

Toward a New Theory of Federalism

We no longer have a theory of federalism. The word has become at once so encompassing and so vacuous that any multitiered decision-making system can be entitled a federation. Even relations between central governments and private business firms are now considered to be an element of federalism.¹ And once the concept of federalism is stripped of any distinctive meaning, we no longer have criteria for the appropriate division of governmental responsibilities among layers of government. Federalism is what federalism does. Even more, we have no orienting concepts which can assist us in explaining the patterns of conflict and cooperation among governmental levels.

Traditional theories of federalism took as their point of departure the presence of two sovereigns within a single domain. Each had sovereign power over its citizens with respect to the functions for which it was responsible. Neither had power to interfere with the proper role of the other sovereign. A constitution defined the distribution of powers between the dual sovereigns.

Sovereignty was divided between central state and local republic in order to avoid both internal and external threats to liberty. Small republics limited the possibility of internal despotism, because the citizen knew and understood affairs of state that touched him closely. He could readily be called upon to participate in the defense of his freedoms. The small republic, however, could be easily overcome by external enemies. Only through joining together in a federation with other republics could a common defense be maintained. It was the permeability of the small republic to external forces that justified its relinquishing certain powers to a higher sovereign.²

This dual-sovereignty theory of federalism linked governmental

structure to political processes and policy outcomes. It provided a rationale for the proper division of powers between the central state and the local republics within the federation. It gave federalism a core definition: the presence of a contractual arrangement—a constitution—that divided powers among the sovereigns. Although changing circumstances would require continuous interpretation of that constitution, the theory provided the necessary conceptual apparatus for doing so.

In the United States, constitutional interpretations after the Civil War expanded the powers allocated to the central government so that the concept of dual sovereignty, somewhat forced even in 1789, became increasingly difficult to sustain. At the close of the Civil War, the "civil rights" amendment to the Constitution decisively asserted the preeminence of the federal prerogative. By 1937 the Supreme Court recognized the interstate effects of almost all commerce, thereby greatly broadening the federal power to regulate business and commercial activities (*NLRB v. Jones & Laughlin Corp.*). Also, the Court legitimated almost all forms of federal grants-in-aid to states and localities (*Steward Machine Co. v. Davis*). However valid the dual-sovereignty theory remained in principle, it had little applicability to a country that came to believe that its liberties were as safe, if not safer, in the hands of the central government.

There can be no return to a theory of dual sovereignty; the work by Grodzins and others discussed in chapter 1 has surely laid that notion to rest.³ But any new theory, like the traditional theory of dual sovereignty, needs to do at least three things. First, it must provide a definition which clarifies the way in which a federal system is distinguished from a decentralized administrative structure. Second, it must use its definition to specify characteristic and appropriate activities of the central and local governments within the federal arrangement. Finally, the theory must account for persistent patterns of conflict and cooperation among levels of government.

Federalism Defined

Federalism is a system of government in which powers are divided between higher and lower levels of government in such a way that both levels have a significant amount of separate and autonomous responsibility for the social and economic welfare of those living within their respective jurisdictions. Within the federation the central government assumes responsibility for relations with foreign countries and determines the exchange relationships among the component units of the federation. The central government may

exercise numerous additional powers, but for the system to remain a federation, lower levels of government must have at least two crucial powers.

First, they must have a significant amount of control over the recruitment of their own political and administrative leadership. A local government whose leaders are selected by officials of the central government, or whose recruitment processes are governed by such stringent, centrally determined criteria that the local community has no effective choice, is a local government without power to take responsibility for the well-being of its inhabitants. Second, local governments must have the power to tax their citizens in order to provide the necessary range of government services. A local government totally dependent upon centrally determined grants has very limited responsibility for the determination of the well-being of the local community. It will always be dependent on external sources of funds and, consequently, will always feel a need for more such funds. Because the funds do not come directly from its own resources, the local authority will have to be subjected to strict central-government supervision to ensure that expenditures are directed toward objectives the central government deems necessary and proper. Without independence from central resources, local government loses the capacity to act responsibly on its own behalf, and thus becomes simply an agent of the central government.

Federalism is thus to be distinguished from simple decentralization, which can occur without the granting of either the recruitment or the financial power to lower decision-making levels. For example, although the United States Forest Service grants considerable decision-making autonomy to its field offices, these lower administrative units do not gather their revenues from local sources or act independently in the recruitment of personnel. If the central administrators of the Forest Service or any other department or agency were to lose these two powers to their district offices, the organization could no longer be considered a single government unit. Indeed, these are precisely the circumstances for which the term "federalism" is appropriately reserved and which at one time might have been characterized as dual sovereignty.

Within a federal system the objectives of central and local governments stand in contrast to one another. Local governments are more concerned about operating efficiently in order to protect their economic base, while the domestic policy structure of the national government is more concerned about achieving a balance between developmental and redistributive objectives. These national-local differences are not a function of any particular political movement or

any political party or group that happens to be in power at a specific time. Although partisanship and group pressures may aggravate or alleviate the tension between the objectives of national and local governments, the local emphasis on economic productivity and the relatively greater national emphasis on equality are functions of the structural relationship of the two levels within the federal system.

Contrasts between National and Local Governments

The interests of local government require that it emphasize the economic productivity of the community for which it is responsible. Because they are open systems, local governments are particularly sensitive to external changes. To maintain their local economic health, they must maintain a local efficiency that leaves little scope for egalitarian concerns. These limits on local government, which have already been elaborated at length, require that local governments concentrate on developmental as against redistributive objectives.

By comparison, central governments are concerned with more than simply developmental objectives. This is not to say that central governments are uninterested in the economic capacities of their societies. For one thing, they have assumed responsibility for managing the domestic economy through manipulation of fiscal and monetary policies. They also promote economic growth through large-scale capital investments in transportation systems, research and development, and, now more than ever, the management of energy and other natural resources. As a result, many federal programs are as concerned with developmental objectives as are programs carried out by states and localities. But these developmental concerns are often coupled with a continuing concern for achieving some degree of equity in social relationships. Tax, welfare, housing, health, and educational policies of the central government are formulated with questions of equality and redistribution often carrying as much weight as questions of economic stability and growth. The commitment to redistributive objectives is due in part to the availability of powers that curb the impact of the external world environment on the nation's economy. The most important of these powers is the capacity to issue passports and visas. Through the exercise of these powers, almost all highly industrialized countries have in recent years carefully restricted immigration. As ethically disturbing as these laws often are, without them many residents of less advantaged countries would move to the industrialized areas, overwhelming their high-wage economies and swamping their

social-welfare systems. The case of the Vietnamese "boat people" provides a particularly poignant example of the dilemma liberal-minded citizens in wealthy countries face.

If control over human migration is vital, national governments also protect their economies from worldwide forces through a host of controls over the movement of capital, goods, and services. Tariffs, quotas, a national currency, control over exchange rates, and the capacity to fund its own indebtedness are among the powers a national government uses to increase its autonomy from external forces. Not all countries can use these devices with equal effectiveness. The United States is particularly fortunate in that foreign exchange amounts to less than 10 percent of its total economic activity. Smaller countries with less self-contained economies have much less scope for autonomous action. But all except the smallest and most dependent—perhaps Hong Kong is the limiting case—have economies less permeable than those for which local governments are responsible.⁴

Where governments in relatively open, pluralist polities have the capacity to redistribute, competition for popular support will provide political parties with an important incentive to advocate the redistribution of income from smaller numbers of high-income groups to the larger numbers having less income. Although the surge for redistribution may be episodic and in response to external impacts such as the major depression of the 1930s and the mobilization of black discontent in the 1960s, competitive politics in industrial societies periodically brings such redistributive pressures to bear on the policies of central governments.

Once a policy has been promulgated, an agency is founded and the administrative staff responsible for implementing the policy develops a loyalty to the substantive mission of the program.⁵ As part of the government, the agency has a legitimate claim on a continuing—perhaps slightly increasing—portion of the national budget. To perpetuate its program, the staff solicits the backing of organized elements serviced by its program, which campaign on its behalf in Congress, in other parts of the executive, in the news media, and among the public at large.

National policies are thus loaded with a variable mix of developmental and redistributive objectives. Programs promulgated at a time when the nation is primarily concerned with economic growth are apt to take an almost exclusively developmental turn. Other programs are passed when the political forces favoring redistribution have gained unusual strength. Other governmental policies, formulated under more ambiguous circumstances, may have a more mixed

set of orientations. But, on balance, the redistributive orientation is greater at the national than at the local level.

Differences in National and Local Politics

Because the interests of local and national governments diverge, the patterns of public policies promulgated by the two levels of government are different. Most clearly, national and local governments tend to rely on contrasting principles for raising revenue.⁶ The national government depends largely on the ability-to-pay principle, which legitimates redistribution. It raises most of its general revenues through a progressive income tax, taxes on corporate earnings, and an excise tax on luxury commodities. Local governments, in contrast, rely more on the benefits-received principle, which legitimates developmental policies. It specifies that individuals should be taxed in accordance with the level of services they receive. In this way, each individual consumes no more services than he pays for at the price necessary to recover the costs of producing the service. Demands for government services are controlled by a pricing mechanism. If the ability-to-pay principle is defended in the name of equality, the benefits-received principle provides an equally compelling efficiency criterion.

The emphasis local governments place on efficiency at the expense of equality is due not to any antiegalitarian commitments of local policymakers but to the constraints under which local governments operate. In order to protect the economic well-being of the community, the government must maximize the benefit/tax ratio for the above average taxpayer. Indeed, it is especially important that the benefit/tax ratio of those taxpayers who contribute disproportionately to the local economy be comparable to that in competing local areas. If residents are taxed according to their ability to pay, the benefit/tax ratio for higher income residents will be particularly low. On the other hand, if residents are taxed according to the level of services received, the ratio of benefits to taxes for the average taxpayer will increase.

Although constitutional and statutory limitations prevent them from applying the benefits-received principle rigorously, local governments are allowed to levy user charges, which are a close approximation of the benefits-received principle. However, local governments face many obstacles in levying user charges. In many cases, the beneficiaries of government services are difficult to ascertain precisely. In other situations, benefits cannot easily be supplied to some residents without providing them to all. Indeed, these are

among the reasons the services became governmental functions in the first place. And even where user charges are practicable, other constraints exist. Courts have ruled that, where charges are levied, the charge must be no more than the amount necessary for providing the service. And what service is being provided is often defined narrowly by the judiciary. Finally, user charges are not deductible against federal income taxes in the same way that property, income, and sales taxes are. Consequently, this particular form of raising local revenues is not subsidized by the federal government in the way local taxes are.

But even though local governments are constrained from applying the benefits-received principle to all revenue raising, they seem to rely on this principle much more than does either the state or the federal government. As can be seen in table 4.1, over the past two decades local governments have relied on user charges to raise over one-fourth of their locally generated total revenues, whereas state governments rely on them for only 12 percent of their revenue and the federal government for only 6 percent. To be sure, many localities fail to exploit user charges fully, and therefore they do not achieve as close an approximation of the benefits-received principle as legal requirements allow. For example, Oakland officials set user charges at levels determined by precedent or by the practice in neighboring communities, and not necessarily at a level which fully recovers costs.⁷ And the United States Advisory Commission on Intergovernmental Relations, even while noting that "[t]here has been a steady growth in the fiscal importance of local user charges," has urged their more widespread use as a mechanism "for diversifying local revenue structures when specific beneficiaries of particular government services can be... identified."⁸ But even if the potential for user charges has not been fully tapped, disproportionate and continuing dependence on such charges by local governments is nonetheless noteworthy.

Even if exploited fully, user charges have only a limited capacity for generating revenues. As a result, most local revenues are not generated by user charges but by a tax. The tax that has become the distinctive prerogative of local governments is the property tax, as can be seen in table 4.1. Admittedly, the increasing dependence of local governments on intergovernmental transfers from the state and federal authorities reduces their dependence on any form of local taxation. And it is true that states no longer depend on the property tax for their revenues. However, as a source of locally generated revenue, the significance of the property tax has abated hardly at all. From 1957 to 1972, the percentage of local revenue raised by the property tax declined by only 4 percent (from 58 to 54 percent).

Table 4.1: Local, State, and Federal Sources of Revenue, Excluding Intergovernmental Transfers (percentage distributions)

Revenue Source	Local			State			Federal		
	1957	1962	1967	1957	1962	1967	1957	1962	1967
User charges ^a	28.3	26.4	26.3	26.1	16.5	13.9	12.4	7.9	6.6
Property tax	58.0	58.3	56.7	54.1	2.3	2.1	1.4	...	...
Income tax	.9	1.0	2.1	3.0	7.5	9.1	16.1	40.9	38.1
Corporation tax	...	...	...	...	4.8	4.3	5.6	24.3	21.0
Sales, gross receipts ^a	5.5	5.1	4.8	6.4	45.8	43.7	40.3	12.8	9.8
Death, gift, other	.5	2.0	2.0	1.8	4.3	7.2	5.4	2.1	2.4
Miscellaneous (general revenue)	4.9	5.2	6.0	6.4	3.3	3.1	3.9	2.0	3.2
Insurance	2.0	2.0	2.1	2.2	15.5	17.6	15.1	10.0	18.9
Total (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total (\$m)	21,357	31,598	44,419	81,216	20,728	30,117	46,794	87,066	161,351
				97,108		106,441		247,849	

^aSources and other notes to this and subsequent tables in this chapter are given in Peterson 1979a.

Significantly, 82 percent of all revenue raised in 1972 from local tax sources still came from the property tax.⁹

This dependence of local governments on the property tax has been a matter of some debate among economists. Critics have claimed that (1) it is income inelastic, (2) it is a surcharge on one particular type of economic good, and (3) it taxes low-income groups disproportionately. However, recent analyses have countered each of these criticisms. To the argument that the property tax does not expand with inflation or economic growth, defenders reply that revenues from this tax grew rapidly in the postwar period.¹⁰ To the claim that the tax is an excise tax on housing that discourages consumption of this particular good, defenders respond that differentials in property tax among local governments are borne by property owners, not necessarily by those consuming the property, and that moreover there are reasons for regarding the tax as more a tax on capital than an excise tax.¹¹ The claim that the property tax is a regressive tax is dependent on the conclusion that it is largely an excise tax borne by the consumer. Since many of the assumptions on which this conclusion rests have been called into question, it is now safer to assert that the property tax is levied roughly in proportion to income and has neither positive nor negative redistributive effects.

These arguments among economists are relevant for those interested in developing any normative theory of tax policy. However, they do not provide satisfactory explanations for the persisting dependence on the tax by local governments. Whatever the objections to the property tax, local governments continue to prefer it over the income or sales tax, simply because it is a tax on those products least equipped to escape its application. Consider the difficulties posed by the major alternatives. Taxes on sales encourage residents to purchase products outside the jurisdiction. Taxes on profits earned within a territory provoke businesses into carrying on their most profitable activities elsewhere. Taxes on locally earned income give residents an incentive to seek employment externally. By comparison, the property levy taxes immobile land and structures attached thereto; the things taxed cannot be readily transported to a new locale. And their users must undergo the substantial costs of permanent physical migration to avoid the tax's application to them. Of course, the tax remains a disincentive for new investments in the community, but from the point of view of local governments much is to be said for a tax whose adverse consequences are delayed as long as possible. Consequently, the traditional property tax remains an integral part of local fiscal policy, and the faddish new sales and income taxes have made but modest headway as sources for local revenue.

Local governments directly tax the profits of local businesses hardly at all. Indeed, the United States census does not even have a separate classification for a direct local tax on business. The reasons are not difficult to discover. According to traditional economic theory, the corporation tax is an excise tax paid by the consumer when he buys a product upon which a surcharge in an amount equivalent to the tax has been placed. But this assignment of the corporation tax burden is applicable only if the tax is applied uniformly throughout a self-contained economic system. If such taxes were levied differentially by local governments and were passed on to the consumer via price increases, the products affected would no longer be competitive with products sold by businesses located in low-tax areas. Businesses in high-tax areas would be driven from the marketplace. Few local governments are eager to kill their golden geese by such a tax.

Fourth, the remaining taxes that local governments utilize are seldom progressive and at times downright regressive. Unlike the federal excise tax, which is reserved for luxury items, the state sales tax is levied on items for which lower income residents spend a relatively high proportion of their budget. Those who save portions of their income (presumably the wealthier save more) are not taxed on that aspect of their earnings at all. And it is the sales tax, not the more progressive income tax, that state and local governments favor as a source of revenue. Not only did states depend on the sales tax for 40 percent of their revenues in 1973, but local governments turned to this tax for 6.4 percent. By comparison, the income tax, which raises 42 percent of federal revenue, accounted for only 16 percent of state revenue and a puny 3 percent of local revenue. Moreover, the few local income taxes that are levied do not usually have the same progressive features characteristic of the federal income tax. Instead, it is the "general practice" with respect to state and local taxes "to follow the flat rate approach."¹²

One need not posit any local business elite to account for this propensity of local governments to favor more regressive taxes. The economic interests of cities which officials must safeguard are of themselves a sufficient explanation. The more starkly the ability-to-pay principle governs local tax policy, the greater the disjunction between taxes levied and benefits received, and the greater the negative impact revenue policy has on the economic well-being of the community. On the other hand, a proportional or (even more) a regressive tax structure comes closer to approximating the benefits-received principle, the principle which, if applied, best strengthens the local economy.

Finally, it is evident that localities have become increasingly de-

pendent on intergovernmental transfers from the state and federal governments. As can be seen in table 4.2, the percentage of local revenues coming in intergovernmental transfers increased from 26.1 percent in 1957 to 37.1 percent in 1973. Of course, it is to the economic interest of localities that their activities be subsidized by grants coming from sources external to the community. And as a result, local governments compete with one another for as many state and federal resources as they can obtain. But the increasing shift in support for local services from locally generated revenues to revenues generated at the state and national levels cannot be attributed simply to the local interest in getting others to foot the bill. That has always been present. Instead, the increasing role of intergovernmental transfers is a concomitant of the redistributive role that local governments are increasingly expected to play.

Federal tax policies are so well known that their difference from the local emphasis on the benefit principle needs only brief mention. First, as can be seen in table 4.1, income tax accounts for over 40 percent of national government revenue, as compared with 16 percent of state and 3 percent of local revenue. The federal income tax is also much more progressive than any of the state and local income taxes. Second, the federal government is the only government that raises a substantial proportion of its revenue through a direct tax on corporate profits. Significantly, the amount collected by this tax has declined steadily from 24 percent in 1957 to 14 percent in 1973. It may be that the potential of capital flight to overseas locations is now putting constraints on national tax policy that hardly existed twenty years ago, when the United States more effectively dominated the world economy. But the federal government is still the one level of government capable of taxing corporate profits directly. Third, excise taxes on luxury items are responsible for a modest amount of federal income—quite in contrast to the heavy dependence of states on the sales tax. The one federal tax which is collected on the benefit principle is the social security tax, which is accounting for an increasing percentage of federal revenue. If the world economy becomes more unified and the national government becomes in-

Table 4.2 Local and Intergovernmental Components of Local Revenues (percentage distributions)

	1957	1962	1967	1973
Local resources	73.9	73.0	68.8	62.9
Intergovernmental transfers	26.1	27.0	31.3	37.1
Total (%)	100.0	100.0	100.1	100.0
Total (\$m)	28,896	43,278	64,608	129,082

creasingly unable to control capital flows, one might anticipate an increasing dependence on this comparatively regressive tax. But at the present time there is little doubt that the federal tax system is far more redistributive than that of states and localities.

In sum, the tax structure of a federal system is highly differentiated. One does not find a marble cake of revenue-generating strategies such that any and all forms of taxation are preferred equally by all levels of government. Although some overlap is obvious, direct intergovernmental comparisons reveal different emphases in the tax policies of the various levels of government. The greatest emphasis on the benefits-received principle seems to lie at the local level, where user charges and other regressive forms of taxation are strongly preferred. The national government is most likely to collect taxes according to the ability-to-pay principle. Although states fall somewhere in between, they share many of the characteristics of the bottom tier.

The Three Policy Arenas

There are structured differences in the expenditure policies of the three levels of government as well. Allocation is the function that local governments can perform more effectively than central governments, because decentralization allows for a closer match between the supply of public services and their variable demand. Citizens migrate to those communities where the allocation best matches their demand curve. Redistribution, on the other hand, is a national function. The more a local community engages in redistribution, the more the marginal benefit/tax ratio for the average taxpayer declines, and the more the local economy suffers. The state can be expected to have policy responsibilities midway between. Finally, developmental policies will be the shared responsibility of all levels of government. For example, stabilization of the economy through fiscal and monetary policies, a most important developmental activity, is a national prerogative. Should a local community attempt to perform this activity, any positive effects its actions have will be quickly dispersed into the larger environment, while the interest on debts incurred will remain a burden the community itself must carry. But other developmental policies may have more specifically local consequences, and in these cases local governments are able to commit their own resources. Building highways and distributing utility services are obvious examples. The level of government that assumes responsibility for a particular type of developmental policy depends on the extent of its ripple effects.

The pattern of financial responsibility for government policies, as

presented in table 4.3, is generally consistent with these hypotheses. Redistributive policies have been the fiscal responsibility of the federal government. Forty-seven percent of its domestic budget was allocated for redistributive purposes even at the beginning of the 1960s and, after the Great Society programs, this increased to over 55 percent. By contrast, the percentage of local revenues used for redistribution was only 12.9 percent in 1962. Significantly, even a decade after the civil rights movement and its supposed impact on local service-delivery systems,¹³ this percentage had increased by less than 1 percent. In 1973 the state was contributing somewhat less than 35 percent of its budget to redistributive programs, more than the local but less than the national contribution in this area.

Table 4.4 provides an alternative way of analyzing the division of fiscal responsibility among the various levels of government. Here the data are percentages across the rows rather than down the columns. Instead of obtaining the percentage of each level of government's total resources devoted to a governmental activity, this table provides the percentage of all expenditures devoted to a particular activity contributed by each level of government. Presented this way, the figures are even more dramatic. Not only was the local contribution to redistribution scarcely more than 10 percent in 1962, but it has declined since that time. On the other hand, the federal role is once again shown to be increasingly significant. If the political pressures for federalizing welfare policy and health care are any sign, this pattern is likely to persist. As the United States continues to become an increasingly integrated political economy, the redistributive function may very well become an almost exclusively federal prerogative.

The allocational function is just as clearly the domain of local governments. The housekeeping services that all members of the community depend upon are both delivered and financed locally. As can be seen in table 4.3, over 28 percent of local government revenues were devoted to this purpose in 1973. The state plays a supporting role, but the proportion of its revenues devoted to this purpose is less than half that of the local governments. Meanwhile, the federal government is involved hardly at all.¹⁴

The developmental function is the more or less equal concern of the three levels of government, all of whom have allocated about 20 percent of their revenues for these activities. The role of the federal government in promoting economic productivity is larger than these figures suggest, once its interest payments on the national debt are taken into account. Since these are in large measure due to the federal government's responsibility for managing the national economy through its fiscal policies, they may be considered to be a cost of

Table 4.3: Governmental Expenditures from Own Fiscal Resources (percentage distributions among functions)

Function	Local			State			Federal ^a		
	1962	1967	1973	1962	1967	1973	1962	1967	1973
Redistributive									
Welfare	2.5	2.5	2.0	6.2	6.4	11.2	12.2	11.9	12.6
Health and hospitals	6.1	6.7	8.4	7.4	7.2	6.2	3.3	3.7	3.5
Housing	2.4	1.5	.9	.2	.2	.4	1.5	1.9	3.4
Social insurance	1.9	2.2	2.3	14.4	9.4	17.0	29.7	34.0	35.6
Subtotal	12.9	12.9	13.8	28.2	23.2	34.8	46.7	51.5	55.1
Allocational									
Housekeeping	26.8	26.4	28.5	12.4	12.9	8.4	4.6	4.5	3.8
Developmental									
Utilities	13.2	13.1	11.1	...	...	...	...	...	...
Postal	...	...	...	...	...	...	...	...	...
Transportation	8.1	6.6	5.7	17.8	16.0	11.3	7.0	7.2	5.1
Natural resources	1.1	1.1	.7	2.9	3.5	2.3	6.2	5.8	4.2
Subtotal	22.4	20.8	17.5	20.7	19.5	13.6	19.3	9.9	7.8
Interest	4.1	4.4	5.6	2.2	2.3	2.7	32.5	22.9	17.1
Education	33.4	35.2	34.2	33.6	39.5	38.4	12.3	12.1	9.9
Other	.4	.3	.4	3.0	2.6	2.2	.8	1.8	5.8
Total (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	99.9
Total (\$m)	33,591	45,853	77,886	29,356	45,288	89,504	58,960	86,852	186,172

^aDomestic only.