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RESEARCH SUMMARY

VERTICAL FISCAL GAPS AND ECONOMIC PERFORMANCE
A Theoretical Review and an Empirical Meta-analysis

In the United States and many other countries, state and local governments receive a lot of money from the federal government. Often these governments lack control over the money they are given: "vertical fiscal gaps" are the proportion of state or local government expenditures funded by central government grants and shared revenues these local governments don't completely control. Such grants often come with conditions, and in some countries are based on local need in an attempt to equalize welfare across the nation. In the United States, Congress is debating changing some of the programs that give money to state and local governments.

A new paper for the Mercatus Center at George Mason University examines evidence in the economics literature and finds that when local governments in the United States and other developed nations become more dependent on the central government's grants, they tend to become less efficient, spending more and taxing more for the same level of services. Voters can also find it difficult to understand which level of government is responsible for which policy.

To read the paper in its entirety and learn more about its author, economist Jason Sorens, see "Vertical Fiscal Gaps and Economic Performance: A Theoretical Review and an Empirical Meta-analysis."

THEORETICAL BACKGROUND

Two primary modes of analysis can be used to evaluate economic policy choices such as grants: the public finance perspective and the political economy perspective.

Public finance theories approach policy with a focus on efficiency. These theories assume that private actors are self-interested and government can regulate their activities in a way that promotes social welfare. Sometimes private actors make mistakes and suffer from market failures, requiring the government to alter incentives to solve the problem.

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- Public finance theories conclude that central-government grants to local governments can serve a useful purpose by aligning local incentives to public welfare.
- When economic and tax policies are decentralized, richer regions enjoy an advantage because they can impose lower taxes for the same services, attracting greater capital investment, thus making themselves even richer. This makes it difficult for poorer regions to catch up. Public finance theories contend that cost-sharing grants can help reduce this disparity by having the central government redistribute revenues between regions in order to equalize spending on public investments.

Political economy theories are founded on analysis of the interests of political actors and how those particular interests can capture governments and politicians.

- *Competitive federalism controls governments.* Citizens can control their government by setting up a system of competitive federalism in which competing jurisdictions enjoy tax and spending autonomy and face hard budget constraints, forcing governments to act in the interests of their citizens, not in the interests of particular groups.
- *Governments seek to diminish competition.* Governments can push back against competitive federalism by forming a cartel of local governments enforced by the central government. By transferring funds from one jurisdiction to another, thus relaxing budget constraints, local jurisdictions can ease competition for citizens and capital. This allows governments to extract more from citizens for the governments' own benefit and the benefit of particular, rather than general, interests.
- *Grant programs increase rent-seeking and harm economic performance.* Political economy theories predict that grant programs will be a tempting target for rent-seeking politics and special interest lobbying, harming economic performance across the board.

KEY FINDING: VERTICAL FISCAL GAPS LEAD TO HIGHER LOCAL DEBT AND SPENDING

To settle the conflict between these two perspectives of federal grant programs, policymakers should look at the evidence on the economic effects of vertical fiscal gaps in the United States and in federal democracies around the world. This paper is the first meta-analysis of the literature on how grants from higher- to lower-level governments affect government performance, and it ties together elements of the two competing theoretical perspectives. Key highlights of the literature review include the following:

- *Vertical fiscal gaps bring higher debt and spending.* The evidence shows that, among federal democracies like the United States, vertical fiscal gaps lead to higher debt and spending—both overall and at the state and local level.
- *Vertical fiscal gaps bring higher tax burdens.* Cost-sharing grants in the United States appear to promote higher state and local tax burdens.

- *Vertical fiscal gaps diminish voter knowledge of policy choices.* Transferring funds also undermines voter knowledge and public-sector efficiency. If voters are confused about which level of government is responsible for certain programs, it is more difficult for them to hold government accountable.
- *Overuse of grants is problematic.* Although intergovernmental fund transfers may sometimes be appropriate, the evidence suggests that for US governments the risk of overuse is greater than the risk of underuse. Grants from higher- to lower-level governments undermine government efficiency and productivity, especially when the grants take an equalizing or cost-sharing form.

CONCLUSION

Congress is debating turning cost-sharing grants to states into block grants or abolishing them altogether. Allowing state governments to fund and administer the relevant programs would be more efficient than the current fiscal system. Governments can enhance democratic control by decentralizing decision-making authority. The evidence suggests that these reforms will be beneficial to state and local governments, which will perform better when they have to rely on taxing their own people and spending the money they raise instead of accepting grants from the federal government.