on the residents of the suburbs to defray the cost of the inner city for services rendered to them, but it does not follow that they should also be called upon to defray the cost of the inner city's poverty problem. The residents of Westchester County should not be responsible for welfare in New York City any more than should wealthy residents of Hawaii or Alaska. The concentration of poverty in the core cities is a national problem, the cost of which should be defrayed on a national basis.

Given Federal assumption of fiscal responsibility for an adequate income maintenance program and for minimum levels of preschool and primary education, the problem of "poor communities" would be largely solved. Under this premise it would also be easier to reconstruct city finances so as to create metropolitan-wide fiscal units. To the extent that a problem of poor jurisdictions still existed, these measures could then be supplemented by a general grant, designed to reduce remaining discrepancies in fiscal capacity and need. But even then, the grant would differ from the present plan for revenue sharing. It would be on a matching basis, rather than a block grant, and more redistributive than is the case with the present per capita arrangement. Matching rates would ideally be related to capacity-need differentials. As it stands, we do not have the data on which the need side of such a formula could be based, but the basic information could, and I hope will, be developed. In the meantime, the obvious first step is the assumption of Federal responsibility for financing an adequate income-maintenance program. Generalized revenue sharing is an attractive idea, but we are just not wealthy enough, fiscally speaking, to indulge in it at this point. Let first things come first.

The design of Federalism, as I see it, should permit constructive cooperation among regions within the nation, retaining freedom of local action where it is feasible and providing joint policies where they are called for. Federalism, then, should not be viewed simply as a halfway-house or compromise between the extremes of complete centralization and decentralization. Rather it should be a constructive way of doing at each level

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of government what can be done best at that level. At the same time it is more than a convenient arrangement between independent units, similar to an agreement between foreign powers. The Federal structure, after all, is erected within the context of a national union. National responsibilities and rights should encompass all members of the subjurisdictions who, while residents of different localities, are nevertheless citizens of the same nation. This at least is the spirit in which my design for fiscal Federalism should be read.

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