

# Fiscal Federalism

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## Abstract

Decentralization of the power in federalized system means a transfer of part of the executive and also legislative power to the lower administrative and political levels. That is how is created and system which is counterweight to the centralization of the power on the highest level, which is more democratic way of governance. Aim of our paper is to zoom in fiscal federalism from few views.

*Keywords: fiscal federalism, decentralization, political level*

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## 1. Fiscal federalism

The use of the term federalism can be various in available literature. In its basic sense it is used for the case, where there is more than level of decision making existing and these levels are arranged in hierarchical order. Each of the level of this structure is partly autonomous in the decision making process and also takes responsibility for each decision. The transfer of executive and legislative power to the various levels of governance allows more flexible, preferable and faster reaction to the suggestions and also it allows the functioning and transparent system of control, where people can control the activity of their elected representatives much easier. The federalism represents in this pathway the aspect of the political system of the states, which raises the effectiveness of the political decision making (Fossati & Panella 1999). The existence of the multi-level public governance provides with the possibility of choice- to centralize the decision in the whole-state agenda or move the decision process to the lower governance levels if it is more effective and beneficial.

The theory of fiscal federalism is the part of the theory of the public finances and is based on existence of the multi-level governance from the economical point of view. The fiscal federalism is focusing on the research of the fiscal relations in the public sector, which has more levels of decision making (governance levels), regardless of whether it is unitary, federative or confederative state. The reasons for the creation of the theory of fiscal federalism were the urgent need to make the democratic decision about financial issues in budgetary system more effective. However, there was also need for decentralization of the public sector. The theory of fiscal federalism directly reacts to these needs and it creates the discussion in many directions about securing the public goods necessary for the people in

current raise of the efficiency of the raised financial funds and intensity of their control by citizens.

We can often meet with the exchanging or not dividing between the terms of fiscal federalism or fiscal decentralization. We presume, that these are two different terms, which content is very similar, however these terms are not identical. In this way we agree to the difference between the fiscal decentralization and fiscal federalism, which was summarized by Křížová. “The main difference is based on the normative character of fiscal federalism, while the fiscal decentralization shows the direction of the transfer of the powers towards the lower levels of governance” (Křížová 2016 p. 534). Fiscal federalism is then the theoretical framework, description of innovative procedures and package of the key principles of which direction should the fiscal decentralization take. The fiscal decentralization also represents the process of meeting the objectives, which come from the concept of fiscal federalism.

Fiscal federalism has despite the political also economical meaning. The connection of both of them creates a more complex understanding of the fiscal federalism. The main part of the fiscal federalism are the financial systems of the public administration, although the wider space is also offered to the relations between the financial connections and to ongoing processes of decentralization and deconcentration. The theory of fiscal federalism is dealing with an optimal allocation of the powers and responsibilities for securing the public services in various levels of the single government (Peková 2011).

Lajtpeková (2009) came with the idea, that the theory of fiscal federalism is based on the research of the configuration of the multilevel system of the public budgets. The multilevel budgetary system is corresponding to the division of the government levels. According to that we can divide both of the systems to locals (local, communal), which is the lowest level and are consist from the smaller political and administrative units- villages, towns or municipalities. The second level is regional level, which is usually the mesolevel between the lowest and highest level. In the case of unitary countries are on the regional level the district, self-governing districts, provinces, departments, self-governing regions and so on. In the federal states are in this level the single states, which are countries of the federation. The central level is in the highest levels of the government. In unitary states it is central government and in the case of federation is on this level the federative government. Last couple of years are connected with the spread of globalization which influences also the creation of the next level of governance. Its influence and role is constantly raising and it is created on higher level, than the central level and represents the multinational level.

Another area of the fiscal federalism interest is the optimal use of the functions of the public finances on specific governance levels. The aim of the fiscal federalism is to propose the optimal solution to assign the public revenues and public expenditures into the levels of the public administration, while the efficiency and usefulness of the financial funds should increase. The theory of fiscal federalism seeks to find the optimal model of dividing the power and responsibilities for the production of the public goods and it is further financing in between the central government level and lower levels of the public government. In addition to decentralize the expenditures to secure the selected public goods is the content of the fiscal federalism also the optimal decentralization of the income components of the budgets on the decentralized levels.

In principle we can identify a number of areas, with which are authors focusing on the fiscal federalism, dealing with (Peková 2004):

- vertical and horizontal structure of the public sector and seeking the optimal relations between the specific levels and units;
- with assignment of the single functions to the specific government levels;

- redistribution of the powers and responsibilities for individual spending areas;
- by setting taxation powers and by reform of the income component of the budgets of the lower governance levels.

The theory of fiscal federalism justifies providing of the specific public services on central or hierarchically lower government level. It distinct if the specific public good should be secured by the state or the specific level of the self-governing district taking into account the effective allocation of the sources in the whole budgetary system. It also seeks the answer for the question of the optimal allocation of the revenues and expenditures competence to the single levels of government and optimization of the fiscal relations in the fiscal system.

As the father of the fiscal federalism we can designate Musgrave. He used this term for the first time in his work from 1959, where he described his view on assigning of the various fiscal functions to the different level governments. Thanks to the distribution of the public sector to the three areas, Musgrave assumed that the centre of the fiscal federalism is that the allocation function of the public sector could have in the different parts of the country the different form, depending from the specific demand of the people for the public services in this area. The application of the principles of the fiscal federalism supposed to bring to the single groups of people in each state the possibility to express its own preferences in the relations to offered and provided public goods. The result is then specific way of taxation and quality and quantity of provided public goods. Musgrave considered the decentralization of the allocation function of the public goods as the basis for fiscal federalism. The stabilization and redistribution function should, however stay in the hands of the central government. These recommendations were later objects of the passionate academic debates. Basically, we have to confirm the general recommendations, which were defined by Musgrave for the division of the fiscal competencies. The macroeconomic stabilization has to be strongly centralized. Handling the financial reserves and loans is almost everywhere in competence of the central monetary authority. In the area of state budget there is only limited space for the decentralized regulation of aggregated demand, because of the openness of single local economies and their connections. Musgrave also doesn't see the space for the decentralization of redistribution function, which was demonstrated on the example, when lower than central government level started realization of the policy with the aim to divide the pensions of the wealthier people to the less wealthy ones. In this case, there is always a risk of the incoming wave of the less wealthy citizens and also there is a risk that the wealthier people will leave.

This prediction was verified in the work of Brown and Oates (1987). In their study they focused on the US and the single states of the federation, where they researches the redistribution of pensions and following migration of the citizens. In the state, where were designated the tools of high redistribution (for example progressive taxes, higher taxes for luxury goods, higher minimal benefits), they noticed the decline of the wealthier citizens and inflow of the poorer citizens. The decentralization of redistribution function itself resulted in unsatisfying level of the public goods in the social area. This opinion is also shared by King (1984), according to who should have redistribution policy always central character and the lower government levels should influence them only in minimum scope within a specified range.

The basis of the fiscal federalism is allocation function. While searching for the optimal model of offering the public goods in different conditions from various preferences we can think about positive impact of decentralisation. This can be most visible in the work of Tiebout (1956) and his models of local financing. In his article he deals with the topic of the public goods and the possibility how to bring allocation of the national pension closer to the efficiency of the private sector.

The basis of the fiscal federalism lies in allocation of the applicable functions and finances to decentralized governance level as efficiently, as its possible (Bird 1999). The theory of fiscal federalism is searching for optimal relocation of the competencies, responsibilities and finances, so the public welfare could be maximized. In this theory, authors tried to identify the general principles, which could firstly lead to the maximization of the public welfare in the case of self-governing districts.

With this specification is also corresponding the definition of the fiscal federalism from Jilek (2008). Jilek as the base of the fiscal federalism considers the optimal allocation of the public revenues, dividing the responsibility and optimization of the relations inside the budgetary system. In fact, it is different use of the allocation, redistribution and stabilization function of the public finances on the different levels of the public government.

Very similarly sees the theory of the fiscal federalism also Provoznicová (2009). She focuses on the selection of the optimal assigning of the responsibilities and ensuring and financing the specific public services and goods between single parts or the levels of the fiscal system.

Just slightly different meaning gives to fiscal federalism Oates in his work from 1972. The theory of fiscal federalism offers the general normative framework to determinate the functions, public services or tolls, which are better to centralize or on the other hand which are better to move to the lower level of government, specifically to the self-governing districts.

In the theoretical frame is the fiscal federalism dealing with the various approaches to determinate the appropriate degree of the fiscal decentralization of the public revenues to the self-governing district. If we would narrow our view, we can assume, that the fiscal federalism is dealing with the multilevel arrangement of the budgetary system. In addition, is the theory of fiscal federalism also dealing with the local finances, dividing and using the financial sources in the case of the public budgets and off-budget funds. The object of the authors interests is also the research of the different kinds of the public goods, their amount and credit, which should be preferably secured by the central or lower level, for the effective allocation of the sources.

The reason for existence of the fiscal federalism is seen by Musgrave and Musgrave (1994) in the spatial limitation of the benefit of the public goods, which results from the spatial limitations of some public goods or services. Therefore it is unnecessary to create a fiscal system which will be created from more governance level and each of them will be responsible for providing the specific public goods. Fiscal decentralism represents an objective status, reflecting the reality of multilevel governance system in each country. Most often are examined the relations in between the central and regional level.

The aim of the fiscal federalism is “recognition of the tasks of the single governance level and their roles in securing the public goods. Simultaneously is the role of the fiscal federalism also financing the public goods and relations creating in between the various levels of the public government” (Oates 2011, p. 39).

Hamerníková and Kubátová (1999) focused on specific part of the theory of fiscal federalism and they tried to find the reason, why there are created a specific structures and hierarchy among the singly fiscal systems. According to their work from 1999 lies the answer in the basic activities and functions of the public sector. Specific activities and functions are then carried out by the corresponding fiscal units, which have their own hierarchy and strictly defined budgetary limits.

The theory of fiscal federalism was created in USA in 50s. Its beginnings are usually connected with the names as Musgrave, Tiebout, Olson or Oates. From its beginning the

theory overcame many changes and development, which could be divided into three basic development periods according to the dominant approach (Oates 2005):

- 1. period - the traditional theory of fiscal federalism (also called as the first generation of the theory of fiscal federalism);
- 2. period - the theory of the public vote;
- 3. period - second generation of the fiscal federalism theory.

The authors of the traditional theory of fiscal federalism, or sometimes recalled also as the authors of the first generation of fiscal federalism, conceive their definitions on that, the district will try to gain the maximum level of welfare for its citizens. The main role of the public sector is with the help of the applicable public policies solve the problems resulting from the failure of economic market. Generally we could consider the three basic presumptions, from which the authors of the first generation of the fiscal federalism utilizing from. First is the existence of the local public goods. Second presumptions, from which is the traditional theory of the fiscal federalism utilizing from, is the fact that the local public goods and services are paid from the sources from local taxes. The last presumption is based on the mobility of the tax payers and final users of the public services.

For traditional and also for first generation of the theory of fiscal federalism is the key argument for the decentralization the existence of the local public goods. The subregion range of benefits from the local public goods is similar to the self-governing district or it is precisely defined by its territory. The self-governing district secures the quality and quantity of the public good, which will directly respond to the preferences of the local citizens. The authors of the first generation based their research on this normative persuasion, which means that providing of the public goods from the view of allocation effectiveness is more optimal, as the providing through central governance level. With this issue was dealing especially Oates (2011), which created so called decentralization theorem. The core of the theorem is to point out the fact, that provision of the local public goods through self governing district is more optimal as to secure them centrally. While in decentralized provision of the public goods is in each self-governing district decide about the quality and quantity of the public services, which would be optimal according to the finances. The benefits from the decentralized provision of the public goods are bigger, when the preferences of the citizens are more various and when the demand for the local goods is less elastic. The normative structure of the decentralization theorem is based on denying, or not taking into account the real conditions and factors. To fulfill the theorem there must be absent the profits from the range and externality and also there must exist the heterogeneity of the demanding preferences and donations contribute to the highlighting of the positives of the fiscal decentralization.

The reality and practice of providing the public services and goods is only in specific occasion directly covers with the area of the concrete self-governing unit. Very often we could come to the situation, where the provision from the local public goods in the selected self-governing district is also useful for the citizens of other districts. The positive impact spills over the borders of the district, which is securing the selected public goods, which creates positive externalities. The traditional theory of fiscal federalism solves this problem in the area of benefits from the local public goods adressess through funds and transfers from the higher governance levels. The common sign for the authors of the first generation of the theory of fiscal federalism is strict limitation only to the decentralization of the allocation function of the public finances. According to them is the central governance responsible for the stabilization and redistribution policy and not for ensuring the optimal level of the public goods in the whole state.



To the first generation of the authors of the theory of fiscal federalism belongs also Tiebout (1956), which in normative direction created a mode in which the citizens make the decision in the place of their living same way as they are buying commodities in the market and where they can compare the offer of the public services and the level of taxation. He elaborated his research to the final model, where with a sufficient number of municipalities, the high mobility of the citizens, excellent awareness of the public about public expenses and revenues of the single municipalities governments, will citizens choose the municipality, which answer to their demands about provided public goods in the more effective way. Thanks to that will be the public sector functioning more effectively and the local governments will be able to gather the taxes, which will match the benefits from the offered public goods. The citizens then can vote „by their feet“, because they can move to the municipality (society), which will offer them the optimal scale and structure of the public goods. The consumers of the public goods (citizens) are split in between the district areas according to their own preferences in the area of public goods. Tiebouts model is based on couple predictions, which are determining and, how is this model applicable. The selected model is applicable if there is existence of:

- large number of self-governing units;
- maximal awareness of the citizens about provisions of the public goods and the level of taxation in single self-governing units;
- optimal number of the citizens for specific self-governing districts;
- optimal size of the self-governing district for providing specific public service and the level of taxation.

However, this model cannot be applicable in the practice, since there are possible obstacles for unlimited mobility of the citizens (created by social networks, fees for the moving, problems seeking the appropriate accommodation). Oates (2011) also reminds us that, Tibouts model is applicable for the population in the cities. If the citizens work in the centre of the city and they live in the suburb, they choose their accommodation on the basis of the offered public goods (education, security, infrastructure). By this they fulfill the prediction, that the consumers are choosing their final self-governing unit, because of their preferences in the relation to the services offered in this area.

To traditional theory of fiscal federalism also belongs with its theory Buchanan (1965). Buchan continued in the tradition of last two predictions from Tiebouts model and tries to specify the optimal size of the district for specific public good. He focuses on the mixed public goods, since in the case of pure public goods is the size of district irrelevant, because other consumers in any other direction don't reduce the benefits of the other consumers. However, in mixed public holdings, with arrival of the new users is the benefit of the original costumers declining, because of the overload effect. According to the theory of clubs is the optimal size of the district for the selected quantities of the provided public goods then, if its the clear profit of the single person maximal-pareto optimal. If there is a change in the amount of the public good or in the number of consumers it has influence also on the optimal size of the district.

After raising the question about normative basis of the theory of fiscal federalism are authors focusing on the application of the theory of the public choice (2nd stage) on the relations in the fiscal systems in the countries. The primary difference compare to the first generation of the traditional authors of the theory of fiscal federalism was the move to the perception of the public government as one of the subjects maximizing the social welfare, to its understanding as the system of the various actors trying to achieve the subjective goals.

The basis of the second stage of the fiscal federalism theory, by which get inspired authors as a Brennan and Buchan in 1980 with their study *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Both authors are transferring the theory of the public choice to the area of fiscal federalism. Rather negatively they see the public sector, which is according to them trying to drain from the economy of state as many sources as possible. With the transfer of the decision powers and the reform of the fiscal system should be the raise of the public sector limited, since there is competition leaking in between the separate governance levels. They predict, that this kind of concurrence will limit the power of the state monopoly in similar way as it is happening in economy.

The specific of the second stage of the theory of fiscal federalism is in comparison with traditional authors the positive perception of the tax concurrence. According to Lockwood (2006), the concurrence does not need to lead to the decline of the tax revenues, since the decline of the taxes is limited by withdrawing the rent, which leads to the raise of the welfare of the single citizens.

The strategic interaction in the area of taxes and in between the various units of the self-governing district is also very common and according to Blochinger and Campos (2011) has the tax concurrence two basic forms. The first form is the clear tax concurrence, when the self-governing units are competing with each other for mobile tax base. The second form of the tax concurrence is the situation, when the representatives of the local governments copy the behaviour of the politicians in the different self-governing unit. The reason for copying this behaviour is the effort to increase their own chances for re-election.

Authors, who based their research on the theory of the public choice is dealing in the fiscal federalism with functioning the various political and fiscal institutions and the relations. Which are created by interaction of various actors (Weingast 2009). Similarly as the theories of the public choice predicts, that the politicians and officers are focusing on their own aims, which are not always same as the general aim of maximization of the citizens welfare. To the traditional questions of the fiscal federalism are increasing with the theory of the public choice new topics, as for example the interregional concurrence, fiscal federalism in the context of the political economy or the fiscal decentralization in the transforming and developing countries.

Quian and Weingast (1997) are claiming, that the traditional theory of fiscal federalism solves the correct division of the public sector and taxes for the increase of the citizens welfare. However, this direction does not explain, why should be public governments acting this way. The normative character of these principles is put by both authors into the question, how could be governments forced to provide the right quality and quantity of the public goods and also protects the market stimulus. As the solution they assume the strict horizontal division of the power on the legislative, executive and judicial power in the democratic state system. By horizontal division of the power is created a primary framework, which should be also accompanied by other measures leading to the maximization of the welfare state. The main tool should be the fiscal decentralization, which should protect the market stimuli in the public sector. Beside the fiscal decentralization, they also recommend the decentralization of information and authorities with the aim to create concurrence environment between the single political-administrative units with the governance levels.

The second generation of authors uncovers the normative nature of the theory of fiscal federalism and puts it besides the real conditions. According to Weingast (2006) is the difference in between the first and second generation of authors following. The traditional theories presume, that the government representatives on all the level are seeking to maximize the welfare and if there are some mistakes encountering, they are not intentionally as they are results of the lack of skills or lack of information. The theory of second generation is based on

the assumption, that the state officers have their own goals, which are results of the system of relations in between the institutions and the organs of the public sectors. Authors such as Tanti (2000) or Prud'homme (1995) are taking into concern, that each actor in the public sector has its own priorities and aims, which tries to fulfil by different ways. To the front is therefore pushing the research of the behaviour of the elected representatives and the officers and on the scene of the fiscal federalism is occurring the research of corruption and clientelism.

In addition to that, Azis (2008) studies the role of the institutional factors and its influence in the fiscal federalism and fiscal decentralization. In his work from 2008 is occurring the hypothesis, according to which is leading element of the fact, if the outputs from application of the certain models of the fiscal federalism or the outputs of the fiscal decentralization will be positive or negative, is mainly the participation of the citizens in the local elections, the amount of the local budget and the initial level of welfare. For positive results in the lower governance level is necessary for the local electorate to be sufficiently informed and educated, which also contribute to the political responsibility.

With the second generation of authors there are applying also the other concepts of the fiscal federalism. The new forms and views are based on the real results of the public policies and the structure of the fiscal system. Authors are utilizing mainly the inspiration from the US, since the US is considered as the excellent research subject for multilevel governance in practice. The new kind of fiscal federalism is for example the experimental federalism (Oates 2008). Its basis comes from the study of the fiscal decentralization as the main aspect for establishing the new forms of the public policies. With dividing the powers in between the federal level and single states was created some kind of "laboratory" of the various types of public policies. If the new public policy proved itself in one state, it is usually an inspirational example, which is followed by other states. The experimental federalism works in two basic dimensions. In the first dimension the central government provides the general framework of new policy, into which the single states or the districts incorporate their own programs. The second dimension comes from the situation, when the new public policy is completely initiated by the decentralized level of government.

With another innovative concept of the fiscal federalism were dealing Musgrave and Musgrave in 1994. They were inspired by the processes of decentralization in the US in 80s. The government on the federal level kept in its hands the public programs for the redistribution, so the programs for social care and the pensions. In this time period was also created a donation system with the participation of the each governmental levels. This primarily lead to the increase of the specific unit for the received fund and the secondary result was more economic usage of the federal finances on the level of the single states.

The current theory of fiscal federalism analysis the decentralization of the public sector and searches for the optimal division of the selected non-market activities of the state and dividing them in between the central level of government and single levels of the self-governing districts. The aim is to gain the allocation to ensure the public goods for the citizens.

Peková (2011) specified couple of basic principles of the theory of fiscal federalism, by which it is possible to generalize the principles of fiscal federalism:

- centralization of the stabilization state policy;
- consistency between self-governing district finances and the state finances. Fiscal policy of the municipalities and the regions needs to be in accordance with the stabilization, fiscal, anti-debt and anti-deficit policy of the state;
- the centralization of the redistribution, mainly in the area of social security;



- optimization of the redistribution of powers and responsibilities for providing the public goods and services between the self-governing districts (local and regional) and state;
- minimum standard of the basic local and regional public goods and anti-discrimination approach towards these goods;
- differ and taking into concern the differences in the preferences of the public goods ensured by the self-governing units;
- optimal fiscal decentralization of the public debts and distribution justice;
- use of the local taxes on the local and regional level with at least minimal tax powers of the self-governing districts;
- straightening the fiscal position in the different spatial tax capacity and tax balance;
- increase efficiency of redistribution relations between the state and the self-governing units;
- optimal fiscal decentralization of the public expenses;
- increase of the allocation efficiency.

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