

OVERVIEW ON FISCAL FEDERALISM

VISÃO GERAL DO FEDERALISMO FISCAL

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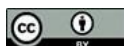
Abstract

This article provides an overview of fiscal federalism, exploring its theoretical underpinnings, practical implementations, and contemporary challenges. Fiscal federalism is defined as the financial and administrative relationships within a federal system of government, addressing the distribution of fiscal responsibilities and resources across central, regional, and local levels. The article examines key principles such as decentralization, subsidiarity, and fiscal equivalence, alongside the evolution of fiscal federalism theory through first and second-generation models. Practical implementations are analyzed using indicators like revenue assignment, expenditure responsibilities, intergovernmental transfers, and fiscal autonomy, culminating in the Fiscal Decentralization Index (FDI). The study highlights how these indicators facilitate cross-country comparisons and inform policy development. Contemporary issues such as globalization, economic disparities, asymmetric federalism, and the flypaper effect are discussed, alongside case studies from the United States, Germany, India, Brazil, and Canada, illustrating the diverse approaches to fiscal decentralization. It concludes that while fiscal federalism holds great promise for enhancing government efficiency and responsiveness, its success depends on careful implementation, continuous assessment, and adaptation to local contexts.

Keywords: Public Finance. Fiscal Federalism. Fiscal Decentralization. Local Government.

Resumo

O presente artigo oferece uma análise abrangente do federalismo fiscal, examinando seus fundamentos teóricos, suas formas de implementação prática e os desafios contemporâneos que permeiam sua aplicação. O federalismo fiscal é compreendido como o conjunto de relações financeiras e administrativas estabelecidas no âmbito de um sistema federativo, voltadas à distribuição de competências tributárias, responsabilidades de gasto e recursos financeiros entre os níveis central, regional e local de governo. O estudo explora princípios estruturantes, tais como descentralização, subsidiariedade e equivalência fiscal, bem como a evolução da teoria do federalismo fiscal a partir das abordagens de primeira e segunda geração. Enquanto a primeira geração enfatiza critérios normativos de eficiência e alocação ótima de recursos, a segunda geração incorpora perspectivas institucionais e incentivos políticos, ampliando a compreensão das dinâmicas intergovernamentais. No plano empírico, as implementações práticas são analisadas por meio de indicadores como a atribuição de receitas, a repartição de responsabilidades de despesa, os mecanismos de transferências intergovernamentais e o grau de autonomia fiscal dos entes subnacionais, culminando na formulação do Índice de Descentralização Fiscal (IDF). Tais instrumentos permitem a realização de comparações internacionais sistemáticas e subsidiam a formulação e o aprimoramento de políticas públicas. Adicionalmente, o artigo aborda questões contemporâneas, incluindo os impactos da globalização, as disparidades econômicas regionais, o federalismo



assimétrico e o denominado efeito flypaper. Estudos de caso referentes aos Estados Unidos, Alemanha, Índia, Brasil e Canadá são mobilizados para ilustrar a diversidade de arranjos institucionais e estratégias de descentralização fiscal. Conclui-se que o federalismo fiscal possui elevado potencial para promover maior eficiência alocativa, responsabilidade governamental e capacidade de resposta às demandas locais. Contudo, sua efetividade está condicionada a um desenho institucional adequado, à avaliação contínua de seus mecanismos e à adaptação às especificidades políticas, econômicas e sociais de cada contexto federativo.

Palavras-chave: *Finanças Públicas. Federalismo Fiscal. Descentralização Fiscal. Governo Local.*

1 INTRODUCTION

Fiscal federalism is a concept in understanding the financial and administrative relationships that exist within a federal system of government. At its core, fiscal federalism addresses the distribution of fiscal responsibilities and resources across different levels of government—central, regional, and local (also sub-national governments, or SNGs). It is concerned with how various levels of government finance their expenditures through revenues derived from taxation, borrowing, and intergovernmental transfers. The theory of fiscal federalism explores the optimal allocation of functions among levels of government to promote economic efficiency, equity, and stability within a nation. As one of the core researchers of fiscal federalism says: *“As a subfield of public finance, fiscal federalism addresses the vertical structure of the public sector. It explores, both in normative and positive terms, the roles of the different levels of government and the ways in which they relate to one another”* (Oates, 1972). Historically, the concept of fiscal federalism emerged as a response to the complexities of governing increasingly diverse and decentralized political entities. As nations expanded and became more heterogeneous, the need to delegate certain responsibilities to regional and local governments became apparent.

This delegation allows governments to cater to the specific needs and preferences of their constituents, promoting efficiency in public service delivery. The seminal works of scholars like Musgrave, Oates and Olson (Musgrave, 1959, Musgrave and Peacock, 1958, Oates, 1972, Olson, 1969) laid the foundation for the study of fiscal federalism, emphasizing the importance of aligning fiscal authority with expenditure responsibilities.

In the modern era, the relevance of fiscal federalism has grown as countries grapple with issues such as globalization, regional disparities, and the demand for greater local autonomy. Globalization has complicated traditional fiscal arrangements, necessitating more sophisticated intergovernmental relations to manage cross-border economic activities and ensure that all regions benefit from global integration. Moreover, economic disparities within countries have prompted debates about the role of central governments in redistributing resources to promote balanced regional development. Fiscal federalism, therefore, is not only about the mechanics of revenue collection and expenditure but also about the broader goals of fostering national unity, economic growth, and social equity.

Early research in this area focused primarily on the division of tasks within the federal government system. However, over time, several authors expanded their scope to all forms of intergovernmental relations, which led to the emergence of the term "fiscal decentralization" as a kind of synonym for "fiscal federalism". The concepts of fiscal federalism and fiscal decentralization are closely related, but they are not identical. Each focus on different aspects of how governmental fiscal responsibilities and functions are organized and managed across various levels of government. However, due to their interconnectedness and interdependence, it is challenging to discuss one without the other.

Fiscal federalism is the broader concept that deals with the division of governmental functions and financial relations among levels of government, typically between the national (federal) government and SNG. It provides the conceptual framework for understanding how these levels of government interact financially. Its focus areas are assignment of functions (explores which functions should be managed by which level), revenue assignment (considers how revenue-raising powers should be distributed among levels) and intergovernmental transfers (design and impact of transfers and grants from higher to lower levels to achieve efficiency and equity). Underlying

Principles of fiscal federalism are subsidiarity (principle suggests that functions should be carried out by the lowest level of government that can do so effectively), efficiency of public service provision and equity (seeks to optimize both efficiency by matching resources to local preferences and equity by redistributing resources where needed). On the other side concept of fiscal decentralization is more implemental and concerned with the actual process and degree to which fiscal responsibilities are devolved from central to subnational level. It examines the practical aspects of transferring functions, resources, and decision-making authority to lower levels. Its focus is on; degree of decentralization (how much fiscal power and responsibility is transferred from central to lower level, autonomy and accountability (emphasizes the importance of SNG having the autonomy to make fiscal decisions while being held accountable for them), capacity building (the ability of SNG to effectively manage their responsibilities). Fiscal decentralization deals with practical challenges of implementation, such as ensuring to have adequate resources, preventing imbalances and managing the potential risks of SNG inefficiency or corruption. In essence, fiscal federalism provides the theory behind how a system should be structured, while fiscal decentralization is concerned with how these principles are implemented in practice.

This overview will explore the theoretical foundations of fiscal federalism, its practical implementations across different countries, and the contemporary challenges it faces. Throughout the text, we will discuss and intertwine the main theories and concepts of fiscal federalism and fiscal decentralization, aiming to present the study area as comprehensively as possible. We will cover both first and second-generation theories, along with case studies that illustrate their implications for governance in the 21st century. Additionally, we will present key indicators used to compare the degree of (de)centralization and evaluate the effectiveness of decentralized systems.

2 METHODOLOGY

This study is based on a qualitative research design grounded in doctrinal legal analysis and a systematized narrative review of the relevant academic and institutional literature. Given the conceptual and interdisciplinary nature of fiscal federalism and fiscal decentralization situated at the intersection of public finance constitutional law and

multilevel governance the research adopts an interpretative methodology aimed at critically examining theoretical frameworks normative principles and comparative institutional practices. The literature review was conducted through structured searches in major academic and legal databases including Scopus Web of Science EconLit SciELO and Google Scholar complemented by institutional publications from international and regional organizations such as the OECD the World Bank and the European Committee of the Regions. The search strategy employed combinations of keywords related to fiscal federalism fiscal decentralization intergovernmental fiscal relations revenue assignment expenditure responsibilities and fiscal autonomy without imposing strict temporal limits in order to capture both seminal contributions and contemporary debates. Sources were selected based on their relevance to the research objectives theoretical or analytical depth and academic credibility prioritizing peer reviewed articles authoritative monographs and recognized policy reports. Purely descriptive studies with narrow empirical scope or limited conceptual contribution were excluded. The analysis involved systematic reading and interpretation of the selected sources with particular attention to the evolution of fiscal federalism theories the identification of core principles and decentralization indicators and the legal institutional implications of different governance models. The synthesis of the literature was conducted through a qualitative narrative approach allowing for the integration of diverse perspectives the identification of convergences and divergences in doctrinal positions and the articulation of theoretical insights with contemporary challenges. This methodological approach ensures analytical rigor transparency in source selection and coherence with the standards of qualitative legal research making it suitable for addressing complex normative and institutional questions within the field of fiscal federalism.

3 THEORETICAL FOUNDATIONS AND PRINCIPLES OF FISCAL FEDERALISM

Fiscal federalism is grounded in the core principles of federalism, which advocate a clear and functional division of powers between central and subnational governments (SNGs). Its theoretical foundations provide a comprehensive framework for understanding how multilevel systems of government can be structured to optimize the

provision of public services, enhance accountability, and maintain fiscal discipline across different tiers of governance. At its core, fiscal federalism seeks to align decision-making authority with fiscal responsibility in a manner that balances efficiency, equity, and macroeconomic stability. Several key principles and theoretical constructs underpin this framework.

One of the foundational principles is the Decentralization Theorem, which posits that subnational governments, by virtue of their proximity to citizens, are better positioned to tailor public services to local preferences and needs, thereby improving allocative efficiency. Oates (1972) argues that, in the absence of significant economies of scale or spillover effects, decentralized provision of public goods leads to more efficient outcomes than uniform provision by central authorities. This result is contingent upon subnational governments possessing sufficient fiscal autonomy to make meaningful expenditure and revenue decisions. The decentralization theorem is closely linked to Tiebout's (1956) hypothesis, which conceptualizes local governments as competing jurisdictions in which individuals "vote with their feet" by choosing to reside in communities that best match their preferences for public goods and tax levels. Together, these frameworks highlight the potential of decentralization to enhance welfare through preference matching and interjurisdictional competition.

Closely related to decentralization is the principle of subsidiarity, which emphasizes that public responsibilities should be exercised by the lowest level of government capable of performing them effectively. Decisions should therefore be taken as close to citizens as possible, with higher levels of government intervening only when objectives cannot be adequately achieved at the local or regional level. In the context of European integration, this principle is closely associated with Schuman (1950) and has become a cornerstone of EU governance. Subsidiarity reinforces the normative case for decentralization by promoting responsiveness, accountability, and democratic legitimacy, while also recognizing the need for central coordination in areas requiring uniformity or collective action.

The principle of fiscal equivalence, introduced by Olson (1969), further refines the theoretical foundations of fiscal federalism by emphasizing the importance of aligning the beneficiaries of public services with those who bear their costs. When the geographic scope of benefits corresponds closely to the jurisdiction responsible for financing and

providing a service, incentives for efficient provision are strengthened and free-rider problems are reduced. Olson's concept complements Musgrave's (1959) classic framework, which distinguishes among the allocation, distribution, and stabilization functions of government. According to Musgrave, these functions should be assigned to the level of government best suited to perform them efficiently, with allocation functions often decentralized, redistribution largely centralized, and stabilization primarily the responsibility of the central government.

Insights from the Coase Theorem further contribute to the analysis of intergovernmental fiscal relations. Originally formulated to address externalities, Coase's theorem suggests that when property rights are clearly defined and transaction costs are low, parties can negotiate to internalize external effects and achieve efficient outcomes (Coase, 1960). Applied to fiscal federalism, this perspective underscores the importance of clearly delineated fiscal responsibilities and institutional arrangements that minimize coordination costs between levels of government. Ambiguity in assignments of revenue authority or expenditure responsibility can lead to inefficiencies, duplication of functions, and disputes over accountability.

Another influential contribution is the theory of market-preserving federalism, which argues that federal systems can enhance economic performance by constraining central government intervention and fostering competition among subnational governments. Weingast (1995) contends that when subnational governments face hard budget constraints and possess meaningful autonomy, they are incentivized to adopt growth-enhancing policies, maintain fiscal discipline, and respond to local economic conditions. This form of competitive federalism can act as a safeguard against excessive centralization and rent-seeking, thereby supporting stable and predictable market institutions.

However, fiscal decentralization also introduces risks, most notably the common pool problem. This problem arises when subnational governments rely heavily on shared national resources or intergovernmental transfers, weakening the link between spending decisions and revenue generation. In such contexts, subnational authorities may have incentives to overspend, expecting that the costs will be partially borne by other jurisdictions or the central government. Weingast (1995) and Rodden and Wibbels (2002) highlight how common pool dynamics can undermine fiscal discipline and lead to soft

budget constraints, making effective institutional design and fiscal rules essential components of sustainable federal systems.

Building on these foundational principles, the evolution of fiscal federalism theory is commonly divided into first- and second-generation approaches. As outlined by Slavinskaite (2021), first-generation theories, rooted in the seminal contributions of Tiebout (1956), Musgrave (1959), Olson (1969), and Oates (1972), adopt a largely normative perspective focused on efficiency and welfare maximization. These models assume benevolent governments and emphasize how decentralization can improve public service provision by aligning policies with local preferences and information.

Second-generation theories of fiscal federalism, which emerged toward the end of the twentieth century, relax these assumptions and incorporate insights from political economy, information economics, and principal–agent theory. Scholars such as Weingast (1995) and Qian and Roland (1998) highlight the strategic interactions between different levels of government and the role of political incentives in shaping fiscal outcomes. These models draw attention to problems of asymmetric information, moral hazard, and weak accountability, emphasizing the risks of soft budget constraints and intergovernmental bargaining. Rodden (2002) further demonstrates how grant systems and institutional arrangements can affect fiscal performance by altering incentives for subnational governments.

As Slavinskaite (2021) observes, second-generation theories represent a shift from the relatively static and normative focus of earlier models toward a more dynamic and realistic understanding of fiscal federalism. By acknowledging the strategic behavior of political actors and the importance of institutional constraints, these approaches provide a more nuanced framework for analyzing the conditions under which fiscal decentralization can enhance efficiency, accountability, and fiscal sustainability.

4 PRACTICAL IMPLEMENTATIONS AND FISCAL DECENTRALIZATION INDICATORS

Fiscal federalism and fiscal decentralization are key aspects of governance, involving the transfer of financial powers and responsibilities from central to lower level of governance. The implementation of systems varies widely across countries, shaped by

historical, political, and economic contexts. Understanding the degree of decentralization and its impact on economic efficiency, equity, and governance requires analysis of various indicators that measure the extent of decentralization. Few of them are listed in continuation and later merged with FDI as one of the quite new approaches to measure degree and effectiveness of the fiscal federalism.

4.1 Revenue assignment and decentralization

Revenue sources are typically divided among different levels of government to balance equity and efficiency in tax collection. Central governments generally have access to broad-based taxes such as income tax and value-added tax (VAT), while lower levels rely on property taxes, user fees, and other more localized revenue sources. Revenue decentralization, which measures the proportion of total government revenue collected by SNG, reflects the financial autonomy of local governments. A higher level of revenue decentralization indicates greater fiscal autonomy, allowing SNG to address region-specific needs more effectively (Finžgar, Oplotnik, 2013). Musgrave and Peacock (1958) underscore the importance of efficient tax assignments to prevent resource misallocation and to maintain economic stability.

4.2 Expenditure responsibilities and decentralization

The allocation of public service responsibilities is guided by the principle of subsidiarity, whereby SNGs are typically responsible for services such as education and healthcare, while central governments manage defense, foreign affairs, and macroeconomic stabilization. Expenditure decentralization gauges the share of total government expenditure managed by SNGs. A higher level of expenditure decentralization means that lower levels have more control over how public funds are spent (Finžgar, Oplotnik, 2013). Bird (1993) emphasizes that clear expenditure assignment is crucial to prevent overlap, reduce inefficiencies, and ensure accountability. Oates (1972) introduced the "Decentralization Theorem," which states that decentralized provision of public goods is more efficient when local preferences and cost structures differ significantly.

4.3 Intergovernmental transfers

These are financial flows from the central to sub-national governments, essential for addressing fiscal imbalances and ensuring uniform standards of public services. These transfers can be conditional (tied to specific purposes) or unconditional (general-purpose grants). While necessary, excessive reliance on intergovernmental transfers can undermine fiscal autonomy and local accountability. Shah and Boadway et. al (2009) highlight the importance of designing these transfers to promote equity while preserving incentives for fiscal discipline. Finžgar, Oplotnik (2013) indicate that in many EU-27 countries, local governments heavily rely on central transfers or borrowing due to insufficient revenue to cover expenditures.

4.4 Borrowing autonomy

Borrowing Autonomy refers to the capacity of SNGs to independently access credit markets and incur debt, typically for infrastructure development. This indicator is vital for understanding the financial flexibility of local government managing fiscal deficits. Higher borrowing autonomy can enhance SNGs ability to invest in long-term projects but also comes with the risk of fiscal mismanagement if not properly regulated (Ter-Minassian, 1997). Effective borrowing autonomy must be balanced with fiscal responsibility to prevent excessive debt accumulation, which could threaten the financial stability of subnational and even national governments.

4.5 Employment decentralization

Are measures the proportion of total government employment at the sub national levels. This indicator provides insight into the extent of decentralization in public administration and service delivery. The Decentralization Index developed by the European Committee of the Regions (2021) categorizes countries based on the share of regional/local employment as a percentage of total government employment.

4.6 Fiscal autonomy

Fiscal autonomy is a crucial aspect of decentralization, representing the degree to which SNGs can independently determine their revenue structures, including the authority to set tax bases and rates. High fiscal autonomy allows local governments to align their revenue generation with local economic conditions and policy objectives. Indicators of fiscal autonomy include the proportion of subnational revenues generated from own-source revenues (taxes, fees, and charges) versus those derived from intergovernmental transfers (Rodden, 2002). Additionally, the capacity to introduce new taxes or adjust existing ones without central government approval is another key indicator of fiscal autonomy. High fiscal autonomy suggests a strong capacity for SNGs to manage their finances independently, contributing to more responsive and accountable governance. However, it must be balanced with fiscal responsibility to prevent negative externalities, such as tax competition leading to a "race to the bottom" (Keen & Konrad, 2013).

4.7 Vertical and horizontal fiscal imbalance

Fiscal imbalances occur when there is a discrepancy between the revenue-generating capacities and expenditure responsibilities of SNGs, often necessitating intergovernmental transfers to fill the gap. Vertical fiscal imbalance represents the gap between subnational revenues and expenditures, leading to a dependency on central government transfers, which can limit the financial autonomy of subnational governments (Boadway, Hobson, 1993). Horizontal fiscal imbalance, on the other hand, refers to disparities in revenue-generating capacity and expenditure needs across different regions or jurisdictions. These imbalances can create inequalities in service provision and economic opportunities. Addressing horizontal fiscal imbalances often requires equalization transfers, designed to reduce disparities and ensure a more equitable distribution of public services (Boadway, Shah, 2009).

5 FISCAL DECENTRALIZATION INDEX (FDI)

FDI is a composite measure that integrates multiple indicators of decentralization into a single metric, thereby enabling systematic cross-country comparisons of fiscal decentralization. Typically, the index combines weighted components such as revenue and expenditure decentralization, fiscal autonomy, and borrowing autonomy. One of the most widely cited formulations of the FDI was developed by Schneider (2003), who used the index to analyse the relationship between decentralization and economic performance. His findings suggest a positive correlation between higher levels of fiscal decentralization and improved economic outcomes, particularly in countries with strong governance frameworks. As a result, the FDI has become a valuable analytical tool for evaluating decentralization policies, illustrating that while fiscal decentralization can enhance government responsiveness and efficiency, its effectiveness ultimately depends on the institutional capacity of subnational governments.

A further application of the FDI can be found in the comparative study by Finžgar and Oplotnik (2013), which examines fiscal decentralization systems across the EU-27. Their analysis incorporates criteria such as fiscal autonomy, revenue and expenditure decentralization, intergovernmental transfers, and the degree of central government influence over local finances. The findings reveal substantial variation in the implementation of fiscal decentralization across EU member states. Northern European countries, including Denmark and Sweden, exhibit relatively high levels of decentralization, characterized by strong fiscal autonomy and well-developed local government systems. In contrast, Southern European countries such as Greece and Portugal display lower levels of decentralization, with subnational governments more heavily dependent on central transfers and possessing limited discretion over financial decisions. This comparative evidence highlights the complexity of fiscal decentralization and underscores the importance of accounting for institutional, political, and economic contexts when designing and implementing decentralization reforms.

Another important contribution to the measurement of decentralization is provided by the Fiscal Decentralization Index developed by the European Committee of the Regions (2021), which assesses decentralization across EU member states by incorporating fiscal, administrative, and political dimensions. The results indicate that

countries such as Germany and Spain demonstrate relatively high degrees of fiscal decentralization, whereas others, including Greece and Portugal, remain more centralized. The report emphasizes the need to strike a balance between granting fiscal autonomy and ensuring that subnational governments possess the administrative and financial capacity required to manage public resources effectively.

Fiscal decentralization indicators and composite measures such as the FDI play a crucial role in both academic analysis and policy design. By offering detailed insights into the fiscal responsibilities and autonomy of subnational governments, these indicators support policymakers in identifying areas where additional resources, authority, or institutional support may be required, thereby contributing to more effective and targeted decentralization strategies. Moreover, higher levels of fiscal decentralization have the potential to improve economic efficiency by enabling subnational governments to allocate resources in line with local preferences and needs. At the same time, these indicators help monitor whether subnational authorities possess sufficient resources to fulfil their assigned responsibilities, ensuring that efficiency gains are not undermined by fiscal constraints.

In addition to efficiency considerations, fiscal decentralization indicators are essential for assessing equity outcomes. While decentralization can strengthen local governance, it may also exacerbate disparities in public service provision across regions. Systematic measurement of decentralization helps to identify such imbalances and informs the design of corrective mechanisms, including equalization transfers. Furthermore, increased transparency regarding the financial roles and responsibilities of subnational governments enhances accountability and reduces the risk of fiscal mismanagement or corruption. Finally, the use of indices such as the FDI enables benchmarking and comparison across countries, fostering policy learning and encouraging reforms in governance structures where decentralization remains limited.

6 CONTEMPORARY ISSUES IN FISCAL FEDERALISM

Modern fiscal federalism faces a range of interrelated challenges and opportunities that reflect the increasing complexity of multilevel governance systems. One of the most significant pressures arises from globalization, which has intensified the interdependence

of national and subnational economies and, in turn, affected the fiscal autonomy of subnational governments. The heightened mobility of capital and labor complicates tax administration, constrains independent fiscal policy at lower levels of government, and increases the need for coordination across jurisdictions. As Tanzi (1996) argues, globalization challenges traditional models of fiscal federalism and necessitates reforms to tax systems in order to preserve both efficiency and fiscal capacity.

Economic disparities among subnational governments constitute another persistent challenge. Although intergovernmental transfers are designed to mitigate differences in fiscal capacity and service provision, achieving an equitable distribution of resources remains complex and often politically contentious. Continuous adjustments to transfer systems are required to balance redistribution with incentives for efficiency. Prud'homme (1995) highlights the inherent tension between equity and efficiency in fiscal decentralization, noting the difficulties associated with reducing regional inequalities without undermining local accountability or economic performance.

These challenges are further complicated in systems characterized by asymmetric federalism, where regions within the same country possess varying degrees of autonomy and fiscal capacity. Such arrangements are common in countries with pronounced regional diversity, including Spain and Canada. While asymmetry allows for institutional arrangements tailored to regional specificities, it can also generate coordination problems, raise concerns about national cohesion, and complicate the equitable distribution of resources. Scholars such as Stepan (1999) and Watts (1999) emphasize that managing asymmetric federal systems requires careful institutional design to prevent conflict between central and regional authorities.

Another well-documented phenomenon affecting intergovernmental fiscal relations is the flypaper effect, which describes the tendency for funds received through central government transfers to result in higher public spending rather than tax reductions at the subnational level. This effect underscores the strong influence of intergovernmental transfers on local fiscal behavior and highlights the importance of designing transfer systems that encourage efficient resource use while avoiding long-term dependency on central funding (Hines & Thaler, 1995).

Second-generation theories of fiscal federalism further illuminate these challenges by incorporating insights from political economy, information economics, and

institutional analysis. These models emphasize the role of political incentives, governance quality, and information asymmetries in shaping fiscal outcomes. While decentralization may enhance efficiency and responsiveness, it also introduces risks related to strategic behavior by subnational governments, soft budget constraints, and fiscal illusion, whereby citizens underestimate the true costs and benefits of public spending (Slavinskaite, 2021).

At the same time, fiscal federalism can act as a catalyst for policy innovation and diffusion. Subnational governments often function as “*laboratories of democracy*”, experimenting with novel policy approaches that, if successful, may be adopted by other regions or scaled up to the national level. This competitive dynamic among jurisdictions can promote learning, adaptability, and more effective governance.

Addressing environmental and social policy challenges further illustrates the need for coordination across multiple levels of government. Such issues frequently involve shared resources and cross-jurisdictional externalities, requiring cooperative governance arrangements. Ostrom’s (1990) concept of polycentric governance, in which multiple overlapping authorities collaborate to manage common-pool resources, is particularly relevant in this context and aligns closely with the logic of fiscal federalism.

Within the European Union, intergovernmental coordination is reinforced not only through fiscal and administrative arrangements but also through legal and judicial mechanisms.

The Preliminary Ruling Procedure, as analyzed by Al Bitar and Bessa Vilela (2025), plays a crucial role in ensuring consistency and cooperation between national authorities and EU institutions. This mechanism illustrates how legal coordination complements fiscal and administrative decentralization, strengthening coherence and accountability in complex multi-level governance systems.

7 CASE STUDIES ON FISCAL FEDERALISM

The practical implementation of fiscal decentralization varies widely across countries, providing a rich array of case studies for analysis. In the United States, a federal system with significant fiscal autonomy for states has fostered competition, particularly in tax policy. This competition has encouraged innovation and efficiency but also led to

disparities in public service provision, reflecting the complexities of managing a decentralized system. In contrast, many developing countries face greater challenges in implementing decentralization. For example, in India, states have considerable fiscal responsibilities, but their reliance on central transfers often undermines autonomy.

In Europe, Germany's federal structure, with its strong *Länder* (states), is often cited as a model of fiscal federalism, where SNGs play a crucial role in public finance. In contrast, Greece's more centralized system has struggled to achieve similar outcomes, reflecting the challenges of implementing decentralization in countries with weaker frameworks (OECD, 2021). Similar challenges we find in Portugal and Albania (Ruel et al (2023) or Albania (Xhindi, Vilela, 2022).

United States: The United States is often cited as a quintessential example of fiscal federalism, with its complex system of intergovernmental fiscal relations. States have significant autonomy to design their own tax systems and public services, leading to a diverse range of fiscal policies across the country. However, this autonomy also results in disparities in public service quality and fiscal capacity. The federal government plays a crucial role in redistributing resources through intergovernmental transfers, such as grants and federal aid programs, to address these disparities, which highlights both the strengths and challenges of decentralized governance (OECD, 2021).

Germany: Germany's system of fiscal federalism is characterized by strong equalization mechanisms designed to ensure uniform living standards across regions. The country employs a system of fiscal equalization payments that redistribute resources from wealthier to poorer states, promoting regional equity and national cohesion (Robin hood system). Germany's approach to fiscal federalism is marked by its emphasis on solidarity, balancing the autonomy of individual states with the need for a cohesive national policy. However, the system also involves complex negotiations and adjustments to balance different interests, illustrating the challenges of managing decentralized system (OECD, 2021).

India: India presents a complex case of fiscal federalism, given its vast diversity in economic development across states and its unique political and administrative structure. The central government in India plays a significant role in redistributing resources through grants and loans, aiming to reduce regional disparities and promote balanced development. India's fiscal federalism is marked by the challenge of

accommodating diverse regional needs while maintaining national unity. The Finance Commission of India is a key institution that reviews the allocation of tax revenues between the central government and the states, reflecting the dynamic nature of India's fiscal system (OECD, 2021).

Brazil: Brazil's federal system is another example of a highly decentralized fiscal structure, where states and municipalities have significant autonomy in revenue generation and expenditure. The Brazilian model allows for considerable variation in fiscal capacity and public service provision across regions, leading to both opportunities for local innovation and challenges in maintaining equity. Brazil's reliance on intergovernmental transfers highlights the importance of federal oversight in ensuring a more balanced distribution of resources. However, the system also faces challenges related to fiscal discipline and coordination between different levels of government (OECD, 2021).

Canada: Canada's federal system is characterized by a high degree of provincial autonomy, particularly in areas such as health care, education, and social services. The Canadian model of fiscal federalism is supported by a system of equalization payments that aim to reduce fiscal disparities among provinces, ensuring that all Canadians have access to comparable levels of public services regardless of their province of residence. The Canadian experience illustrates the benefits of decentralization in accommodating regional diversity while maintaining national standards. However, it also underscores the ongoing challenges of managing intergovernmental relations in a way that balances autonomy with national cohesion (OECD, 2015).

8 FISCAL DECENTRALIZATION AND EUROPEAN CHARTER OF LOCAL SELF-GOVERNMENT (MELLS)

Before we conclude, it's essential to highlight one of the most significant multilateral treaties, endorsed by over 47 countries: MELLS, the European Charter of Local Self-Government (Council of Europe, 1985). This includes all member states of the Council of Europe, making it one of the most widely accepted treaties within the framework. The Charter is legally binding in these countries, ensuring that the principles of local self-governance are upheld across Europe, established by the Council of Europe

in 1985. The Charter aims to safeguard the rights of local authorities and ensure their autonomy in governing their communities. It sets out the principles governing the organization, functioning, and financial independence, emphasizing the importance of SNG as a cornerstone of democracy in Europe. For our purposes, financial independence and autonomy, articles 4 and 9 are of especial importance. Article 4 outlines the scope of local self-governance, asserting that local authorities should have the right to exercise full discretion in the management of their affairs within the limits of the law. It emphasizes that public responsibilities should be exercised by the authorities closest to the citizens, with central authorities intervening only when the scale of the task or the nature of the activity requires it. This article also stresses that local authorities must be allowed to adapt their practices to local conditions, thereby enhancing the responsiveness and effectiveness of local governance (Council of Europe, 1985). Article 9 focuses on the financial autonomy of local authorities, which is crucial for their ability to function effectively. The article states that local authorities should have access to adequate financial resources that they may freely dispose of within the framework of their powers. It highlights that a significant portion of these resources should come from local taxes and charges, for which the authorities have the power to determine the rate. Additionally, the article calls for financial transfers from higher levels of government to be fair and predictable, with local authorities being consulted on how these resources are distributed. It also insists on the need for local authorities to have access to capital markets for investment purposes. Together, these articles underline the core principles of the Charter, ensuring that local authorities are empowered both in terms of decision-making and financial independence. By adhering to these principles, the Charter promotes democratic governance, where decisions are made closer to the citizens and local governments have the resources needed to meet the needs of their communities effectively (Council of Europe, 1985).

9 CONCLUSIONS

Fiscal federalism remains a cornerstone in understanding the complex financial relationships within federal systems of governance. This concept not only shapes the distribution of resources and responsibilities across different levels of government but also influences the broader goals of economic efficiency, equity, and stability. The

theoretical foundations laid by scholars such as Musgrave, Oates, and Olson provide critical insights into the principles that guide fiscal federalism, emphasizing decentralization, subsidiarity, and fiscal equivalence. These principles advocate for the alignment of fiscal responsibilities with local needs and preferences, fostering a more efficient and responsive governance structure. The practical implementation of fiscal federalism, however, reveals significant diversity influenced by historical, cultural, and institutional factors across countries. Contemporary issues such as globalization, economic disparities, and asymmetric federalism present ongoing challenges to the implementation of fiscal federalism. The mobility of capital and labour in a globalized world complicates traditional fiscal arrangements, necessitating greater coordination among different levels of government. Additionally, the existence of economic disparities between regions requires consideration of intergovernmental transfers to ensure fair distribution of resources.

Indicators such as revenue and expenditure decentralization, fiscal autonomy, and borrowing autonomy, along with composite measures like the Fiscal Decentralization Index, provide valuable tools for assessing the degree and impact of decentralization. They help policymakers design more effective decentralization policies, ensuring that local governments have the resources and autonomy needed to address region-specific needs while maintaining overall economic stability.

In conclusion, while fiscal federalism holds great promise for enhancing government efficiency and responsiveness, its success depends on careful implementation, continuous assessment, and a deep understanding of the local context. The ongoing challenges underscore the importance of dynamic and adaptive approaches. As countries continue to navigate the complexities of decentralized governance, the principles and practices of fiscal federalism will remain crucial in promoting effective, equitable, and responsive government structures in the 21st century.

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Authors' Contribution

All authors contributed equally to the development of this article.

Data availability

All datasets relevant to this study's findings are fully available within the article.

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