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A FEDERALIST FISCAL CONSTITUTION FOR AN IMPERFECT WORLD: LESSONS FROM THE UNITED STATES

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INTRODUCTION

However history assesses the Reagan Presidency, there is little doubt that it has challenged in a central way how we conduct our national fiscal policy. The old axioms of federal spending, tax, and debt policy have each been threatened by at least one Reagan policy initiative.[1] No less important is the Reagan challenge to our current structure of federal-state-local fiscal relations. While the core reforms of the Reagan New Federalism proposal never quite made it into law, the Reagan budgets have significantly curtailed the levels of federal support for state and local governments.[2] Perhaps most importantly, the Reagan federalism initiatives have forced a serious rethinking of the evolutionary path of our federalist public economy, an evolution that has moved the financial and management responsibility for public goods and services steadily upward to the national level.[3] What was once an *interactive network* of independent local and state governments has become an *interlocking hierarchy* of governmental subdivisions financed and managed to an increasing degree from Washington.[4] The Reagan challenge has forced us to ask a fundamental question: Is this the federalist structure we really want?

Any clear answer to this question requires a well-articulated view of what a federalist economy can do. In this exploratory essay, there is no reason not to ask for a first-best economy in which all resources are efficiently allocated and fairly distributed. Surprisingly perhaps, it is not difficult to imagine a federalist public economy that can achieve these dual objectives. It is called a Tiebout-Coase public economy, in honor of the two men who first clarified its basic structure.[5] The second section summarizes this underlying structure and describes the resulting federalist economy.

The demands of the Tiebout-Coase public economy, however, are severe. In addition to the requirement that there be a perfectly competitive supply of all factors of production including entrepreneurs who provide public services, the Tiebout-Coase economy needs fully informed and mobile consumers capable of negotiating *all* trades of mutual advantage. Anything less than full information and perfect contracting undoes the promises of Tiebout and Coase. Yet imperfect information and imperfect contracting are realities of economic life. The Tiebout-Coase public economy is an enlightening image of the first best, but it should not become the standard against which we judge the performance of real federalist economies with their inherent and unavoidable imperfections. Our standards should be derived within the bounds

imposed by real economies. The third section conjectures (it's too early for theorems) what these standards might be, based on an understanding of the structure of one real economy--the United States today.

The last section puts in perspective the present U.S. federalist economy and recent reform proposals. A few directions for reform are suggested, several of which look beyond the legislature to the possibility of judicial, executive, and constitutional implementation.

FISCAL FEDERALISM IN AN IDEAL WORLD

Perhaps the best way to focus on the efficiency of the American federalist system is to begin with an ideal world in which people and resources are divided among lower levels of government (local jurisdictions) and higher levels of government (either states or the national government). Once jurisdiction boundaries are determined, a number of political mechanisms can be used to decide on the appropriate role for each unit of government. The goal is a utilitarian one--to maximize the value of all privately and publicly supplied goods and services enjoyed by individuals within our society. In such a multi-level federalist economy, two separate but related efficiency issues arise. First is *inter*jurisdictional efficiency, involving the appropriate allocation of people and capital among jurisdictions. Such interjurisdictional efficiency is achieved when the level of public goods and services is sufficient to satisfy individuals' demands at minimum cost. Second is *intra*jurisdictional efficiency; which is achieved when the choice of government activities in each jurisdiction maximizes the sum over all individuals within the jurisdiction of their willingness to pay for those activities (net of any cost involved).

In a federal system both interjurisdictional and intrajurisdictional inefficiencies can arise, the former because the decisions and actions of individuals within one jurisdiction can have effects on individuals located in other jurisdictions (i.e., can *generate spillovers*), and the latter because the political process may not produce outcomes within a jurisdiction that maximize the well-being of the residents. In a broad sense the choice of the appropriate jurisdiction to be responsible for a government activity involves a trade-off--the larger the jurisdiction, the less likely that there will be spillovers from one jurisdiction to the next, but the more likely that the political process will lead to a misallocation of resources within jurisdictions. Each of the two efficiency issues are treated in turn, first looking at efficiency within jurisdictions, and then at efficiency among jurisdictions.

The Efficient Community Provision of Public Services

Suppose that the population of a particular jurisdiction is fixed (i.e., there is no migration) and that households have similar tastes for the public goods that the community is to provide. For the provision of such goods to be efficient, three conditions must be satisfied. The first condition guarantees that the appropriate level of each public good will be produced, and the second and third that the production process will be a cost-minimizing one.[6]

To give focus to each of these conditions, suppose that a community wishes to determine the budget (and implicitly the level) to be spent on education, as well as the inputs of teachers and buildings that are required. The efficient level of education is the level that maximizes the aggregate benefit to the community members less the cost of production. This level is achieved when aggregate *marginal*

willingness to pay for education by households within the community is equal to the marginal cost of producing education. Intrajurisdictional efficiency requires that this condition hold for each and every good that is publicly provided. The intuition is straightforward: the marginal cost of production represents the opportunity cost of using private funds for public production. When this cost is outweighed by the benefit that the public goods generate, public provision should be increased. Efficiency is achieved when the marginal benefit of provision is equal to the marginal cost.

The second condition focuses on production efficiency. It requires that the production of public goods should utilize factor inputs efficiently, just as private firms would do in competitive markets. Teachers should be hired up to the point at which the marginal increment to educational output associated with the additional use of teachers is equal to the cost of hiring the teachers (as given by the wage rate plus the cost of benefits). Similarly, capital equipment (school buildings, teaching equipment, etc.) should be purchased or leased up to the point at which its marginal product (the additional educational output) is equal to its marginal cost. The combination of labor and capital to be used will be technically efficient when both of these input-hiring conditions hold.

The third condition also involves production efficiency. It requires that public services be produced at minimum average cost per person served. Were this not the case, another community that produced the public good more cheaply would spring up as a new development, and there would be a rapid movement of households to that community. For any given community size, the minimum average cost condition is equivalent to the condition that we would expect any competitive firm to satisfy: production inputs are varied over the long run so that the product can be produced as cheaply as possible. Thus, intrajurisdictional efficiency requires efficiency in public production, just as the efficiency of competitive markets requires efficient private production.

The public economy, however, differs from the private economy in that the number of households that are to be serviced by the public good is likely to vary. In the extreme case of a *pure public good*, the additional cost of providing the good is zero, so that the size of the community does not matter. However, in any other case of a *congested public good*, size does matter, since the marginal cost of producing the good will increase (after some point) as the number of households in the community increases. In this more complex case, the third efficiency condition involves issues of community size as well as efficiency in production. The condition that determines optimal community size is that the average cost per household of public service provision be equal to the marginal cost of adding another household to the community. Were the average cost higher, the population of the community would be too small--more residents would allow the community to take advantage of economies of scale in producing public goods, and average cost would fall.

The Efficient Public Economy

In order to satisfy the conditions that are necessary for the efficient provision of each and every public service, either of two general institutional structures can be adopted: a highly centralized planning structure, or a fully decentralized market structure.

The model that comes closest to making the case for a decentralized system of local governments has been developed from a pathbreaking paper by Charles

Tiebout.[7] The "Tiebout", or "competitive government," model is similar to a model of a purely competitive market in that there are numerous jurisdictions and a mobile population. Each jurisdiction offers a (potentially) different tax-expenditure-regulation package, and there are a sufficient number of jurisdictions to allow each household to choose one that supplies its desired public-sector package, given each household's income and the cost of providing that package.

Because information is perfect, mobility is costless, and the public sector operates in a technically efficient manner, each individual will reveal his or her preference for public services simply by moving into the community of choice. If there is another jurisdiction that provides a better public service, or the same service at a lower cost, there is nothing to stop the individual from relocating. As a result of this fiscally-motivated migration, the competitive government model allocates public sector packages among individuals in a manner that is similar to the way in which the competitive private market allocates its goods among individuals. If there is no community that provides the exact bundle of public services that a household wants, a new community that provides those services at minimum average cost will immediately appear.

In the Tiebout world, there are no spillovers across jurisdictional boundaries. When a government decides to produce a public good such as education, the benefits are obtained only by the residents of the jurisdiction. When benefits and costs do extend beyond the local boundaries, the "optimal" fiscal unit may be a higher (state or federal) level of government. And when governments are deciding how to spend or to regulate, those decisions are determined on the basis of desires of current residents and not on the decisions that other governments have made or are likely to make.

The Tiebout economy can arise naturally from the competitive behavior of the actors involved. Profit-maximizing developers of land and housing are motivated to produce the level of public good provision demanded by the efficient population size. Like private firms, they can minimize costs by choosing the efficient mix of capital and labor purchased in a competitive market. Mobile households, on the other hand, with zero search and transactions costs, and with full information about alternative options for public goods, will locate to insure that each household obtains its preferred level of public output. Thus, in our ideal federalist scheme, the Tiebout economy is the institution that provides the efficient production and allocation of a given local public good.

It has been argued that if the assumption that publicly provided goods are pure public goods is replaced with the more realistic view that they are quasi-private, then we lose the performance of the Tiebout economy.[8] By itself, however, the assumption of publicness and the production of some (or even all) of the goods involved is not sufficient to undo the optimal performance of a Tiebout economy. In a world with zero transactions costs and full information, one might imagine a cooperative allocation that emerges from bargaining among affected parties--in other words, the Coase theorem might apply. For example, in cases where a public good benefits two or more Tiebout communities (e.g., transportation that requires a large public infrastructure), a Coasian bargain *might* arise in which joint production internalizes the externality. The Coase framework is one in which property rights are well-specified so that each household knows its own endowment and the endowments of others; information, administrative, and transactions costs more generally are minimal; *and* all mutually beneficial trades or bargains are made. The institution that facilitates and enforces the Coasian bargains is a higher level of government (e.g., a

county for water and air quality, a state for roadways, and a national government for defense). The mechanisms established to internalize these cross-community externalities can involve regulation (included in this category would be direct provision of the overlapping public good) or taxes and subsidies.

Note that the Coasian bargain is an explicitly institutional response to the problem of spillovers among jurisdictions. In this scheme, Coasian bargains via more centralized governments provide the institution that can satisfy the necessary conditions for our efficiency ideals (as stated above) to hold. Suppose, for example, that the efficient population size for the provision of police services is 50,000. Two neighboring communities, however, find that there are substantial spillovers generated by crime, so each community would like the other to increase its police patrols near the common border. A Coasian bargain between the communities can lead to a mutually satisfactory allocation of police resources to support those patrols, while otherwise allowing the communities to choose their production inputs efficiently.

Another important example of such a Coasian bargain could be "Pareto-optimal" income redistributions.[9] To the extent that individuals care about the economic well-being of those less well off, yet wish to free-ride on the charity of others, there is an externality that *might* well be resolved through a Coasian bargain.[10] If the utility of one household influences another's, the Coasian bargain will involve lump-sum taxes and transfers. If the consumption or work effort of one household influences the utility of another, then the Coasian bargain will involve commodity specific transfers (or in the case of work effort, a wage subsidy or tax). The central government again will be called upon to enforce the agreed to tax-transfer system.

Some of the additional characteristics that are associated with an ideal Tiebout-Coase economy are as follows:

(1) Everyone within a given Tiebout community has the same marginal benefit curve for the provision of the public good. The effective implication is that there is no conflict on the provision of the public good--hence *no politics*.

(2) All financing of the public good is done by an annual *head tax* equal to the average cost per person of paying for the public good. This insures that individuals move into communities only up to the efficient point at which their marginal cost (the head tax) is equal to the average cost of production.

(3) Given any plausible variety in demands for public goods *and* the need for sufficient competitors to insure efficiency, one should expect to see numerous communities providing public services. The evidence on the efficient level of congestion (jurisdictions of approximately 10,000 can provide education, protection, recreation, and public health--larger jurisdictions are needed for infra-structure) suggests jurisdictions in the size of 10,000 to 50,000.

(4) One would expect to see Coasian regulations of local communities and/or Coasian taxes and subsidies facilitated by central government production of such goods or the use of central government matching-grants-in-aid. Further, to the extent that spillovers involve utility interdependence among households across (Tiebout) jurisdictional lines, there will be central government transfers to households either as lump-sum payments or commodity specific transfers. All central government activities will be financed by lump-sum taxes.

FEDERALISM IN AN IMPERFECT WORLD

The applicability of the idealized Tiebout-Coase public economy to any real economy--either as description or prescription--is limited by the applicability of its underlying assumptions. To the extent that one or more of these important assumptions are violated, the fiscal institutions of the Tiebout-Coase economy may have to be altered. What these "second-best" institutions might be, is specified here, written as a fiscal constitution for a federalist economy in an imperfect world.

The Limitations of Tiebout and Coase

As typically specified, five conditions define the environment of the Tiebout-Coase economy: (T1), the perfectly elastic supply of public goods communities, each capable of replicating all attractive fiscal features of its competitors; (T2), costlessly mobile households who (T3), are fully informed of the fiscal attributes of each community; (C1), common knowledge of the preferences and economic abilities of all households; and (C2), a willingness on the part of all households to bargain and to conclude all mutually advantageous trades. The loss of any one of these five requirements significantly complicates the Tiebout-Coase economy, and may lead to a failure of that economy to achieve an efficient allocation of social resources.

Consider first the consequences of a less than perfectly elastic supply of fiscal communities. The inability of an aspiring fiscal entrepreneur to replicate an attractive local community occurs whenever an important input into the production of public services is not available at a uniform price to all suppliers. For example, one community may be advantageously located next to a lake for recreation, have hired a particularly skilled teacher for education, or have obtained a special surveillance system for crime protection. Replication of these unique (land, labor, and capital) inputs can only occur at rising marginal costs, and, as in a private goods economy, economic rents will be earned by those factors of production in scarce supply. The presence of these publicly created rents introduces an additional layer of economic bargaining--now between the fiscal entrepreneur and the factors of public goods production--absent in the original Tiebout-Coase economy. If Coasian bargaining succeeds, then economic efficiency remains. If Coasian bargaining fails, significant inefficiencies in public goods production may arise as factors are misallocated. At this point searching for additional fiscal institutions to control the resulting market failure might begin.

The lack of fully informed and costlessly mobile households also threatens the efficacy of the original Tiebout competitive fiscal structure. First, costly household mobility may raise problems for the Tiebout economy. In those instances in which relocation can be obtained for the payment of a fixed fee or when the public good itself can be transported to the household, there will be no significant allocation effects, though the household will enjoy less fiscal surplus because of the payment of transportation costs for themselves or for the public good. But when the production of the public good is site-specific (i.e., consumption requires proximity) and when the relocation of the household is costly on the margin (i.e., the relocation affects private resource allocations) then the perfect Tiebout economy cannot guarantee overall (i.e., market plus public sector) efficiency. Household relocations to achieve a more efficient public sector will create real externalities for the private economy. The usual example is labor leaving one community for less productive employment in another, but fiscally more attractive, community; the consequence is a less efficient private

economy.[11]

The Tiebout-Coase solution to such fiscally created externalities will be, as before, to allow communities to strike Coasian bargains to internalize these externalities. Such bargains will involve the imposition of a "congestion tax" on households that relocate, where the value of the tax equals the difference in their relative productivities in the communities. Tax proceeds should then be divided between all residents in the affected communities on a lump-sum basis. Again, however, Coasian bargaining is asked to bear the burden of a Tiebout market failure. To the extent that it cannot, misallocations will result that may warrant the creation of an additional (central) government institution.

Second, less than full information about the costs and levels of public goods production also create difficulties for the Tiebout economy. Households have two options: go it alone and risk being exploited by better informed fiscal entrepreneurs and local factors of production, *or* hire an agent (called a "city manager" or "mayor" for households in place and a "real estate agent" for households relocating) to protect household interests. To the extent the market for "agents" works perfectly--all inefficient or exploitive providers are exposed, and only truthful agents survive--the final public goods outcome will still be efficient, but some households' fiscal surplus will be allocated to the agents as payment for services performed. Such payments can be made as a contingent fee conditional on the performance of the agent in managing the purchase of the public good, or as a competitively determined lump-sum payment to a previously identified--by reputation or certification--"truthful" agent.[12] Complications arise when information about agent performance is costly and some deceitful agents survive, or when the expertise provided by agents to households cannot itself be kept private. In both instances there will emerge externalities in the market for agents that can cause an inefficient level of information about the fiscal performance of the Tiebout communities to be provided.[13] Once again we can turn to Coasian bargains--this time between households needing information about communities--for a solution to this market failure. As before, if there is a failure to achieve such bargains the inefficiencies will remain. We may need new central government institutions to monitor, or perhaps even replace, this marketplace for fiscal agents.

With failures in the Tiebout competitive economy, the burden for efficient public goods allocations shifts to the Coasian process of bargaining. Assumption (C1)--bargainers must have full information about all agents' tastes and abilities--insures that all beneficial trades are known to the bargaining parties. The second assumption--bargainers must be willing to conclude all beneficial trades--is needed to insure that such trades actually take place. The failure of either assumption means a market failure for the Tiebout-Coase public goods economy, and raises the possibility of using extra-market institutions to correct the failure. Both assumptions are indeed suspect.

The assumption of full information about everyone's tastes and abilities by all bargaining agents clearly is not valid; the only issue is whether some market process will arise to provide the needed information. It has been argued above that this is unlikely, however, given the fact that information is often a public good (i.e., exclusion is not possible), and costly to collect. With less than full information, bargains between benefiting parties may fail to find best allocations because they do not know the full range of possible trades that might improve their situations.[14] While obvious examples involve externalities between neighboring communities, redistributive income policy is probably the most important single instance of this

problem. Whether motivated from the perspective of pure altruism or as social insurance to satisfy "cooperative egoism," efficient redistribution policy requires full knowledge of the tastes and abilities of all potential beneficiaries so that transfers can be given to the "right" people without creating adverse incentive effects. If the deserving recipients cannot be accurately identified and lump-sum transfers paid, then inefficient redistribution--to the extent the bargaining parties choose to redistribute at all--is the outcome. *Either* the "wrong" people receive transfers, *or* transfers go the "right" people with undesirable incentive effects, *or* both. In a federalist public economy, such adverse incentive effects manifest themselves in part through the inefficient relocation of eligible households to communities providing transfer payments.[15] If there is a solution to this problem, it must be found in the creation of an additional extra-market institution capable of overcoming the inherent weaknesses of the Tiebout-Coase economy in providing needed information on tastes and abilities. A central government capable of discovering and providing information about pollution management, air defense coordination, or the incentive effects of income transfers is one such institution.

Providing information may not be enough, however. Robert Cooter has recently clarified an important fact previously overlooked by proponents of Coasian bargaining. Each Coasian bargain does two things: it establishes an efficient exchange, thereby creating economic surplus, *and* it distributes that surplus among the bargaining parties. Proponents of Coase emphasize the first outcome and have largely ignored the implications of the second.[16] Yet it is well known that the division of any economic pie is a bargaining problem that may have no solution.[17] Coasian bargainers will not be immune to this problem when they negotiate; and to the extent that they succumb, Coasian bargaining may break down. Simply put, all bargainers may take a hard-line stance in hopes of increasing their share of the resulting economic surplus, but with the unfortunate consequence that no agreement is reached at all! The typical example is when all parties benefiting from a public good refuse to pay their taxes (i.e., "free ride") with the ultimate consequence that none of the good is provided. The Coase assumption (C2) that bargainers will always strike the efficient bargain is simply too strong.[18] We need to explore what alternative institutions might be constructed to overcome such strategically induced failures of Coasian bargaining. In a federalist public economy, it might well be a strong central government.[19]

Beyond Tiebout and Coase

The original fiscal constitution for the Tiebout-Coase economy placed all of the responsibility for the provision of public goods at the community level, either through direct provision or through networks of local communities, called "counties" if the network is small, or "states" if the network is large. These networks are established by joint agreements and are designed to internalize interjurisdictional externalities. There is no requirement that these networks be permanent; as the pattern of spillovers changes so too may the controlling network of communities. Further, in this Tiebout-Coase economy the only required function for a central government is to enforce these interjurisdictional contracts. On occasion one may see the central government providing some goods or services that all communities unanimously agree ought to be produced nationally--for example, military defense and the guarantee of free trade across regions--but this agenda is also flexible as the reach of spillovers changes over time. Were one to observe a Tiebout-Coase federalist

fiscal order, one would see a minimalist national government responsible for enforcing contracts, insuring free trade and providing national defense; a network of ever-changing "state" and "county" governments controlling specific inter-community spillovers via regulations, taxes, and transfers; and local communities producing most public goods.

This resulting federalist structure is only appropriate, however, for the Tiebout-Coase economy. To the extent the true economy deviates from the world of Tiebout and Coase, an alternative federalist fiscal structure may be in order. In fact, deviations from the Tiebout-Coase economy are most likely. Communities cannot be easily duplicated, households are often ignorant and immobile, and strategic bargaining is commonplace. All of which strongly suggests the need to move beyond Tiebout and Coase when specifying a preferred structure of government.

Failures of the Tiebout economy because communities cannot be duplicated or because households are immobile or uninformed can be solved by Coasian bargaining supplemented, when information is imperfect, by the use of knowledgeable agents.

The implication of such Tiebout failures for the structure of government is often to move the resolution of these failures to a level of government above the local community. For example, when communities cannot be duplicated at a common cost because of the scarcity of important factors of production, the unique factors often bargain with households over the final price of local services. Those bargains must be certified and enforced by a governmental unit above the local level.[20] When households are less than perfectly mobile, geographically encompassing governments such as central cities or counties may be able to produce varying levels of services from a common facility and transport the desired amount of the good to each family.[21] Or when localized production is most efficient, taxes and subsidies administered by a higher level of government can solve the problems of costly mobility.[22] Finally, when households are less than fully informed about local fiscal matters, a market for fiscal experts may arise, but a process of independent certification is often required to insure that those markets function efficiently. Government or quasi-governmental professional associations above the local community can provide this review function.[23] As the Tiebout economy fails, there is added pressure on the Coasian bargaining process to solve the problems of public resource allocations. In a federalist public economy, that means more work for the network of governments comprising counties and states. Yet even with failures in the Tiebout economy, the federalist economy remains highly decentralized.

An expanded role for the national government comes with the failure to achieve all desired Coasian bargains between local communities. Bargaining fails either because local communities do not see all the advantages to local bargaining or because they bargain strategically with one another and fail to reach an agreement. In either case, there is now a role for centrally decided allocations to supplant local bargaining. When local information about the consequences of bargaining is inadequate, an encompassing government may be able to provide such information through various enforcement mechanisms that reveal true costs and benefits.[24] When local governments fail to reach agreement because of strategic behavior, an encompassing government can establish an enforced allocation that the local units might well prefer. Importantly, in both instances, the solution to the failure to reach agreement is a centrally decided, coercive imposition on local governments. It is in this need for coercion caused by the breakdown in voluntary Coasian bargaining that the reasons for increasing the role of the national government are found.

The national government assumes the responsibility for the failed Coasian bargains between communities either as an arbitrator of last resort for when agreements occasionally falter, or as the permanent, direct provider when agreements are never reached. Even though national provision may not balance benefits and costs perfectly in each locality, communities may still prefer such provision to no agreement at all. Examples include the national supervision of environmental policy, the provision of national parks, or the construction of a national highway system.[25]

Perhaps the two most important examples of the failure of Coasian bargaining in a decentralized public economy are the agreement to redistribute income to needy households, and the agreement to jointly manage the overall macroeconomic performance of the economy.

Mark Pauly and Richard Tresch have argued persuasively that redistributive preferences can have an important geographical dimension. Proximity causes familiarity, and familiarity breeds concern. If so, redistribution policy should allow for regional differences, yet regional agreements--particularly interconnected regional agreements--may not emerge because of strategic bargaining. If so, a national redistribution policy that explicitly grants some degree of local choice may be the second-best compromise.[26] Similarly, strategic bargaining between localities is likely to prevent the design of a coordinated macroeconomic policy. Small communities will have only trivial effects on the overall economy, while no large community will willingly bear the full burden of controlling inflation through tax increases or stimulating national job growth through local debt creation.[27] The only recourse if a voluntary agreement cannot be reached is a coercive, national government fiscal policy.

Having defined the domain of national governments in an imperfect world, how are these national decisions to be enforced? In the *very* special case where everyone in society has identical preferences for goods, services, and redistribution (endowments are unknown, however), the answer is straightforward: optimize *the* national social welfare function defined over goods, services, and income (or leisure). Since endowments are not known, first-best (lump-sum) taxation is not feasible as a redistribution policy, and second-best policies such as an income or a consumption tax must be used.[28] Whether local communities should be allowed to use such redistributive taxes in addition to the Tiebout head tax is an open question. In this case the presumption is *no*, since such taxes may lead to local tax exporting and tax competition, both of which create new spillovers and inefficiencies.[29] Further, the national government may want to tax the local provision of public goods, because excluding them from taxation may lead to second-best inefficiencies, (since other private consumption commodities are taxed) or because these goods create intercommunity externalities.[30] In this special world of identical preferences, the fiscal constitution assigns to the national government responsibility for failed Coasian bargains (including income redistribution) and dictates exactly what the appropriate national spending levels and tax rates should be.

When preferences are not identical, however, matters are not so easy. Now the federalist fiscal constitution must specify a mechanism for determining citizen preferences for goods, services, and redistribution when the citizens have every incentive to free-ride and conceal. The design of such a constitution is the core problem of the "new" political economy. A variety of alternatives has been proposed, ranging from dictatorial preference-revealing tax schemes to referendum politics.[31] One potentially attractive compromise may be a majority-rule representative

government with representatives chosen from local communities.[32] In this case, the federalist constitution again specifies the domain of central government policy as the reconstruction of failed Coasian bargains, but now, rather than dictating the second-best outcomes, the constitution only specifies a mechanism for preference revelation and bargaining--for example, majority-rule representative government.

Finally, an important attribute of these, now nationally set, second-best agreements is that they must be coercive. Whereas the Tiebout-Coase world allows counties and states to voluntarily come and go as the shifting pattern of spillovers requires, in a second-best world of free-riders, coalitions of local communities must be defined and enforced centrally. In any second-best federalist constitution, the national government now assumes responsibility for drawing these lines, though it may yield to the preferences of the local communities as to how to do so. Communities now have an incentive to construct such coalitions, knowing that if they do not agree amongst themselves a truly unattractive pairing may be imposed. The outcome is a group of locally decided, but centrally enforced, state and county by boundary lines. Further, if learning is possible in this imperfect world, then there are good reasons to establish these local coalitions as long-term contracts. The end result will be a federalist system with permanent, nationally enforced but often locally decided, state and county boundary lines.

Summary: A Structure of Federalism for an Imperfect World

The resulting fiscal constitution for an imperfect world assigns to the national government responsibility for all truly national public goods (defense and the maintenance of free trade), the judicial task of enforcing valid contracts between communities, and the additional second-best task of discovering and correcting all failures in intercommunity Coasian bargains, the most important of which are redistributive and macro in character. In the simple case of identical preferences, the fiscal constitution can specify precisely the level of national expenditures, taxes, and transfers as those that maximize society's common welfare. When citizen preferences are not identical, however, those preferences must be discovered before a national policy can be chosen. The fiscal constitution must therefore specify a mechanism to reveal preferences; a majority-rule, representative government is one alternative.

Finally, to minimize free-riding and the cost of learning about citizen preferences or endowments, the national government should organize local communities into permanent coalitions called counties (small coalitions) or states (larger coalitions). Counties and states will retain responsibility for correcting within coalition spillovers using regulations, taxes, and transfers. Local governments--the building blocks of this federalist economy--provide local (i.e., congestible) public goods and finance those local goods by head taxes.

This fiscal constitution is envisioned as a flexible document, capable of guiding institutional fiscal reform in a dynamic world of changing tastes, endowments, and technologies. To this end there is no task more fundamental task than drawing, or redrawing, the lines of responsibility between central and local governments; President Reagan's "New Federalism" and the U.S. Supreme Court recent decision in *Garcia v. San Antonio Metropolitan Transit Authority*[33] both struggle with this issue. Figure 1 illustrates how the proposed constitutional principles outlined here might be used to provide a solution. Each proposed reassignment can be analyzed in five steps with the appropriate answer at each step assigning the function to either the national or local level.[34]

FIGURE 1

Guidelines For National Or Local Provision In Federalist Fiscal Economy

1) Is the current national activity justifiably a national public good involving national externalities, *or* is the activity necessary for the creation, administration, and enforcement of inter-community Coasian bargains?

NO	YES
(Go to 2)	(Go to 3)

2) Is there compelling evidence that the current national function is a correction for widespread failure of Coasian bargains within the local sector?

NO	YES
Local Allocation	(Go to 3)

3) Is the activity currently provided efficiently by the national government?

NO	YES
(Go to 4)	National Allocation

4) Is there a reform that might improve the performance of the national government in the provision of the activity?

NO	YES
Local Allocation	(Go to 5)

5) Is that reform implementable by legislative or judicial branches, or by constitutional amendment?

NO	YES
Local Allocation	National Allocation

Consider, for example, the question of whether a current national activity should remain a national government responsibility. At step (1) ask: Is the current national activity justifiably a national public good involving national externalities (e.g., national defense, the promotion of free trade), *or* is the activity necessary for the creation, administration and enforcement of intercommunity Coasian bargains? If the answer to either is *yes*, the function remains at the national level. If the answer to both is *no*, then proceed to the second test: Is there compelling evidence that the current national function is a correction for a failed Coasian bargain? The analysis here is necessarily speculative. Can a mutually beneficial exchange between two or more communities that does not now exist be envisioned because of imperfect information or strategic behavior? If *no*, the activity at issue should now be returned to the local level.[35] If *yes*, move to the third level of inquiry: Is the activity currently well provided by the national government?

The standards used to judge the performance of the national government are obviously crucial at the third level. Importantly, they must be standards of relative institutional performance (could the local sector do it better?), and not a counsel of perfection. If the answer is *yes*, the activity is well-provided, then the activity should remain in the national domain. If the answer is *no*, move to the final two stages and ask: Is there a constitutional reform that might improve the performance of the national government in the provision of the activity, and then if such reforms can be imagined, can they be implemented? If so, then the function should remain a national responsibility. If no such reforms can be put in place, then in the final analysis the activity should be returned to the local level.

REFORMING FEDERALISM IN THE UNITED STATES: THE NEED FOR GUIDING PRINCIPLES

The structure of fiscal federalism is, and should be, a dynamic one. As tastes, technologies, and the distribution of economic endowments change, so too must the fiscal structure, which regulates and provides for government services. Reform of that structure becomes necessary when the structure is no longer responsive to the public service needs of the economy. There is a strong sense in the United States that this may be such a time. There is much evidence to indicate dissatisfaction with the performance of the local public economy, while the policy responses of the national representative legislature--Congress--are often viewed with disfavor as well.[36] Review and reform seem sorely needed.

Necessarily one must look outside of the federalist structure itself--beyond local communities and representative national legislatures--to such nonfederalist institutions as the courts, the president, or state-constitutional amendments by popular referendum. The United States has recently tried all three, but without much success. The central problem in each instance has been the lack of useful, and well-understood, guiding principles to aid in the design of an improved federalist fiscal economy.

Most recently, and notably, the U. S. Supreme Court in *Garcia* ruled that the Court will defer to Congress in matters of economic federalism, rather than engage in the uncertain task of allocating economic tasks. In effect the Court has declined, for now at least, the responsibility for review and reform of our federalist economy. As emphasized by Justice Blackmun in his majority opinion, the major obstacle that persuaded the Court to step back was the lack of a compelling set of constitutional principles to guide their inquiries.

President Reagan, as the champion of his "New Federalism," has not been so shy. In January 1982, the Reagan Administration proposed a significant break with the recent historical trend towards the centralization of financing of government services. The Reagan proposal sought to return to states and localities all financial responsibility for income redistribution (AFDC and food stamps) as well as responsibility for more than sixty federal (mostly low-income) programs in education, community development, transportation, and social services. The likely net effect of such a reform would have been to significantly reduce the level of public funding for lower income households, probably well below even what President Reagan has called his level of "safety net" support. Recent calculations by Gramlich and by Inman have shown that because of inter-state fiscal strategies--the desire to free ride--the Reagan plan would have led to a decline in national support for the poor by as much as 50 percent, pushing many low income families below the poverty line.[37] However attractive the policy might seem politically, it makes little economic sense in light of our constitutional principles of federalism. The intellectual underpinnings of Reagan's New Federalism is the first-best federalism of the Tiebout-Coase economy; yet, as argued, this is an imperfect world requiring the centralization of the redistributive function for just the reasons Gramlich and Inman have noted. Congress was right to reject the Reagan plan.

There is a third avenue for reform of the present federalist economy, the popular referendum leading to a constitutional amendment. California via Proposition 13 (a limit on local property taxation to rates no larger than 1 percent of market value), Massachusetts via Proposition 2-1/2 (a limit on local property taxation to 2.5 percent) and Michigan via the Headlee Amendment (limiting state revenues to a constant share of state personal income) have each sought since 1978 to reform their state and local fiscal economies via the amendment process. In each case, survey evidence strongly indicates that the amendments passed because voters believed that the production of government services was inefficient and that budget limitations might root out such inefficiencies.

There is no strong evidence that the majorities who approved these measures wanted to reduce state and local services or establish a new tax structure.[38] Unfortunately, the limitations have often had exactly these effects by denying local communities the opportunity to freely choose their preferred levels of local services and by pushing taxation away from the now constrained local property tax.[39] In contrast, there is no good evidence that the limitations have induced any significant reduction in the cost of local services.[40] Rather than seeing the local fiscal economy as a first-best world as Reagan did, the proponents of tax limitations saw just the opposite, an economy in disarray and out of control. Proponents went in the opposite direction for their solution too, a centrally imposed tax limitation whose ultimate effects caused more harm than good. Their mistake was, like Reagan's, a failure to properly understand the workings of our public economy against any set of guiding principles for a federalist fiscal constitution.

The lesson from these recent efforts at reform of the U.S. federalist economy is clear: without the guidance of a well-articulated fiscal constitution the reform process is in danger of either being paralyzed with inaction, or being prodded into extreme reaction. Neither strategy is likely to serve well. To find a more reasoned middle road, it is essential to begin by searching for well-reasoned principles to guide the way. The authors hope the federalist constitution for an imperfect world outlined here will prove to be a contribution to this end.