Fiscal Federalism

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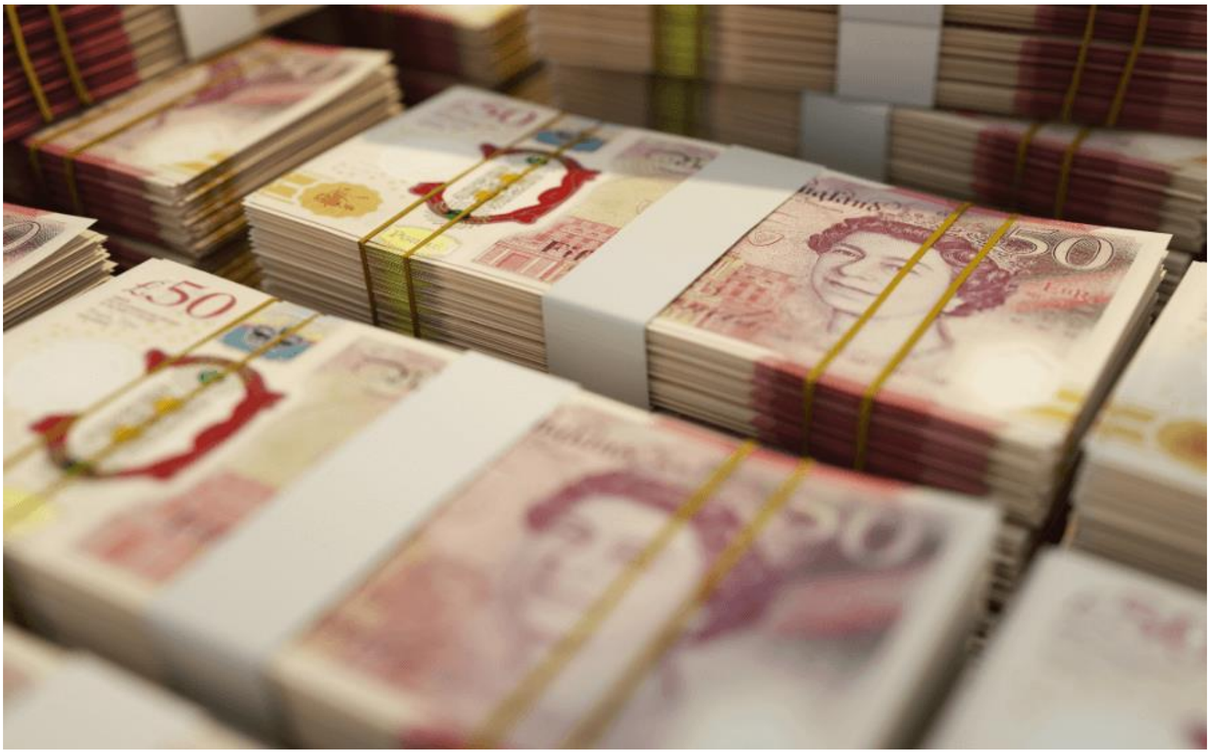

Figure 1- Image from Canva

This review was carried out as part of the '[improving public funding allocations to reduce geographical inequalities](#)' project, funded by the Ministry of Housing, Communities and Local Government and the Economic and Social Research Council. The project aims to propose better ways of allocating public funding in England, based on a much clearer understanding of the funding system and the policy problems arising from it.

This is a multi-partner project led by the University of Birmingham.

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The organisation of responsibilities and finances between different levels of the state is a fundamental task for governments in achieving their political and public policy goals. This arrangement of powers and resources underpins how funding is allocated and distributed between government levels and geographical areas. Fiscal federalism refers to this organisation of responsibilities and funding. It has become increasingly important internationally following the expanded roles of national governments and their policies and funding programmes in responding to the Global Financial Crisis in 2008, the COVID-19 pandemic from 2020, and the recent geopolitical disruptions of conflict in Ukraine and the middle east. Fiscal federalism also informs debates about the decentralisation of governance and funding in devolving centralised states including the UK. This review outlines the definition of fiscal federalism, its underlying assumptions, principles of public funding allocation, advantages and disadvantages, before concluding.

Summary

- Fiscal federalism is the organisation of powers and resources between different levels of government and geographical areas
- Key assumptions are that governments are not equally effective in raising taxes and delivering spending programmes due to the lack of perfect information, administrative costs can vary across governments depending on their capability and degree of centralisation, and in some governance systems governments can run budget imbalances
- Key principles guiding public funding allocation in fiscal federalism are efficiency, equity, accountability, responsiveness, stability, fiscal autonomy, and intergovernmental collaboration
- The main mechanisms for allocating public funding are revenue allocation (including taxation powers and intergovernmental transfers), expenditure responsibilities, fiscal autonomy, and fiscal equalisation
- Advantages of fiscal federalism include allocative and productive efficiencies, positive fiscal externalities, and equity
- Disadvantages of fiscal federalism include economic inefficiencies, negative fiscal externalities, and co-ordination problems between government levels
- Fiscal federalism provides a framework to inform the allocation of powers and resources between different levels of government and guide to which functions and funding are best centralised and decentralised.

What is Fiscal Federalism?

Fiscal federalism is how responsibilities and finances are divided between different levels of government to improve economic efficiency and achieve public policy objectives (Driessen and Hughes 2020). Responsibilities include requirements to provide specific public goods and services such as education, health, and housing, and powers to levy taxes and spend public money.

Federalism is a form of governance based upon a federal or central national government with subnational units integrated within a single political system with powers and resources divided between the different levels. Countries with federal governance include Australia, Belgium, Canada, Germany, India, Mexico, and the USA. Subnational units of government are organised at different geographical scales including regional and local levels. Examples include federated states and federal territories in Australia, regions and provinces in Belgium, provinces and territories in Canada, federal states in Germany, states and union territories in India, and states in Mexico and the USA.

Fiscal federalism originated in the USA from the formation of the Republic in the late 1800s as the national federal government provided funding for states to help pay for public goods and services including infrastructure such as canals and roads, colleges and universities, and militia (Rozell and Wilcox 2019). The central concerns of fiscal federalism are the raising, borrowing and spending of money in federal governance systems (Anderson 2010).

Underpinned by public economics and rational choice theories, fiscal federalism seeks the optimal or most desirable or satisfactory division responsibilities and finances between government levels (Musgrave 1959). It provides a framework and theory but does not provide views on the level or nature of overall government intervention or expenditure or the kinds of public goods and services governments should provide (Driessen and Hughes 2020).

The Assumptions underlying the Fiscal Federalism

Fiscal federalism theory is based on several assumptions. In the basic form of the model, for governments it assumes they aim to maximise the collective wellbeing of residents, they are equally effective in collecting taxes and delivering spending programmes, their budgets are balanced between income and expenditure, and they operate with full information about how different government levels behave (Driessen and Hughes 2020). For people and firms, it assumes they are identical and express no variation in preferences, cannot move between areas, and only respond to policy changes by varying their consumption of public goods and services.

In extensions of the basic model more attuned to real world conditions, fiscal federalism assumes governments are not equally effective in raising taxes and delivering spending programmes due to the lack of perfect information, administrative costs can vary across governments depending on their capability and degree of centralisation, and in some governance, systems governments can run budget imbalances (Shah 2007). People and firms are assumed to be rational economic actors but have different preferences and are mobile across space and time (Tiebout 1956). For example, people vary in their demands for different types of public goods and services which translates into differences in what and how much government intervention they prefer and which political parties they vote for. People and firms can also move between subnational government areas to minimise their tax payments and maximise their consumption of public goods and services.

The Principles of Public Funding Allocation in Fiscal Federalism

Several core principles inform the allocation of public funding in fiscal federalism (Anderson 2010). In federal governance systems such principles often involve trade-offs, for example between efficiency and equity, that are critical to the design of governance structures, public funding allocation, and evaluation of public policies (Agrawal et al. 2024):

- Efficiency – economic efficiency means public funding should be allocated to maximise the overall welfare of all residents and generate the highest benefits relative to costs. Fiscal efficiency is the minimisation of the costs of raising and administering public funds, for example streamlining tax collection systems and reducing bureaucracy.
- Equity – horizontal equity means individuals with similar economic situations are treated equally regardless of where they live and disparities in public goods and services levels and living standards between areas are minimised. Vertical equity ensures funding is allocated on the basis of needs and higher levels of resources are allocated to areas and/or individuals with higher levels of need.
- Accountability – responsibilities for revenue generation and expenditure should be clear for each government level to enable them to be held to account by people as taxpayers and voters. Funding should be transparent to enable people to understand how public funds are raised and spent.
- Responsiveness – allocation of public funds should respond to local needs and preferences with each level of government allocated sufficient resources to undertake their assigned responsibilities, avoiding unfunded mandates, and be flexible to allow local governments to tailor their provision of public goods and services to local conditions and needs .
- Stability – public funding allocation should be stable and predictable over time to enable lower government levels to plan and budget effectively. National government should provide stabilisation through providing additional fiscal support to lower levels of government during economic downturns and shocks.
- Fiscal autonomy – lower government levels should have a degree of autonomy in generating their own revenues through taxes, charges and investments to incentivise fiscal responsibility and service delivery innovation. Taxation autonomy should be matched by expenditure autonomy to allocate funding to address local aspirations and needs.
- Intergovernmental collaboration – co-operation supports different government levels to address common challenges and responsibilities and consultation and negotiation enable dialogue and relations between levels of government to ensure efficient and equitable funding allocation and resolution of disagreements.

Fiscal federalism has several key components relating to the allocation of public funding (Shah 2007). Revenue allocation comprises, first, taxation powers, giving different levels of government authority to levy various types of taxes. National governments typically raise corporate and personal income tax, value-added tax or goods and services taxes on consumption, and excise taxes on specific goods including alcohol, fuel, gambling, and tobacco. In some federal systems, subnational governments have powers to levy sales, income and excise taxes, for example some US states. Local governments typically have powers to levy taxes on commercial and residential property, sales, and businesses including licenses.

Revenue allocation, second, comprises intergovernmental transfers which are allocations of funding from higher to lower government levels. These transfers are used to balance disparities in tax raising capacities and expenditure demands between richer and poorer areas and to enable the comparable or uniform provision of public goods and services across areas. There are several types of transfers: grants-in-aid are funds provided for specific purposes for example education, healthcare and infrastructure and these may include a requirement for matching funds from the lower government level; block grants are lump-sums that afford lower government levels some discretion and flexibility in their use within agreed guidelines; project grants are allocated for specific purposes following competitive applications for funding; revenue sharing is when proportions of higher level government tax revenue is shared with lower government levels; and, equalisation transfers are payments to redistribute resources and reduce fiscal disparities between areas.

Expenditure responsibilities are requirements on specific government levels to provide certain public goods and services and are allocated funding accordingly. For example, defence, health, large-scale infrastructure, regional and urban policy, and social security might be provided at the national level while local economic development, education, housing, local infrastructure, and public safety including emergency and policy services are local level responsibilities.

Fiscal autonomy is the level and nature of freedom each government level has in taxing and spending. This authority for lower government levels to raise their own revenues is central to efficient and responsive governance. Such fiscal autonomy is integral to enable the levying of taxes and expenditures in relation to locally determined preferences and priorities central to democratic political systems. Fiscal localisation refers to increasing fiscal autonomy for lower levels of government within decentralising governance systems.

Fiscal equalisation is the mechanism through which disparities in tax raising capacities and expenditure demands in different government areas are equalised through the redistribution of resources between them. Typically, more prosperous areas with stronger tax bases and lower public goods and services demands generate revenue surpluses. These surpluses are then transferred to less prosperous areas with weaker tax bases and greater public goods and services demands that generate fiscal deficits (Rozell and Wilcox 2019). This equalisation ensures provision of the funding for comparable or uniform levels of public goods and services across the country.

Fiscal Federalism: Advantages and Disadvantages

Advantages

Fiscal federalism provides several advantages (OECD 2022).

Allocative efficiencies in the distribution of public resources are better matched to addressing the different preferences of people and firms in different areas for public goods and services and decentralisation to appropriate lower government levels with greater local information and knowledge on specific needs and opportunities.

Productive efficiencies in the more efficient administration and delivery of government services by local actors with more information and knowledge about the particularities of local conditions tailoring policies to local needs, for example in education and housing, and mobilising local knowledge to increase economic activities and growth.

Fiscal externalities or spillover effects – also called 'programme effects' – are recognised on people or firms other than the programme targets (Driessen and Hughes 2020). Positive fiscal externalities can benefit wider areas, for example through over-investment and over supply of public goods and services such as education, health and infrastructure enabling access to populations in geographically adjacent areas.

Equity through fiscal equalisation and transfers delivering fairness by reducing inequalities in tax raising capacity and public expenditure needs to help provide comparable or uniform levels of public services and providing economic stabilisation in response to economic downturns and shocks. Fiscal equalisation and transfers enable the allocation of funding to different types of places with different financial capacities and needs.

Accountability by providing a clear division of responsibilities to enable people as voters, taxpayers, and public goods and services consumers to see and understand which level of government is responsible for which taxes and government goods and services and, in more decentralised forms of federal governance, bringing government and decision-making closer to the people.

Innovation as lower levels of government operate as 'laboratories of democracy' and compete in formulating new policy ideas and experiments to address local issues and utilise scarce public resources more efficiently. If these innovations are evaluated as effective they can be learnt from and adopted and adapted by other areas and the federal government.

Policy divergence within the national territory as areas are enabled to formulate, design and deliver policies tailored to their particular aspirations, needs, and priorities.

Disadvantages

Fiscal federalism has several disadvantages (Anderson 2010).

Economic inefficiencies when the tax policies of different areas are suboptimal for the national fiscal system, for example through tax competition where regions lower taxes to attract people and firms but risk eroding their tax base and displacing population and businesses from other areas in a ‘race to the bottom’. Population movement between richer and poorer areas can introduce inefficiencies that then require further policy interventions to remedy.

Negative fiscal externalities create costs for wider areas, for example through under-investment and under supply of public goods and services such as education, health, and infrastructure displacing population demand to geographically adjacent areas.

Co-ordination problems arise between different levels of government. This is an issue when responsibilities are shared, for example between national and regional levels, or overlapping which can lead to duplication, administrative redundancies, and increased provision costs. Policy areas can be fragmented, inconsistent, uneven, and inefficient in their provision in different places, for example variations can exist in the level and quality of public goods and services that then perpetuate inequalities through unequal provision and outcomes.

Complexity and bureaucracy generated by convoluted and unclear division of responsibilities between levels of government can create complex and bureaucratic governance structures, slowing decision-making and policy formulation and delivery and increasing the costs of maintaining multiple government and administrative levels.

Inequalities and disparities arise through resource imbalances between wealthier regions with more prosperous economies and larger tax bases able to generate resource surpluses to invest in public goods and services provision. Whereas poorer regions with less dynamic economies and smaller tax bases run resource deficits and are limited in their capacity to invest in public provision. Poorer regions are dependent upon fiscal equalisation mechanisms of financial transfers from the national central state which do not always fully compensate for geographical differences in fiscal capacity and reinforce rather than ameliorate fiscal inequalities.

Accountability – complex divisions of responsibilities and powers between government levels can create a lack of clarity and confuse people, weakening accountability, transparency and democratic oversight and eroding trust in government. When the location of responsibilities is unclear it becomes uncertain which level of government is accountable for specific taxes and policies. This situation can lead to blame shifting for policy and public goods and service delivery problems between government levels.

Political challenges can include inter-area tensions and conflicts, for example if areas perceive they are not receiving what they perceive as their ‘fair’ share of national resources through fiscal equalisation mechanisms. Ideology and politics can disrupt the rational search for an optimal division of powers and resources between government levels given different views on the role of government and public funding across the political spectrum. Higher levels of government can doubt and distrust the capacities and capabilities of lower levels to formulate and deliver policy.

Policy divergence can also be a disadvantage if areas pursue their own policies that contradict or conflict with national policies and undermine commitments to comparable or uniform provision of public goods and services across the national territory.

Institutional problems from unfunded mandates when higher levels of government assign responsibilities on lower levels without adequate and matching funding generating financial pressures and forcing them to reduce expenditure, increase taxes, and/or find new sources of revenue. Lower levels of government can be fiscally irresponsible and mismanage their finances if they assume higher levels of government will bail them out of situations of financial distress and unbalanced budgets. Higher corruption is associated with decentralised federal systems (Freille et al. 2007).

Conclusions

Several conclusions can be drawn from this high level review of fiscal federalism for improving public funding allocations for places for reducing geographical inequalities in the UK setting.

Fiscal federalism offers a framework to inform decision making about which functions and funding are best centralised and decentralised amongst different government levels (Oates 1999). Yet the theory guides the rational and optimal division of responsibilities across levels of government based upon specific assumptions that can differ from real world situations (Driessen and Hughes 2020). Multiple varieties of federal governance exist in practice, varying in the nature and extent of their alignment with core fiscal federalism principles and assumptions, as well as distinct national models with particular characteristics (Hueglin 2013). Some federal systems are more symmetrical with similar powers and resources in each territory, such as Germany and the US, while others are more asymmetrical such as Spain. Identifying and maintaining an optimal form of fiscal federalism is challenging in the changing real world of political economies.

Federal governance systems and their fiscal arrangements vary in relation to their historical origins, number and nature of constituent units, executive and legislative institutions, electoral and political party systems, and division of powers (Anderson 2010). How functions and resources are divided between government levels is highly dependent on context (Driessen and Hughes 2020). This means the history and geography of governance is important and shapes how fiscal federalism works and evolves. The variation in forms of fiscal federalism and specifically mechanisms of public funding allocation to areas mean there are multiple opportunities for learning and adaptation within the scope of the UK's highly centralised governance system and government ambitions for further decentralisation. While fiscal autonomy is currently limited especially in England, there is potential for movement towards a more decentralised, federalised system (Kendle 1997).

The potential for fiscal federalism to address emergent governance challenges is critical for its future development in the UK. Rising geographical inequalities and the increased spatial concentration of income and wealth reinforces inequities in fiscal capacity across jurisdictions and tests fiscal equalisation systems and financial transfers (Agrawal et al. 2024). In a situation of relatively high levels of taxation and debt alongside rising demands for increasingly costly public goods and services, fiscal federalism may provide opportunities to address geographically uneven demands for public goods and services and tax bases and equalisation and redistribution. Political polarisation, the geography of discontent, and rise of populism threaten the political relationships and solidarities between areas within nation states and support for fiscal transfers and redistribution. Trade-offs are evident for policy diversity that benefits some local areas and addresses their local interests and national ambitions for simplicity, uniformity, and equality of treatment and public goods and services provision (Agrawal et al. 2024).

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